

Class 12th
CBSE - Analysis Of Financial Statement - (Volume - III)
Chapter 2 : Financial Statement Analysis
Vidhi Commerce Classes - CA Vidhi Jain

(Commerce ki पाठशाला)

1. Meaning of Financial Statement Analysis:

Financial Statement Analysis refers to the **systematic examination and interpretation** of financial statements to understand the **profitability, liquidity, solvency, efficiency and financial position** of a business.

2. meaningful information for decision-making.

Objectives of Financial Statement Analysis

Main Objectives:

- To assess profitability of the business
- To judge liquidity position
- To determine solvency and stability
- To evaluate operational efficiency
- To compare performance over years
- To help in forecasting and planning

3. Users of Financial Statement Analysis

User	Purpose
Management	Planning & decision making
Shareholders	Return on investment
Creditors	Safety of loans
Investors	Growth & stability
Government	Tax & regulation
Employees	Job security

4. TOOLS / TECHNIQUES OF FINANCIAL STATEMENT ANALYSIS

Flow Chart:

Financial Statements ↓ Comparative Statements ↓ Common Size Statements ↓ Ratio Analysis ↓ Cash Flow Analysis

5. Comparative Financial Statements

Meaning:

Statements showing financial data of two or more years side-by-side to identify changes.

Types:

1. Comparative Balance Sheet
2. Comparative Statement of Profit & Loss

Advantages:

- Shows trend of performance
- Helps in inter-firm comparison

- Easy to understand

Limitations:

- Ignores price level changes
- Based on historical data

6.Common Size Financial Statements**Meaning:**

Statements in which each item is shown as a percentage of a common base.

Base:

- Balance Sheet → Total Assets / Total Liabilities
- P&L → Net Sales

Advantages:

- Useful for comparison
- Highlights cost structure

7.RATIO ANALYSIS**Meaning:**

Ratio Analysis is the quantitative relationship between two accounting figures.

Classification of Ratios:

1. Liquidity Ratios 2. Solvency Ratios 3. Activity Ratios 4. Profitability Ratios

8. FORMULA CHART (MOST IMPORTANT)**Liquidity Ratios:**

- Current Ratio = Current Assets / Current Liabilities
- Quick Ratio = (CA – Inventory – Prepaid) / CL

Solvency Ratios:

- Debt Equity Ratio = Long-term Debt / Shareholders' Funds
- Proprietary Ratio = Shareholders' Funds / Total Assets

Activity Ratios:

- Inventory Turnover = COGS / Avg Inventory
- Debtors Turnover = Net Credit Sales / Avg Debtors

Profitability Ratios:

- Gross Profit Ratio = GP / Net Sales × 100
- Net Profit Ratio = NP / Net Sales × 100
- Return on Capital Employed = EBIT / Capital Employed × 100

9. CASH FLOW STATEMENT (INTRO LINK)

Financial Statement Analysis is incomplete without Cash Flow Analysis.

Activities:

- Operating Activities
- Investing Activities

- Financing Activities

10. LIMITATIONS OF FINANCIAL STATEMENT ANALYSIS

- Based on historical data
- Ignores qualitative factors
- Window dressing possible
- Affected by accounting policies

Question 1: Comparative Balance Sheet

The Balance Sheets of X Ltd. as at 31 March 2024 and 31 March 2025 are given below. Prepare a Comparative Balance Sheet.

(Full question data with figures)

Solution:

Comparative Balance Sheet showing increase/decrease and percentage change.

Inference: The company shows improvement in financial position due to increase in fixed assets and reserves.

Question 2: Comparative Statement of Profit and Loss

From the following information, prepare a Comparative Statement of Profit and Loss.

Solution:

Statement showing sales growth, expense control and increase in net profit.

Question 3: Common Size Balance Sheet

From the following Balance Sheet, prepare a Common Size Balance Sheet.

Solution:

Each item expressed as percentage of total assets.

Conclusion: Helps in inter-firm comparison.

Question 4: Common Size Statement of Profit and Loss

Prepare a Common Size Statement of Profit and Loss.

Solution:

Each item expressed as percentage of net sales.

Question 5: Current Ratio

Calculate Current Ratio from the following information.

Solution:

Current Ratio = Current Assets / Current Liabilities

Question 6: Quick Ratio

Calculate Quick Ratio.

Solution:

Quick Ratio = (Current Assets – Inventory – Prepaid Expenses) / Current Liabilities

Question 7: Debt-Equity Ratio

Calculate Debt Equity Ratio.

Solution:

Debt Equity Ratio = Long-term Debt / Shareholders' Funds

Question 8: Gross Profit Ratio

Calculate Gross Profit Ratio.

Solution:

Gross Profit Ratio = (Gross Profit / Net Sales) × 100

Question 9: Return on Capital Employed (ROCE)

Calculate Return on Capital Employed.

Solution:

ROCE = EBIT / Capital Employed × 100

Question 10: Trade Receivables Turnover Ratio

Calculate Trade Receivables Turnover Ratio.

Solution:

Trade Receivables Turnover Ratio = Net Credit Sales / Average Trade Receivables

Case Study–Based THEORY Questions with Answers

CASE STUDY 1: Liquidity Position

X Ltd. has high current assets but is unable to pay its short-term liabilities on time.

Question: Which tool of Financial Statement Analysis should be used to analyse this situation? Explain.

Answer: Ratio Analysis should be used, specifically Liquidity Ratios such as Current Ratio and Quick Ratio. These ratios help in assessing the firm's ability to meet its short-term obligations and judge its liquidity position.

CASE STUDY 2: Inter-firm Comparison

Two companies operating in the same industry have different sizes of operations.

Question: Which statement should be prepared to compare their performance and why?

Answer: Common Size Statement should be prepared as it expresses each item as a percentage of a common base. This removes the effect of size difference and facilitates inter-firm comparison.

CASE STUDY 3: Trend Analysis

Management wants to study increase or decrease in profits over the last two years.

Question: Which financial statement will help and how?

Answer: Comparative Statement of Profit and Loss will help as it shows absolute increase/decrease and percentage change in profits over different periods.

CASE STUDY 4: Investor's Decision

An investor wants to know the return earned by the company on the capital invested.

Question: Which ratio should be calculated and why?

Answer: Return on Capital Employed (ROCE) should be calculated as it measures overall profitability and efficiency with which capital is employed in the business.

CASE STUDY 5: Creditworthiness

A bank is considering granting a long-term loan to a company.

Question: Which ratio will the bank analyse and why?

Answer: Debt-Equity Ratio will be analysed as it shows the relationship between long-term debts and shareholders' funds and helps in assessing long-term solvency.

CASE STUDY 6: Sales Efficiency

Despite increase in sales, net profit has declined.

Question: Which analysis will help identify the reason?

Answer: Common Size Statement of Profit and Loss will help identify increase in expenses as a percentage of sales, which may be the reason for decline in net profit.

CASE STUDY 7: Working Capital Management

A company has excess inventory leading to blockage of funds.

Question: Which ratio should be used to analyse this problem?

Answer: Inventory Turnover Ratio should be used as it shows the speed at which inventory is converted into sales and helps in evaluating inventory management efficiency.

CASE STUDY 8: Receivables Management

A firm is facing difficulty in collecting cash from customers.

Question: Name the ratio used and state its significance.

Answer: Trade Receivables Turnover Ratio is used. It indicates how efficiently receivables are collected and helps in assessing credit policy of the firm.

CASE STUDY 9: Limitations Awareness

Financial Statements show good profitability but the firm is facing financial stress.

Question: State one limitation of Financial Statement Analysis highlighted here.

Answer: Financial Statement Analysis is based on historical data and ignores qualitative factors, hence it may not present the true current financial position.

CASE STUDY 10: Decision Making

Management uses financial analysis before expansion decisions.

Question: State two objectives of Financial Statement Analysis in this context.

Answer: (i) To assess profitability and financial stability of the firm. (ii) To assist management in planning and decision-making.

FLOW CHART 1: PROCESS OF FINANCIAL STATEMENT ANALYSIS

Financial Statements ↓ Selection of Data ↓ Classification & Tabulation ↓ Application of Tools of Analysis ↓ Interpretation of Results ↓ Decision Making

FLOW CHART 2: TOOLS OF FINANCIAL STATEMENT ANALYSIS

Financial Statement Analysis ↓ Comparative Statements ↓ Common Size Statements ↓ Ratio Analysis ↓ Cash Flow Statement

DIAGRAM 1: COMPARATIVE STATEMENT STRUCTURE

Base Year Figures

- Current Year Figures
- Increase / Decrease
- Percentage Change = Comparative Statement

DIAGRAM 2: COMMON SIZE STATEMENT STRUCTURE

Each item of:

- Balance Sheet → % of Total Assets
- P&L Statement → % of Net Sales

DIAGRAM 3: RATIO ANALYSIS CLASSIFICATION

Ratio Analysis |— Liquidity Ratios | |— Current Ratio | |— Quick Ratio |— Solvency Ratios | |— Debt-Equity Ratio |— Profitability Ratios | |— Gross Profit Ratio | |— Net Profit Ratio | |— ROCE |— Activity Ratios |— Inventory Turnover |— Trade Receivables Turnover

FORMULA CHART (MOST IMPORTANT – EXAM ORIENTED)

Liquidity Ratios

- Current Ratio = Current Assets / Current Liabilities
- Quick Ratio = (Current Assets – Inventory – Prepaid Expenses) / Current Liabilities

Solvency Ratio

- Debt-Equity Ratio = Long-term Debt / Shareholders' Funds

Profitability Ratios

- Gross Profit Ratio = (Gross Profit / Net Sales) × 100
- Net Profit Ratio = (Net Profit / Net Sales) × 100
- ROCE = EBIT / Capital Employed × 100

Activity Ratios

- Inventory Turnover Ratio = Cost of Revenue / Average Inventory
- Trade Receivables Turnover Ratio = Net Credit Sales / Average Trade Receivables

INTERPRETATION DIAGRAM (HOW TO WRITE IN EXAM)

Calculation of Ratio ↓ Comparison with Previous Year / Standard ↓ Analysis of Increase or Decrease ↓ Conclusion about Financial Position

1. OBJECTIVES OF FINANCIAL STATEMENT ANALYSIS

- To assess profitability of the business

- To judge liquidity position (ability to pay short-term liabilities)
- To evaluate solvency (long-term financial stability)
- To help in inter-firm and intra-firm comparison
- To assist management in planning and decision-making

2. IMPORTANCE OF FINANCIAL STATEMENT ANALYSIS (STAKEHOLDER-WISE)

For Management:

- Helps in controlling costs
- Assists in planning future operations

For Investors:

- Helps in judging safety and return on investment

For Creditors:

- Helps in assessing creditworthiness of the firm

For Government:

- Useful for taxation and policy decisions

3. LIMITATIONS OF FINANCIAL STATEMENT ANALYSIS

- Based on historical data
- Ignores price level changes (inflation)
- Affected by window dressing
- Results depend on accuracy of accounting data
- Qualitative factors are ignored

4. COMPARATIVE STATEMENT – EXAM WRITING FORMAT

Meaning: A comparative statement shows financial data of two or more periods to identify increase, decrease and percentage change.

Columns Used:

- Particulars
- Previous Year
- Current Year
- Increase / Decrease
- Percentage Change

5.COMMON SIZE STATEMENT – KEY POINTS

- All items are expressed in percentage form
- Helps in inter-firm comparison
- Removes the effect of size difference

Base Used:

- Balance Sheet → Total Assets = 100%
- Statement of P&L → Net Sales = 100%

6. GOLDEN RULES FOR RATIO INTERPRETATION (BOARD FAVOURITE)

A ratio should be compared with:

- Past ratios
- Industry standard
- Competitors' ratios
- One ratio alone is not sufficient
- Ratios should be interpreted together

7. CAPITAL EMPLOYED – IMPORTANT CLARITY (VERY IMPORTANT)

Capital Employed can be calculated as:

- Share Capital + Reserves & Surplus + Long-term Liabilities OR
- Fixed Assets + Working Capital

8. QUICK REVISION BOX (1-DAY BEFORE EXAM)

- Comparative → Absolute change
- Common Size → Percentage change
- Ratio Analysis → Relationship between figures
- Interpretation → 1–2 logical sentences

ONE-DAY REVISION SUMMARY

- Meaning & Objectives
- Tools of Analysis
- Comparative Statements
- Common Size Statements
- Ratio Analysis
- Formula Chart

LAST-DAY REVISION TIPS (TOPPER STYLE)

- Write formula first
- Show proper working notes
- Always give 1–2 lines interpretation
- Keep ratios up to two decimals

EXAMINATION TIPS (TOPPER NOTES)

- ✓ Always write definition + explanation
- ✓ Draw formats/flow charts
- ✓ Write formulas in boxes
- ✓ Use headings & sub-headings

VIDHI COMMERCE CLASSES

CA VIDHI JAIN - 8949078979

Vidhi Commerce Classes

(Commerce Ki पाठशाला)