

CUET · ACCOUNTANCY · CLASS XII · CODE 301

# Analysis of Financial Statements

CUET unit: Analysis of Financial Statements

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## Snapshot

- Introduces the meaning, significance and objectives of financial statement analysis as a process of critical evaluation of balance sheet and statement of profit and loss data (NCERT §4.1, p. 171).
- Identifies users of analysis (finance manager, top management, trade payables, lenders, investors, labour unions, government/researchers) and the focus area of each (NCERT §4.2, p. 172-173).
- Develops the first three tools in detail: **Comparative Statements** (horizontal analysis), **Common Size Statements** (vertical analysis) and **Trend Analysis**; mentions **Ratio Analysis** and **Cash Flow Analysis** as separate chapters (NCERT §4.4, p. 174-175).
- Provides the standard format and percentage-change formula for comparative statements and the base-100 percentage method for common-size statements (NCERT §4.5-§4.6, p. 176-186).
- Closes with the five **limitations** of financial analysis (price-level changes ignored, accounting-procedure changes hidden, only a study of reports, monetary-only information, accounting concepts not current values) (NCERT §4.7, p. 187).
- CUET regularly draws direct factual MCQs and numerical MCQs (percentage change, base = 100) from this chapter.

## Detailed Notes

### 2.1 Core concepts

**Definition (§ 4.1, p. 171).** Financial Statement Analysis is the process of **critical evaluation** of the financial information in the financial statements to understand and make decisions about the firm; it studies the relationship among various financial facts and figures to gain insight into profitability, operational efficiency, financial health and future prospects.

**Analysis vs Interpretation (§ 4.1, p. 171-172).** "Financial analysis" includes both **analysis** — simplification of financial data by methodical classification — and **interpretation** — explaining the meaning and significance of the data. The two are complementary: analysis is useless without interpretation, and interpretation without analysis is impossible.

**Judgemental process (§ 4.1, p. 172).** Financial statement analysis estimates current and past positions and operating results, with the primary objective of determining the best estimates and predictions about future conditions. It supports both **cross-sectional analysis** (comparison with other firms / industry) and **time-series analysis** (firm's own performance over time).

**Significance — by user group (§ 4.2, p. 172-173).** (a) **Finance manager** — rational decisions on operating policies, investment value, credit ratings, efficiency, and control through review of deviations. (b) **Top management** — ensures efficient resource use, measures success of operations, appraises individuals and evaluates internal control. (c) **Trade payables** — judge liquidity and ability to meet short-term and continued obligations. (d) **Long-term lenders** — assess long-term solvency, profitability, cash-generating ability and capital structure relationships. (e) **Investors** — focus on present and future profitability, capital structure, management efficiency; decide whether to buy, sell or hold shares. (f) **Labour unions** — assess whether the firm can afford or absorb a wage increase through productivity or price rises. (g) **Others** — economists and researchers study business and economic conditions; government uses analysis for price regulation, taxation, etc.

**Objectives (§ 4.3, p. 173-174).** Include assessing current profitability and operational efficiency, ascertaining the relative importance of components, identifying reasons for changes, judging ability to repay debt and assessing short-term and long-term liquidity.

**Tools of financial analysis (§ 4.4, p. 174-175).** (1) **Comparative Statements** — show profitability and financial position for different periods in comparative form; same accounting principles must be used else the deviation must be footnoted; also called "horizontal analysis". (2) **Common Size Statements** — express each item as a percentage of a common item, allowing comparison across years and across firms of different sizes; also called "vertical analysis" or "component percentage statements". (3) **Trend Analysis** — studies operational results and financial position over a series of years; trend percentage = each item of different years expressed as a percentage of the same item in the **base year**, which is set to **100**. (4) **Ratio Analysis** — describes significant relationships between items of the balance sheet and statement of profit and loss, measuring profitability, solvency and efficiency (developed in leac205). (5) **Cash Flow Analysis** — tracks the actual movement of cash; net cash flow = inflow – outflow; cash flow statement summarises causes for change in cash position between two balance-sheet dates (developed in leac206).

**Comparative Statements — preparation (§ 4.5, p. 176).** Three steps: (i) list absolute figures for two periods, (ii) find absolute change (Year 2 – Year 1), (iii) compute **percentage change = (Absolute change ÷ First-year figure) × 100**. The format has five columns: Particulars, First Year, Second Year, Absolute Change (+/-), Percentage Change (+/-). NCERT's Illustration 1 (p. 177) demonstrates: BCR Co. Ltd. Revenue from operations rises ₹60,00,000 → ₹75,00,000, absolute change ₹15,00,000, percentage change 25%.

**Common Size Statements — preparation (§4.6, p. 182-183).** Choose a common base = 100. For the Statement of Profit and Loss the base is **Revenue from operations**; for the Balance Sheet the base is **Total assets** (or Total liabilities). Express every other item as a percentage of that base. The format has four columns: Particulars, Year 1 Amount, Year 2 Amount, Year 1 %, Year 2 %. NCERT's Illustration 5 (p. 183) shows COGS in 2015-16 = ₹12,00,000 ÷ ₹25,00,000 × 100 = 48%.

**Trend Analysis (§4.4 ¶ 3, p. 175).** Base year is taken as 100; each subsequent year's figure is expressed as a percentage of the same item in the base year. Useful for identifying long-run growth or decline patterns.

**Limitations of financial analysis (§4.7, p. 187).** (1) Ignores price-level changes (historical-cost data); (2) may mislead if changes in accounting procedure are not known; (3) is only a study of the company's reports; (4) considers only monetary information — non-monetary aspects are ignored; (5) statements are based on accounting concepts so they do not reflect the current position. The analyst must also be conscious of window-dressing, varying accounting policies, conventions and personal judgement.

## 2.2 Definitions to memorise

Term	Definition	Page
Financial Statement Analysis	Process of critical evaluation of financial information in financial statements to understand and make decisions (NCERT §4.1).	171
Analysis	Simplification of financial data by methodical classification (NCERT §4.1).	171
Interpretation	Explaining the meaning and significance of the financial data (NCERT §4.1).	171
Comparative Statements	Statements showing profitability and financial position for different periods in comparative form (horizontal analysis) (NCERT §4.4).	174
Common Size Statements	Statements expressing each item as a percentage of a common item (vertical analysis / component percentage) (NCERT §4.4, §4.6).	174, 182
Trend Analysis	Technique of studying operational results over a series of years; each year expressed as a percentage of the same item in the base year (base = 100) (NCERT §4.4).	175
Ratio Analysis	Technique measuring comparative significance of items of the income statement and balance sheet to assess profitability, solvency and efficiency (NCERT §4.4).	175
Cash Flow Analysis	Analysis of actual movement of cash into and out of the organisation; net cash flow = inflow – outflow (NCERT §4.4).	175

Term	Definition	Page
Intra-firm Comparison	Comparison of a firm with its own past performance (time-series) (NCERT §4.1).	172
Inter-firm Comparison	Comparison of one firm with another firm or industry (cross-sectional) (NCERT §4.1).	172
Horizontal Analysis	Alternative name for Comparative Statements analysis (NCERT §4.4).	174
Vertical Analysis	Alternative name for Common Size Statements analysis (NCERT §4.4).	174
Component Percentage Statement	Synonym for Common Size Statement (NCERT §4.6).	182
Base Year	The year against which all other years are measured in trend analysis (set to 100) (NCERT §4.4).	175
Absolute Change	Year 2 figure – Year 1 figure, used in comparative statements (NCERT §4.5).	176
Percentage Change	$(\text{Absolute change} \div \text{First-year figure}) \times 100$ (NCERT §4.5).	176
Net Cash Flow	Cash inflow – Cash outflow (NCERT §4.4).	175
Window Dressing	Practice of presenting financial statements more favourably than actual position (NCERT §4.7).	187
Trend Percentage	Percentage that each item of subsequent years bears to the base-year item (NCERT §4.4).	175
Cross-sectional Analysis	Comparison with other firms / industry at a point in time (NCERT §4.1).	172
Time-series Analysis	Comparison of a firm's own performance across time (NCERT §4.1).	172
Operational Efficiency	Ability of the firm to use resources productively (NCERT §4.3).	173
Liquidity	Ability of the firm to meet short-term obligations (NCERT §4.2).	173
Long-term Solvency	Ability of the firm to meet long-term obligations and survive (NCERT §4.2).	173

## 2.3 Diagrams / processes to remember

**Exhibit 4.1 — Format of Comparative Statement (NCERT p. 176).** Five columns — Particulars, First Year, Second Year, Absolute Change (+/-), Percentage Change (+/-).

**Percentage-Change Formula (NCERT p. 176).**  $(\text{Absolute Increase or Decrease} \div \text{First-year absolute figure}) \times 100$ .

**Illustration 1 — Comparative Statement of Profit and Loss (BCR Co. Ltd.)**

(NCERT p. 177). Revenue from operations rises ₹60,00,000 → ₹75,00,000, absolute change ₹15,00,000, percentage change 25%.

**Illustration 3 — Comparative Balance Sheet (J. Ltd.) (NCERT p. 179).** Total Equity & Liabilities rises ₹27 lakh → ₹35 lakh, absolute change ₹8 lakh, percentage change 29.63%.

**Exhibit 4.2 — Format of Common Size Statement (NCERT p. 182).** Four columns — Particulars, Year 1 Amount, Year 2 Amount, Year 1 %, Year 2 %.

**Illustration 5 — Common Size Income Statement (NCERT p. 183).** Revenue from operations = 100; COGS in 2015-16 =  $12,00,000 \div 25,00,000 \times 100 = 48\%$ .

**Illustration 7 — Common Size Balance Sheet (XRI Ltd.) (NCERT p. 185).** Total Assets = 100; Share Capital  $15,00,000 \div 41,50,000 \times 100 = 36.14\%$ .

**Process — Comparative Statement preparation.** (i) List items in column 1. (ii) Insert prior-year figures in column 2. (iii) Insert current-year figures in column 3. (iv) Compute absolute change in column 4. (v) Compute percentage change in column 5 using the first-year figure as denominator. (vi) Footnote any change in accounting policy.

**Process — Common Size Statement preparation.** (i) Identify the base — Revenue from operations (for P&L) or Total Assets/Liabilities (for Balance Sheet). (ii) Express every other item as  $(\text{item} \div \text{base}) \times 100$ . (iii) Use four columns — two amounts and two percentages.

**Process — Trend Analysis.** (i) Select a base year. (ii) Set the base-year figure for each item to 100. (iii) For each subsequent year, express  $(\text{Year } i \text{ figure} \div \text{Base-year figure}) \times 100$ . (iv) Identify the trend — upward, downward, fluctuating.

## 2.4 Common confusions / NTA trap points

1. **Horizontal vs Vertical.** Comparative = horizontal; Common Size = vertical. Students often swap (NCERT §4.4 ¶1-2, p. 174).
2. **Base in common-size P&L.** Revenue from operations (not Total revenue or Net profit) (NCERT §4.6, p. 182).
3. **Base in common-size Balance Sheet.** Total assets / Total liabilities — not Capital (NCERT §4.6, p. 182).
4. **Trend analysis base.** Base year is **100** — not the latest year (NCERT §4.4 ¶3, p. 175).
5. **Percentage change denominator.** Uses the first (earlier) year as denominator, not the second year (NCERT §4.5, p. 176).
6. **Limitations list.** Includes price-level changes ignored, non-monetary info ignored — but does NOT include "ignores time value of money" or "ignores ratio analysis" (NCERT §4.7, p. 187).

7. **Trade payables vs Long-term lenders.** Trade payables → short-term liquidity; long-term lenders → long-term solvency (NCERT §4.2, p. 173).
8. **Analysis ≠ Interpretation.** Analysis = simplification + classification; Interpretation = explaining significance (NCERT §4.1, p. 171).
9. **Common size vs comparative.** Common size shows structure (each item as % of base); comparative shows change (absolute and % change over years) (NCERT §4.4, p. 174).
10. **Investor vs labour union focus.** Investor = profitability of shares; labour union = wage-increase affordability (NCERT §4.2, p. 173).
11. **Trend analysis is for several years.** Comparative statements typically two years; trend analysis many years (NCERT §4.4 ¶1, ¶3, p. 174-175).
12. **Tools list has five.** Comparative, Common Size, Trend, Ratio, Cash Flow — not six or four (NCERT §4.4, p. 174-175).

## 2.5 Journal entry templates

Analysis of Financial Statements is a presentation-and-comparison topic — it does not generate journal entries of its own. However, the tabular templates below show how a single data set is restated for analysis, alongside two illustrative entries common in adjacent topics.

### (a) Comparative Statement of Profit and Loss — template (NCERT Exhibit 4.1, p. 176)

Particulars	2015-16 (₹)	2016-17 (₹)	Absolute Change (₹)	% Change
I. Revenue from operations	60,00,000	75,00,000	+15,00,000	+25.00%
II. Other income	4,00,000	5,00,000	+1,00,000	+25.00%
III. Total Revenue (I+II)	64,00,000	80,00,000	+16,00,000	+25.00%
IV. Expenses	40,00,000	50,00,000	+10,00,000	+25.00%
V. Profit before tax	24,00,000	30,00,000	+6,00,000	+25.00%

### (b) Common Size Statement of Profit and Loss — template (NCERT Exhibit 4.2, p. 182)

Particulars	2015-16 (₹)	2016-17 (₹)	2015-16 %	2016-17 %
I. Revenue from operations	25,00,000	30,00,000	100.00%	100.00%
II. Cost of materials consumed	12,00,000	13,80,000	48.00%	46.00%
III. Employee benefits	4,00,000	4,80,000	16.00%	16.00%
IV. Finance costs	1,50,000	1,80,000	6.00%	6.00%

Particulars	2015-16 (₹)	2016-17 (₹)	2015-16 %	2016-17 %
V. Depreciation	50,000	60,000	2.00%	2.00%
VI. Profit before tax	7,00,000	9,00,000	28.00%	30.00%

**(c) Trend Analysis — template (NCERT § 4.4 ¶ 3, p. 175)**

Particulars	2014-15 (₹)	2015-16 (₹)	2016-17 (₹)	2014-15 %	2015-16 %	2016-17 %
Sales	20,00,000	24,00,000	30,00,000	100	120	150
Net Profit	2,00,000	2,40,000	3,30,000	100	120	165

**(d) Common Size Balance Sheet — template (NCERT Illus. 7, p. 185)**

Particulars	2015-16 (₹)	2015-16 %
I. Equity & Liabilities		
Share Capital	15,00,000	36.14%
Reserves & Surplus	8,00,000	19.28%
Long-term borrowings	10,00,000	24.10%
Current liabilities	8,50,000	20.48%
<b>Total</b>	<b>41,50,000</b>	<b>100.00%</b>

**(e) Transfer of profit to reserves (illustrative journal entry behind the analysis above)**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
Mar 31	Statement of Profit and Loss .....Dr.		1,00,000	
	To General Reserve A/c			1,00,000
	(Being amount transferred to General Reserve — visible in Reserves & Surplus row of Common Size BS)			

**(f) Long-term borrowing taken (illustrative — Balance Sheet impact)**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
Apr 1	Bank A/c .....Dr.		10,00,000	
	To Long-term Borrowings A/c			10,00,000
	(Being long-term loan raised — flows into Long-term Borrowings row of Comparative BS)			

**(g) Recording an exceptional item (would distort comparative analysis if not flagged)**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
Mar 31	Loss by Fire A/c .....Dr.		2,00,000	
	To Inventories A/c			2,00,000
	(Being inventory destroyed by fire — disclosed as exceptional item in P&L; affects comparability)			

**(h) Window-dressing reversal — sale to related party (illustrative)**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
Apr 1	Sales A/c .....Dr.		5,00,000	
	To Trade Receivables A/c			5,00,000
	(Being last-day sale of doubtful realisation reversed — analyst should flag window-dressing)			

 **Practice MCQs**

**Q1. Which of the following best defines "analysis" in financial statement analysis?**

- A. Explaining the meaning and significance of financial data
- B. Simplification of financial data by methodical classification
- C. Forecasting future profitability and cash flows
- D. Verification of accounting records by an auditor

**Q2. Comparative statements and common size statements are respectively called:**

- A. Vertical analysis and horizontal analysis
- B. Trend analysis and ratio analysis
- C. Horizontal analysis and vertical analysis
- D. External analysis and internal analysis

**Q3.** From the following statement of profit and loss of BCR Co. Ltd., the percentage change in Revenue from operations from 2015-16 to 2016-17 is: | Particulars | 2015-16 (₹) | 2016-17 (₹) | |---|---|---| | Revenue from operations | 60,00,000 | 75,00,000 |

- A. 20%
- B. 25%
- C. 15%
- D. 33.33%

 **12 more MCQs + answer key**

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## PYQ Alignment

This chapter is a high-yield CUET source — direct factual questions on tools (horizontal vs vertical, base = 100 in trend), numerical MCQs on percentage change and common-size percentages (especially modelled on Illustrations 1, 5 and 7), and assertion-reason or match-type items on users of financial analysis and limitations appear almost every cycle, typically accounting for 6–8 MCQs per CUET 301 Accountancy paper. See [/pyq/accountancy](#) for drill sets.

### CUET 2025 — Actual PYQs from this chapter

**Q.1 (CUET 2025)** Which of the following indicates limitation of financial analysis?

- A) Focus on facts and relationships related to managerial performance B) Do not consider price level changes C) Indicate the ability to meet obligations D) Provide vital information to stakeholders Tests: §2 Limitations of Financial Analysis — ignores price-level changes. Answer: Not in extracted key

**Q.11 (CUET 2025)** Comparison of financial statements over several years is known as:

- A) Vertical analysis B) Ratio analysis C) Trend analysis D) Horizontal analysis Tests: §3 Tools of Analysis — horizontal/trend analysis distinguished. Answer: Not in extracted key

**Q.13 (CUET 2025)** Which analysis estimates current and past financial position and predicts future conditions?

- A) Cash flow analysis B) Trend analysis C) Ratio analysis D) Financial statement analysis
- Tests: §1 Meaning of Financial Statement Analysis — diagnostic and predictive purpose. Answer: Not in extracted key

### **CUET 2023 — Actual PYQs from this chapter**

**Q.19 (CUET 2023)** Common Size Statements are also known as:

- A) Dynamic analysis B) Horizontal analysis C) Vertical analysis D) External analysis
- Tests: §3 Tools of Analysis — Common Size Statements as Vertical Analysis. Answer: Not in extracted key

