Financial Statement Analysis

The process of critical evaluation of the financial information contained in the financial statements in order to understand and make decisions regarding the operations of the firm is called 'Financial Statement Analysistgv

Significance of Analysis of Financial Statements

Financial analysis is useful and significant to different users in the following ways: -

(a) **Finance manager**: Financial analysis focusses on the facts and relationships related to managerial performance, corporate efficiency, financial strengths and weaknesses and creditworthiness of the company. A finance manager must be well-equipped with the different tools of analysis to make rational decisions for the firm. The tools for analysis help in studying accounting data so as to determine the continuity of the operating policies, investment value of the business, credit ratings and testing the efficiency of operations. The techniques are equally important in the area of financial control, enabling the finance manager to make constant reviews of the actual financial operations of the firm to analyse the causes of major deviations, which may help in corrective action wherever indicated.

(b) **Top management**: The importance of financial analysis is not limited to the finance manager alone. It has a broad scope which includes top management in general and other functional managers. Management of the firm would be interested in every aspect of the financial analysis. Company Accounts and Analysis of Financial Statements their overall responsibility to see that the resources of the firm are used most efficiently and that the firm's financial condition is sound. Financial analysis helps the management in measuring the success of the company's operations, appraising the individual's performance and evaluating the system of internal control.

(c) **Trade payables**: Trade payables, through an analysis of financial statements, appraises not only the ability of the company to meet its short-term obligations, but also judges the probability of its continued ability to meet all its financial obligations in future. Trade payables are particularly interested in the firm's ability to meet their claims over a very short period of time. Their analysis will, therefore, evaluate the firm's liquidity position.

(**d) Lenders**: Suppliers of long-term debt are concerned with the firm's longterm solvency and survival. They analyse the firm's profitability over a period of time, its ability to generate cash, to be able to pay interest and repay the principal and the relationship between various sources of funds (capital structure relationships). Long-term lenders analyse the historical financial statements to assess its future solvency and profitability.

(e) Investors: Investors, who have invested their money in the firm's shares, are interested about the firm's earnings. As such, they concentrate on the analysis of the firm's present and future profitability. They are also interested in the firm's capital structure to ascertain its influences on firm's earning and risk. They also evaluate the efficiency of the management and determine whether a change is needed or not. However, in some large companies, the shareholders' interest is limited to decide whether to buy, sell or hold the shares.

(f) Labour unions: Labour unions analyse the financial statements to assess whether it can presently afford a wage increase and whether it can absorb a wage increase through increased productivity or by raising the prices.

(g) Others: The economists, researchers, etc., analyse the financial statements to study the present business and economic conditions. The government agencies need it for price regulations, taxation and other similar purposes

Tools of Analysis of Financial Statements–

The most commonly used techniques of financial analysis are as follows: -

1. Comparative Statements: These are the statements showing the profitability and financial position of a firm for different periods of time in a comparative form to give an idea about the position of two or more periods. It usually applies to the two important financial statements, namely, balance sheet and statement of profit and loss prepared in a comparative form. The financial data will be comparative only when same accounting principles are used in preparing these statements. If this is not the case, the deviation in the use of accounting principles should be mentioned as a footnote. Comparative figures indicate the trend and direction of financial position and operating results. This

analysis is also known as 'horizontal analysis'. The two comparative statements are Comparative income statement and Comparative balance sheet.
2. Common Size Statements: These are the statements which indicate the relationship of different items of a financial statement with a common item by expressing each item as a percentage of that common item. The percentage thus calculated can be easily compared with the results of corresponding percentages of the previous year or of some other firms, as the numbers are brought to common base. Such statements also allow an analyst to compare the operating and financing characteristics of two companies of different sizes in the same industry. Thus, common size statements are useful, both, in intra-firm comparisons over different years and also in making inter-firm comparisons for the same year or for several years. This analysis is also known as 'Vertical analysis'.
3. Trend Analysis: It is a technique of studying the operational results and financial position over a series of years. Using the previous years' data of a business enterprise, trend analysis can be done to observe the percentage changes over time in the selected data. The trend percentage is the percentage relationship, in which each item of different years bear to the same item in the base year. Trend analysis is important because, with its long run view, it may point to basic changes in the nature of the business. By looking at a trend in a particular ratio, one may find whether the ratio is falling, rising or remaining relatively constant. From this observation, a problem is detected or the sign of good or poor management is detected.
4. Ratio Analysis: It describes the significant relationship which exists between various items of a balance sheet and a statement of profit and loss of a firm. As a technique of financial analysis, accounting ratios measure the comparative significance of the individual items of the income and position statements. It is possible to assess the profitability, solvency and efficiency of an enterprise through the technique of ratio analysis.
5. Cash Flow Analysis: It refers to the analysis of actual movement of cash into and out of an organisation. The flow of cash into the business is called as cash inflow or positive cash flow and the flow of cash out of the firm is called as cash outflow or a negative cash flow. The difference between the inflow and outflow of cash is the net cash flow. Cash flow statement is prepared to project the manner in which the cash has been received and has been utilised during an accounting year as it shows the sources of cash receipts and also the purposes for which payments are made. Thus, it summarises the causes for the changes in cash position of a business enterprise between dates of two balance sheets.

Format for Comparative income statement

Particulars	Previous Year	Current Year	Increase/Decrease	Increase/Decrease (Percentage)
Net Sales	xxx	xxx	xxx	xxx
(-)Cost of Goods Sold	xxx	xxx	xxx	xxx
Gross Profit (A)	xxx	xxx	xxx	xxx
(-)Operating Expenses • **Administrative Expenses** • **Selling and Distribution Expenses**	xxx	xxx	xxx	xxx
Total Operating Expenses(B)	xxx	xxx	xxx	xxx
A-B= Operating Profit	xxx	xxx	xxx	xxx
(+)Non-operating Income	xxx	xxx	xxx	xxx
Total	*xxx*	*xxx*	*xxx*	*xxx*
(-)Non-operating Expenses	xxx	xxx	xxx	xxx
EBT	*xxx*	*xxx*	*xxx*	*xxx*
(-) Tax	xxx	xxx	xxx	xxx
EAT	*xxx*	*xxx*	*xxx*	*xxx*

Format for Comparative Balance Sheet

Particulars	Previous Year	Current Year	Increase/Decrease	Increase/Decrease (Percentage)
Equity and Liabilities				
Share Holders Fund	xxx	xxx	xxx	xxx

• Share Capital	xxx	xxx	xxx	xxx
• Reserves and Surplus	xxx	xxx	xxx	xxx
Total Share Holders Fund				
Non Current Liabilities				
• **Secured Loans**	xxx	xxx	xxx	xxx
• **Unsecured Loans**	xxx	xxx	xxx	xxx
Total Non Current Liabilities	xxx	xxx	xxx	xxx
Current Liabilities	xxx	xxx	xxx	xxx
Total Current Liabilities	xxx	xxx	xxx	xxx
Total Equity and Liabilities	xxx	xxx	xxx	xxx
ASSETS				
Non- Current Assets				
Fixed Assets	xxx	xxx	xxx	xxx
Total Fixed Assets	xxx	xxx	xxx	xxx
Investments	xxx	xxx	xxx	xxx
Total Investments	xxx	xxx	xxx	xxx
Current Assets	xxx	xxx	xxx	xxx
Total Current Assets	xxx	xxx	xxx	xxx
Total Assets	xxx	xxx	xxx	xxx

Problems

1. The income statement of a concern are given for the year ending 31/3/2013 and 31/3/14.Rearrange the figures in a comparative form and study the profitability position of the concern

Particulars	2013-14(Lakhs)	14-15(Lakhs)
Net Sales	600	800
Cost of Goods Sold	400	500
Gross Profit	200	200
Operating Expenses	40	50
Operating Profit	160	250
Non Operating Income	20	25
Non Operating Expenses	30	40
Net Profit	150	235

2. The information given below about a company for the years ending 31.-3.2014 and 31.03.2015

Particulars	13-14	14-15
Gross Profit on sales	2,40,000	1,50,000
Net Income on sales	5%	10%
Net Income	40,000	60,000

Rearrange the figures in a comparative form and study the profitability position of the concern

3. The income statement of a concern are given for the year ending 31/3/2014 and 31/3/15.Rearrange the figures in a comparative form and study the profitability position of the concern

Particulars	2013-14	14-15
Net Sales	7,85,000	9,00,000
Cost of Goods Sold	4,50,000	5,00,000
Administration Expenses	70,000	72,000

Selling Expenses	80,000	90,000
Interest Paid	25,000	30,000
Income Tax	70,000	80,000

4. The income statement of a concern are given for the year ending 31/3/2014 and 31/3/15.Rearrange the figures in a comparative form and study the profitability position of the concern

Particulars	2013-14	14-15
Net Sales	30,00,000	28,00,000
Cost of Goods Sold	20,00,000	18,00,000
Gross Profit	10,00,000	72,000
Operating Expenses	7,00,000	6,00,000
Operating Profit	3,00,000	4,00,000
Non-operating Income	25,000	20,000
Non-operating expenses	75,000	60,000

Liabilities	S & Co	K&Co
8 %Preference Share Capital	1,00,000	1,50,000
□□□□□□□ Share Capital	2,00,000	3,00,000
Reserves and Surplus	82,000	1,00,000
8% Debenture	1,00,000	80,000
Creditors	75,000	90,000
Outstanding expenses	43,000	30,000
	6,00,000	**7,50,000**
Land & Building	1,80,000	2,40,000
Plant and Machinery	2,00,000	1,90,000
Furniture	1,00,000	1,10,000
Stock	80,000	1,30,000
Debtors	30,000	50,000
Cash at Bank	10,000	30,000
	4,38,000	**8,08,000**

5. The balance sheet of S & Co and K&Co are as follows

Liabilities	S & Co	K&Co
Preference Share Capital	1,20,000	1,60,000
□□□□□□□ Share Capital	1,50,000	4,00,000
Reserves and Surplus	14,000	18,000
Long term loan	1,15,000	1,30,000
Bills Payable	2,000	-
Sundry creditors	12,000	4,000
Outstanding expenses	15,0000	6,000
Proposed Dividend	10,000	90,000
	4,38,000	**8,08,000**
Land & Building	80,000	1,23,000
Plant and Machinery	3,34,000	6,00,000
Temporary Investment	1,000	40,000
Inventories	10,000	25,000
Book- Debts	4,000	8,000
Prepaid Expenses	1,000	2,000
Cash and Bank Balances	8,000	10,000
	4,38,000	**8,08,000**

Compare the financial position of two companies with the help of a common size balance sheet.

6. Prepare a common size income statement

Particulars	2014(Rs in ‘000)	2015(Rs in ‘000)
Sales	500	700
Miscellaneous Income	20	15
	520	**715**
Expenses:		
Cost of Sales	325	510
Office Expenses	20	25
Selling Expenses	30	45
Interest	25	30
	400	**610**
Net Profit	120	105
	520	**715**

7. Following are the Balance Sheets of Zim and Co and Zam& Co as on 31-12-2013

Liabilities	Zim& Co	Zam&Co
□□□□□□□ Share Capital	2,00,000	3,00,000
10% Preference Share Capital	2,00,000	2,50,000
12% Debenture	1,00,000	2,00,000
Reserves and Surplus	1,00,000	1,20,000
Sundry Creditors	1,50,000	4,10,000
Bank overdraft	-	50,000
Dividend Provision	50,000	70,000
	8,00,000	**14,00,000**
Land & Building	80,000	2,40,000
Plant and Machinery	3,00,000	6,25,000
Investments	1,00,000	2,00,000
Stock	1,50,000	2,00,000
Debtors	1,00,000	1,20,000
Cash at Bank	70,000	1,35,000
	8,00,000	**14,00,000**

Compare the Financial position of the two companies with the help of Common –Size Balance Sheet and comment.

8. Calculate trend percentages from the following balance sheet of Hindustan Industries Lt. compute

Particulars	2011 (Rs)	2012(Rs)	2013(Rs)
Share Capital	2,00,000	2,50,000	3,00,000
Reserves	1,00,000	1,50,000	1,50,000
Loan	2,00,000	1,00,000	50,000
Sundry Creditors	3,00,000	4,00,000	2,00,000
Buildings	2,00,000	2,50,000	3,00,000
Plant	2,00,000	2,50,000	1,00,000
Stock	2,50,000	2,50,000	1,50,000
Debtors	1,00,000	1,50,000	1,00,000
Cash at Bank	50,000	50,000	50,000

9. From the following calculate trend percentages

Particulars	2011	2012	2013
Sales	6,00,000	8,00,000	10,00,000
Cost of Goods Sold	3,00,000	5,00,000	6,00,000

Selling Expenses	1,00,000	1,50,000	2,00,000
Administrative Expenses	50,000	60,000	80,000
Financial Expenses	30,000	40,000	20,000

10. Calculate the trend percentages from the following figures if X Ltd taking 2001 as the base and interpret them.

Year	Sales	Stock	PBT
2011	1,881	709	321
2012	2,340	781	435
2013	2,655	816	458
2014	3,021	944	527
2015	3,768	1,154	672

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