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SUBJECT- FINANCIAL ACCOUNTING

LIMITATIONS OF FINANCIAL STATEMENTS

Financial statment or report is the formal or written record which provides information about the financial activities of business, status, condition, and position of the business and much other business entities. Financial statements include (a) Balance sheet (b) Statement of profit and loss and (c) Cash flow statement. These financial statements have some advantages as well as some disadvantages. Let us see the limitation of financial statement.

The limitations of financial statments are those factors that one should be aware of before relying on them to an excessive extent. Having knowledge of these factors can result in a reduction in investing funds in a business, or actions taken to investigate further. Let us discuss them in detail.

1. Based on historical costs:

Financial statements donot disclose the current worth of the company. Initially we record transactions at their cost. The value of assets and liabilities changes over time.

Sometimes items, such as marketable securities, we alter the amount to match changes in their market values, but other items, such as fixed assets, donot change. Thus, the balance-sheet could be misleading if we present a large part of the amount which is based on historical costs.

2. <u>Based on Personal Judgment:</u>

The value of assets that appears in the statements depends on the standards of the person who deals with it. For example, the method of depreciation, mode of amortization of assets etc, depends on the personal judgement of the accountant.

3. <u>Inflationary effects:</u>

If the situation of inflation the rate is relatively high, the amounts of assets and liabilities in the balance-sheet will appear inordinately low, as we cannot adjust it for inflation. This mostly applies to long-term assets.

4. <u>Judgment in respect of various accounting policies:</u>

As we prepare a balance-sheet on the basis of going concern concept, where asset valuation doesnot represent realizable value or replacement value of the asset.

And we know that the amount that we express through financial statements is not accurate. Further, it depends on the judgement of the management in respect of accounting policies followed.

5. <u>Intangible assets not recorded:</u>

we do not record many intangible assets as assets. Instead, we charge any expenditure made to create an intangible asset as an expense.

This policy underestimates the value of a business, especially one that who spend a large amount to build up a brand image or to develop new products. It is a particular problem for startup companies that who create intellectual property, but so far who generates minimal sales.

6. <u>Interim reports are produced:</u>

As we know financial statements are interim reports, thus these are not final reports. Therefore, a user can gain an incorrect view of financial results by only looking at one reporting period. we can only compute final gain or loss of the business at the time of termination of business.

7. <u>Not always comparable across companies:</u>

If a company wants to compare the results of its company with different companies, their financial statements are not always comparable, because different companies use different accounting practices.

8. <u>False figures</u>:- The management team of a company may skew the results. This situation arises when there is undue pressure to report excellent results, such as when a bonus plan calls for payouts only if the sales level increases. One might suspect the presence of this issue when the results spike to a

level exceeding the industry norm.

9. Lack of non-financial factors:

The financial statments take into consideration only financial factors and they do not address non-financial issues, such as the environmental attentiveness of a company's operations, or how well it works with the local community.

A business reporting excellent financial results might be a failure in these other areas such as the image of the business, the loyalty of its workers, etc.

10. Figures are distorted:

Financial statments provide information about either historical results or the financial status of a business as of a specific date. The statments do not provide any value in predicting what will happen in the future.