Introduction to Financial Statement Analysis

1 Mark Questions

1.State any one limitation of financial statement analysis.(Delhi 2014,2013,2010; All India 2014,2014(C), 2013,2010)
Ans. Qualitative aspect is ignored Qualitative aspects like quality of management, quality of labour force,public relations are ignored while carrying out the analysis of financial statements, as financial statements are confined to monetary matters only.

2.State any one objective of financial statement analysis. (All India 2013; Delhi 2013,2010)
Ans. Inter-firm comparison With the help of financial statement analysis inter-firm comparison become easy. It helps in assessing own performance as well as that of others.

3.State one advantage of financial statements analysis. (Delhi, 2013)
Ans. Financial statement analysis helps the management to judge the overall as well as segmentwise operational efficiency of the business.

4.Explain how financial statements analysis ignores qualitative elements. (All India 2013)

Or

State how qualitative aspects are ignored in financial statements analysis. (Delhi 2011C)
Ans. Financial statements analysis ignore qualitative elements as it is confined to the monetary matters only because quality cannot be measured in monetary terms.

5.State the significance of analysis of financial statements to 'top management'.(All India 2012)
Ans. Financial statement analysis enables the 'top management' to evaluate the overall efficiency of the business. It provides adequate information for planning, budgeting and controlling the affairs of the business.

6.State the significance of analysis of financial statements to 'lenders'? (Delhi 2012)
Ans. Lenders can judge long-term and short-term solvency of the business or its ability to repay debts and interest through analysis of financial statements.

7.How is the financial statements analysis useful to finance manager? (All India 2011)
Ans. Financial statements analysis is useful to finance manager for taking financial decisions for the business. It provides adequate information for financial planning.

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8.State the interest of tax authorities in the analysis of financial statements.(All India 2011; HOTS)
Ans. Tax authorities are interested to analyse the financial statements to know about the revenue of business firm and for the collection of various types of taxes.

9.How is 'window dressing' a limitation of financial statements analysis? (All India 2010)
Ans. 'Window dressing' refers to displaying the rosy picture of an enterprise through financial statements. Sometimes material information is concealed in financial statements due to 'window dressing'.

10.How the solvency of a business is assessed by financial statements analysis?(Delhi 2010)
Ans. The solvency of a business is assessed by financial statements analysis through long-term and short-term solvency ratios.

3 Marks Questions

11.Explain advantages or objectives of financial statements analysis.(Delhi 2010; All India 2010)
Ans. Advantages of financial statements analysis are as follows:
(i) Financial statements analysis helps the management to judge the overall as well as segment wise operational efficiency of the business.
(ii) Financial statements analysis measures the short-term and long-term financial position of the business.
(iii) Financial statements analysis assesses the growth potential of the business.

12. What is meant by analysis of financial statements? State any two limitations of
analysis of it. (Delhi 2010 C, 2009 C, All India 2009)
or
Explain any three limitations of analysis of financial statements.(Delhi 2010 C, 2009 C; All India 2009)

Ans. Analysis of financial statements is the systematic numerical representation of the relationship of one financial fact with the other to measure the profitability, operational efficiency, solvency and the growth potential of the business. Various items of statement of profit and loss and balance sheet are compared and their inter-relationship is established. Limitations of analysis of financial statements are as follows:
(i) Financial statement analysis ignores qualitative aspects like quality of management, labour force and public relations.
(ii) Suffering from the limitations of financial statements.
(iii) Financial statements are historical in nature.

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13. Why is analysis of financial statements important to creditors? (All India 2009; hots)
Ans. Creditors supplying goods to the business are interested to know as to whether the business would be in a position to pay their amount on due date. For getting such information, financial analysis can be used. Financial statements help to know the liquidity and short-term solvency position of the firm.

14. What is vertical analysis of financial statements? (All India 2009)
Ans. Also called as static analysis, this analysis is made to review and analyse the financial statements of one particular year only. Such analysis is useful in comparing the performance of several companies of the same types or divisions or departments in one enterprise. Ratio anal/sis and common size statements are examples of this type of analysis.

15. What is horizontal analysis of financial statements? (Delhi2009)
Ans. Also called as dynamic analysis, this analysis is made to review and analyse the financial statements of a number of year-. and therefore, based on financial data taken for those years. It shows comparison of finam sal data for several years against a chosen base year. It is very useful for long-term trend analysis and planning.

16. What is the importance of financial statements analysis? (Delhi 2009)
Ans. Importance of financial statements analysis are as follows:

(i) judging the operational efficiency of the business It is very significant that the company must know the operational effic iency of its business. The financial statements analyst can judge the operational efficiency of the business by calculating profitability ratios.

(ii) Measuring the profitability Financial statements show the gross profit, net profit and other expenses. The relationship of these items can be established with sales. Gross profit, net profit, expenses and operating ratios may be calculated and the profitability of the business can be ascertained.

(iii) Measuring short-term and long-term financial position The financial statements analyst can judge long-term and short-term solvency of the firm or its ability to repay debts and interest thereon through analysis of financial statements.
(iv) Indicating the trend of achievements Financial statements of the previous years can be compared and the trend regarding various expense, purchase, sales, gross profit and net profit can be ascertained, cost of goods sold, values of assets and liabilities can be compared and the future prospects of the business can be indicated.
(v)Assessing the growth potential of the business The trend and dynamic analysis of the business provides sufficient information indicating the growth potential of the business.
(vi)Inter-firm comparison With the help of financial statement analysis, inter-firm comparison becomes easy. It helps in assessing own performance as well as that of other, if mergers and acquisition are to be considered.

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