Chapter - 4 Part-B

Financial Statement Analysis

Financial Statements analysis is a systematic process of studying the relationship among the various financial factors contained in the financial statements to have a better understanding of the working and the financial position of a business.

“**Financial analysis consists in separating facts according to some definite plan, arranging them in groups according to certain circumstances and then presenting them in a convenient and easily read and understandable form.**”

-Finney and Miller

in simple words analysis of financial statements is a more comprehensive study of balance sheet and profit and loss account using the tools of analysis to get a proper understanding of profitability and financial position of business.

Objectives or Purposes of Financial Statement Analysis

To measure the **Profitability or Earning Capacity** of the business -analysis helps in measuring the profits and earning capacity of business. it helps in judging whether the profits are accurate or not.

To measure the **Financial Strength** of the business - analysis helps in understanding the financial postion of the company. it helps in judging the financial health of the business.

To make **Comparative Study** within the firm (intra – firm) and with other firms (inter - firm)- analysis helps in comparisons of financial statements. There are two types of comparisons-

1) intra firm- it is the comparison within the business ie previous year and current year or from one department to another. it is also known as trend analysis.

2) inter firm- it is the comparison of one business to another ie comparing one company to

another. it is known as cross sectional analysis.

To judge the **Efficiency of Management-** profits and assets of the business helps in judging the efficiency of the business ie whether the business is utilising its resources in an efficient manner or not.

To provide **Useful Information's to** the Management- analysis helps the management to get useful insight of the business which helps them in taking many managerical decisions.

To find out the **Capability for payment of interest, dividend** etc.- profitability of the business helps in judging whether the business will be able to pay interest and dividend. analysis helps in judging the capability of the business of paymnet of interest and dividend.

To measure the **Short-term and Long-term Solvency** of the business- analysis helps in judging whether the business will be able to pay its short term and long term dues.

Limitation of Financial Statement Analysis

Based on basic financial statement which themselves suffer from certain limitations- financial accounting has certain disadvantages itself which becomes the limitation of its analysis for example financial accounting records only historical cost which becomes the limitation of its analysis.

Ignores changes in price level.- financial accounting analysis does not take in to consideration the current changes in the prices in the economy.

Affected by the personal ability and bias of the analyst.- since analysis is done by the accountant he or she applies their on personal judgement while using the tools of analysis which affect the analysis.

Lack of qualitative analysis as only those transaction and events are recorded which can be measured in terms of money.- only those transactions in financial statements can be analysed which can be measured in money.

When different accounting policies are followed by the two firms then comparison between their financial statement becomes unreliable.- since accounting is dependent upon personal judgement of the accountant sometimes different policies adopted by accountant makes it difficult to compare the financial statements

Analysis of single year's financial statement have limited use- single year financial statements are of limited use as they cannot be used for inter firm and intra firm comparisons.

Also affected by the Window dressing- if the values of different assets and liabilities are not shown at fair value the analysis will not give a fair picture of the business.

Types of Financial Statement Analysis

There are two main approaches for the analysis of financial statements.

Horizontal Analysis: In this type of analysis, figure in the financial statements for two or more years are compared and analyzed. It helps in knowing the trends of the business over a period of time. It is also known as Time series analysis or Dynamic Analysis. Comparative statements and cash flow statements are example of horizontal analysis.It is also known as intra firm analysis

Vertical Analysis: In this type of analysis, figures in the financial statement for a single year are analysed. It involves the study of relationship between various items of Balance Sheet or statement of Profit & Loss of a single year or period. It is also known as Static Analysis. Common size statements and ratio analysis relating to a particular accounting period are examples of this type of analysis.It is also called inter firm analysis.

Significance or Importance of Financial Analysis: the importance of the analysis is for two users-

i) internal users- these are the users within the business which require analysis of financial statements.the internal users are-

For Management: To know the profitability, liquidity and solvency position to measure the effectiveness of its own decisions taken and to take corrective measure in future.

For employees : employees need analysis to know about the profitability of the business as it is directly related to the salary and bonus they will get.

2) external users- these are the users outside the business which require analysis of financial statements. the external users are -

For Investors: Investors want to know the earning capacity and future growth prospects of the business which helps in assessing the safety of their investment and reasonable return.

For Creditors: Short-term creditors want to know the liquidity position of the business where as long term creditors want to know about the solvency position and ability to pay the interest consistently.

For Govt: To know the profitability position for taking taxation decision and to take decisions about the price regulations.

For Employees: To know the progress of the company for assessing bonus, possible increase in wages and to ensure stability of their jobs.

For Customers: To know about the continuance of the business in future.

Tools for financial statement analysis

The various tools used for analysis of financial statements are :

Comparative Statement : Financial Statements of two years are compared and changes in absolute terms and in percentage terms are calculated. It is a form of Horizontal Analysis.

Common Size statement : Figures of Financial statements are converted it to percentage with respect to some common base.

In Common size Income Statement **Sales/Revenue from Operations** is taken is common base where as in Common size Balance Sheet Total assets or **Total Equity and Liabilities** are taken as common base.

Ratio Analysis : It is a technique of Study of relationship between various items in the Financial Statements.There are mainly four types of ratios-

1) liquidity ratio
2) solvency ratio
3) activity ratio
4) profitability ratio

Cash Flow Statement : It is a statement that shows the inflow and outflow of cash and cash equivalents during a particular period which helps in finding out the causes of changes in cash position between the two balance sheet dates.It is prepared under accounting standard 3

Comparative Statements

It is a statement that shows changes in each item of the financial statement in absolute amount and in percentage, taking the amounts of the preceding as counting period as the base.

Types of Comparative Statements :

1. Comparative Balance Sheet; and
2. Comparative Statement of Profit and Loss.

Comparative Balance Sheet : It shows the increases and decreases in various items of assets, equity and liabilities in absolute term and in percentage term by taking the corresponding figures in the previous year's balance sheet as a base.

Format for a Comparative Balance Sheet

Comparative Balance Sheet of ……… Ltd.

As at 31st March 2014 and 2015

Particulars	2014 Rs. (previous year)	2015 Rs (current year).	Absolute Change Rs. (current year- previous year)	Percentage Change %
1. EQUITY AND LIABILITIES (1) Shareholders' funds (a) Share capital (b) Reserves and surplus (2) Non-current Liabilities (a) Long-term borrowings (b) Other Long term liabilities (c) Long-term provisions (3) Current liabilities (a) Short-term borrowings (b) Trade payables (c) Other Current liabilities (d) Short-term provisions				

Total				
II. ASSETS (1) Non-current assets (a) Fixed assets (b) Non-current investments (c) Long-term loans and advances (2) Current Assets (a) Current investments (b) Inventories (c) Trade receivables (d) Cash and cash equivalents (e) Short term loans and advances (f) Other current assets				
Total				

*Percentage change = absolute change/ previous year *100
for example -

pariculars	note no	2016 (A)	2017 (B)	absolute change C= B-A	percentage C/A*100
share holder fund		500000	300000	200000	40
current liabilities		30000	20000	10000	50
total liabilities		530000	320000	210000	40.38
assets					
fixed assets		220000	200000	20000	9.09
current assets		310000	120000	190000	61.29
total assets		530000	320000	210000	40.38

COMPARATIVE STATEMENT OF PROFIT AND LOSS/COMPARATIVE INCOME STATEMENT

Comparative Income Statement: It shows the increases and decreases in various items of income Statement in absolute amount and in percentage amount by taking the corresponding figures in the previous year's Income Statement as a base.

Format for a Comparative Statement of Profit and Loss

Comparative Statement of Profit and Loss

For the years ended on 31st March, 2014 and 2015

Particulars	2014 Rs. (previous year)	2015 Rs. (current year)	Absolute Change Rs. (current year- previous year)	Percentage Change %
I. Revenue form operations II. Other Income III. Total Revenue (I+II) IV. Expenses : a.Cost of Material consumed b.Purchases of Stock-in-Trade c.Changes in Inventories of Finished Goods, Work-in-progress and Stock-in-trade d.Employees Benefit Expenses e.Finance Cost f.Depreciation & Amortisation Expenses g.Other Expenses Total Expenses V. Profit before Tax (III-IV) Less : Income Tax VII. Profit after Tax				

percentage = absolutechange/ previous year*100

Importance of Comparative Statement

To make the data simple and more understandable.

To indicate the trend with respect to the previous year.

To compare the firm performance with the performance of other firm in the same business.

PARTICULARS	2016 (A)	2017 (B)	ABSOLUTE CHANGE (B-A)	PERCENTAGE C/A*100
revenue from operation	10,00,000	30,00,000	20,00,000	200
total income (A)	10,00,000	30,00,000	20,00,000	200
cost of production	2,00,000	3,00,000	1,00,000	50
other expenses	1,00,000	2,00,000	1,00,000	100
total expenses(B)	3,00,000	5,00,000	2,00,000	66.7
profit (A-B)	7,00,000	25,00,000	18,00,000	257.14
-TAX	(1,00,000)	(5,00,000)	4,00,000	400
PROFIT AFTER TAX	6,00,000	20,00,000	14,00,000	233.3

Common Size Statement

Common Size Financial Statements are the statements in which amounts of the various items of financial statements are converted into percentages to a common base.

Types of Common Size statements :

1. Common Size Balance sheet; and
2. Common Size Statement of Profit and Loss.

Common Size Balance sheet : It is a statement in which every item of assets, equity and liabilities is expressed as a percentage to the total of all assets or to the total of Equity and Liabilities.

Format for a Common Size Balance Sheet :

Common Size Balance Sheet of................Ltd.

As at 31st March, 2014 and 2015

Particulars	Absolute Amounts	Percentage of Balance

			Sheet Total	
	2014 Rs.	**2015 Rs.**	**2014 %**	**2015 %**
1. EQUITY AND LIABILITIES (1) Shareholders’ funds Share capital Reserves and surplus (3) Non-current Liabilities Long-term borrowings Other Long term liabilities Long-term provisions (4) Current liabilities Short-term borrowings Trade payables Other Current liabilities Short-term provisions Total				
II. ASSETS (1)Non-current assets Fixed assets Non-current investments Long-term loans and advances (2)Current Assets Current investments Inventories Trade receivables Cash and cash equivalents Short term loans and advances Other current assets Total				

note - all the items are divided by the total of balance sheet to calculate the percentage.

pariculars	note no	2016 (A)	2017 (B)	PERCENTAGE 2016 (divide by total 530000)	percentage 2017 (divide by total 320000)
share holder fund		500000	300000	94.3	93.75
current liabilities		30000	20000	5.7	6.25
total liabilities		530000	320000	100	100
assets					
fixed assets		220000	200000	41.50	62.5
current assets		310000	120000	58.49	37.5
total assets		530000	320000	100	100

Common Size Income Statement or Statement of Profit and Loss: It is a statement in which every item of Statement of Profit and Loss is expressed as a percentage to the amount of Revenue from Operations.

Format for a Common Size Statement of Profit and Loss:

Common Size Statement of Profit and Loss

For the years ended on 31st March, 2014 and 2015

Particulars	Absolute Amounts		Percentage of Revenue from operation (Net Sales)	
	2014 Rs.	**2015 Rs.**	**2014 Rs.**	**2015 Rs.**
I. Revenue from operations II. Add : Other Income				

III. Total Revenue (I+II)				
IV. Expenses : a. Cost of Material consumed b. Purchases of Stock-in-Trade c.Changes in Inventories of Finished Goods, Work-in-progress and Stock-in-trade d. Employees Benefit Expenses e. Finance Cost f. Depreciation g. Other Expenses				
Total Expenses				
V. Profit before Tax (III-IV)				
Less : Income Tax VII. Profit after Tax				

note- all the items are divided by revenue from operations of that year to calculate the percentages.

PARTICULARS	2016 (A)	2017 (B)	PERCENTAGE 2016 (divide by 10,00,000)	PERCENTAGE 2017 (divide by 30,00,000)
revenue from operation	10,00,000	30,00,000	100	100
total income (A)	10,00,000	30,00,000	100	100
cost of production	2,00,000	3,00,000	20	10
other expenses	1,00,000	2,00,000	10	6.67
total expenses(B)	3,00,000	5,00,000	30	16.67
profit (A-B)	7,00,000	25,00,000	70	83.3
-TAX	(1,00,000)	(5,00,000)	10	16.67
PROFIT AFTER TAX	6,00,000	20,00,000	60	66.67