

PART – 2
CHAPTER 4
ANALYSIS OF FINANCIAL STATEMENTS

Short Answer Questions

Question 1

List the techniques of Financial Statement Analysis.

Answer:

The techniques of the financial statement analysis are as follows:

1. Comparative financial statement.
2. Common size statement.
3. Trend Ratio.
4. Average analysis.
5. Statement of change in working capital.
6. Fund flow statement.
7. Cash flow statement.
8. Ratio analysis.
9. Cost volume ratio analysis.

Question 2

Distinguish between Vertical and Horizontal Analysis of financial data.

Answer:

Basis of Difference	Horizontal Analysis	Vertical Analysis
Meaning	It can be referred as the comparison made	It can be referred to as the comparison

	to the item of financial statement with the item of the financial statement of one accounting period to the base year accounting period's corresponding item.	made between the item of the financial statement with the same accounting period's common item.
Purpose	Its resolves the purpose of the determination of the change in any item during any particular accounting period. This change in item is expressed either in terms of absolute figures or in the percentage or in both.	Its resolves the purpose of the determination of the proportion of the item with the common item of that same accounting period. This change in item is either expressed in ratio or in the terms of the percentage.
Usefulness	It useful for indicating the growth or the decline of the item.	It is helpful in the prediction of the relative proportion of the item with the common item.

Question 3

State the meaning of Analysis and Interpretation.

Answer:

The process of the analysing and the interpretation of the financial statement deals with the systematic and the critical examination of the financial statements. It not only establishes the relationship of cause and effect between the varying items of any financial statement, but it is also responsible for representing the financial statement in a well established and a proper manner. Thus, the main purpose of the financial statement is to present the data in the manner that it is easily understandable to anybody. This thus helps the users of the financial statement to assess the financial statement in a proper manner.

Question 4

State the importance of Financial Analysis?

Answer:

The importance of the financial statement can be highlighted from the fact that it defines the relationship between the various elements of the financial statement. It can be said to be helpful in predicting the profit earning capacity of any business, assessing the long-term solvency and evaluating the financial status to help the decision making process by the management of the organization.

Question 5

What are the Comparative Financial Statements?

Answer:

The comparative financial statement in the general sense can be said to be the statement that enables the inter and the intra firm comparison of the financial information. These help the users to assess the progress and the development of any organization in the relative terms. Hence the comparative financial statement allows the users of the financial statement to derive the information on the factual basis without getting confused and ambiguous.

Question 6

What do you mean by Common Size Statements?

Answer:

The common size statement reflects the relationship of the various items of the financial statement in the terms of the percentage. Thus the items of the Trading and Profit and Loss Account such as Cost of Goods Sold, and Expenses can be expressed in the terms of the percentage expressed in terms of percentage which makes it easy for the user of the financial statement to make the comparisons and derive the needed information.

Long Answer Questions

Question 1

Describe the different techniques of financial analysis and explain the limitation of the financial analysis.

Answer

There are various types of techniques of financial analysis. Some are-

- **Comparative statements:** The comparative statement deals with the comparisons made between the items of the financial statement of the profit and loss, the balance sheet and the cash flow statement of the particular accounting period for the two or more than two accounting periods.
- **Common size statement:** The common size statement is responsible for showcasing the relationship among the each. It shows the relationship between each and every component with the whole.
- **Trend analysis:** It calculates the ratios of the different various accounting periods to make interpretations and take relevant decisions.
- **Statement of change in working capital:** It is used for reflecting the change in term of the increase or the decrease of the working capital during an accounting period.
- **Fund flow analysis:** The fund flow analysis is responsible for indicating that from where did the funds come and what was the application for the funds for the particular accounting period.
- **Cash flow analysis:** The cash flow analysis is used for the purpose of showcasing the flow and the movement of the cash and the bank balance

Limitation of financial analysis-

- I. When the operations of the company are complex and heterogeneous, there may rise the inability to make the comparisons in the rightful manner and this problem may become even more worse when different accounting practices were adopted for different accounting periods.
- II. The interpretation of these is made by the individuals who may make the faulty interpretation of the figures and derive inconclusive results.
- III. In order to make the interpretations, it requires for an individual to have the specialized knowledge and the relevant skills so that the interpretations are made in the consistent manner.

Question 2

Explain the usefulness of trend percentages in the interpretation of the financial performance of a company.

Answer:

The usefulness of the trend percentage is that it makes it easier for the user to make the interpretations of the progress made by any business:

- The trend analysis gives the users of the accounting information to forecast the trend of the future of the business.
- These trends are expressed in the terms of the percentage which makes the process of the analysis easier and less complex and time consuming.

- The trend analysis showcases the broader picture of the organization which deals with providing the insights about the financial and the operational viability and the performance of the business.

Question 3

What is the importance of comparative statements?

Illustrate your answer with particular reference to the comparative income statement.

Answer:

The comparative statement shows the changes made in the position of the business in the comparative terms that it by making the comparisons between the figures of one year with another year in the form of the percentage.

- The comparative statements are thus easy to understand for the user of the financial information who can derive the conclusions based upon the comparisons made between the two or more than two years.
- It is responsible for showcasing the trend and identifying it by putting the data of the sales, expenses of stock etc.
- It is helpful in indicating the positive as well as the negative points and thus the management of the organization can easily identify the reasons behind the failure.
- It thus helps the process of the decision making by making the predictions easy and viable.

Question 4

What do you understand by analysis and interpretation of financial statements? Discuss its importance.

Answer:

The analysis and the interpretation of the financial statement refers to the determination of the significance of the financial statement in order to make it possible for the forecasting to be made and the prospects of the earning the profit, ability to repay the debts and the interest and the profitability of the organization can be made.

It focuses on the identification of the strength and the weakness of any business organization and to make the analysis of the data which is contained in the financial statement by the application of the various kinds of the techniques.

Thus, the importance of the financial statement can be highlighted from the following:

- The basis of the decision making is scientific on the adhoc basis. It is hence easier to read and understood.
- Not everyone can understand and analyse the financial statement and the analysis can thus be made on the mutual relationship of the experience and the observation.
- It allows the correct decisions to be taken at the correct time.

It makes it possible for the verification and the examination the correctness of the data which is interpreted.

Question 5

Explain how common size statements are prepared giving an example.

Answer:

The common size statement is known as a vertical analysis in other terms. This is a technique of making the analyses of the financial statement by reflecting upon the expenses and the revenue on year to year basis and it further allows the determination of what factors have been changed. It is useful for establishing the relationship between the various components

Income statement of A limited

(in rupees)

Particulars	2018	%	2017	%
Sales	11,00,000	100%	10,00,000	100%
Consumption of stock	7,50,000	68.18%	6,95,000	69.50%
Direct expenses	1,50,000	13.62%	80,000	8%
Gross Profit	2,00,000	18.20%	2,25,000	22.50%

Numerical Questions

Question 1

Following are the balance sheets of Alpha Ltd. as at March 31st, 2016 and 2017. You are required to prepare Comparative Balance Sheet.

Particulars	2016 Rs.	2017 Rs.
I. Equity and Liabilities		
Equity share capital	2,00,000	4,00,000
Reserves and surplus	1,00,000	1,50,000

Long-term borrowings	2,00,000	3,00,000
Short-term borrowings	50,000	70,000
Trade payables	30,000	60,000
Short-term provisions	20,000	10,000
Other current liabilities	20,000	30,000
Total	6,20,000	10,20,000
II. Assets		
Fixed assets	2,00,000	5,00,000
Non-current investments	1,00,000	1,25,000
Current investments	60,000	80,000
Inventories	1,35,000	1,55,000
Trade receivables	60,000	90,000
Short term loans and advances	40,000	60,000
Cash at bank	25,000	10,000
Total	6,20,000	10,20,000

Answer:

Comparative Balance Sheet
as on March 31, 2016 and 2017

Particulars	2016 (Rs)	2017 (Rs)	Absolute Change	Percentage Change
I. Equity and Liabilities				
1. Shareholder's Fund				
a. Equity Share Capital	2,00,000	4,00,000	2,00,000	100

b. Reserves and Surplus	1,00,000	1,50,000	50,000	50
2. Non-Current Liabilities				
a. Long Term Borrowings	2,00,000	3,00,000	1,00,000	50
3. Current Liabilities				
a. Short Term Borrowings	50,000	70,000	20,000	40
b. Trade Payables	30,000	60,000	30,000	100
c. Short Term Provisions	20,000	10,000	(10,000)	(50)
d. Other Current Liabilities	20,000	30,000	10,000	50
Total	6,20,000	10,20,000	4,00,000	64.5
II. Assets				
1. Non-Current Assets				
a. Fixed Assets	2,00,000	5,00,000	3,00,000	150
b. Non Current Investments	1,00,000	1,25,000	25,000	25

2. Current Assets				
a. Current Investments	60,000	80,000	20,000	33.3
b. Inventories	1,35,000	1,55,000	20,000	14.8
c. Trade Receivables	60,000	90,000	30,000	50
d. Short Term Loans and Advances	40,000	60,000	20,000	50
e. Cash and Cash Equivalents	25,000	10,000	(15,000)	(60)
Total	6,20,000	10,20,000	4,00,000	64.5

Question 2

Following are the balance sheets of Beta Ltd. as at March 31st, 2016 and 2017:

Particulars	2017 Rs.	2016 Rs.
I. Equity and Liabilities		
Equity share capital	4,00,000	3,00,000
Reserves and surplus	1,50,000	1,00,000
Loan from IDBI	3,00,000	1,00,000
Short-term borrowings	70,000	50,000
Trade payables	60,000	30,000
Short-term provisions	10,000	20,000
Other current liabilities	1,10,000	1,00,000

Total	11,00,000	7,00,000
II. Assets		
Fixed assets	4,00,000	2,20,000
Non-current investments	2,25,000	1,00,000
Current investments	80,000	60,000
Stock	1,05,000	90,000
Trade receivables	90,000	60,000
Short term loans and advances	1,00,000	85,000
Cash and cash equivalents	1,00,000	85,000
Total	11,00,000	7,00,000

Prepare comparative Balance Sheet.

Answer:

Comparative Balance Sheet
as on March 31, 2016 and 2017

Particulars	2016 (Rs)	2017 (Rs)	Absolute Change	Percentage Change
I. Equity and Liabilities				
1. Shareholder's Fund				
a. Equity Share Capital	3,00,000	4,00,000	1,00,000	33.3
b. Reserves and Surplus	1,00,000	1,50,000	50,000	50

2. Non-Current Liabilities				
a. Long Term Borrowings (Loan from IDBI)	1,00,000	3,00,000	2,00,000	200
3. Current Liabilities				
a. Short Term Borrowings	50,000	70,000	20,000	40
b. Trade Payables	30,000	60,000	30,000	100
c. Short Term Provisions	20,000	10,000	(10,000)	(50)
d. Other Current Liabilities	1,00,000	1,10,000	10,000	10
Total	7,00,000	11,00,000	4,00,000	57.14
II. Assets				
1. Non-Current Assets				
a. Fixed Assets	2,20,000	4,00,000	1,80,000	81.8

b. Non-Current Investments	1,00,000	2,25,000	1,25,000	125
2. Current Assets				
a. Current Investments	60,000	80,000	20,000	33.3
b. Inventories (Stock)	90,000	1,05,000	15,000	16.6
c. Trade Receivables	60,000	90,000	30,000	50
d. Short Term Loans and Advances	85,000	1,00,000	15,000	17.65
e. Cash and Cash Equivalents	85,000	1,00,000	15,000	17.65
Total	7,00,000	11,00,000	4,00,000	57.14

Question 3

Prepare Comparative Statement of profit and loss from the following information.

Particulars	2016-17 Rs.	2015-16 Rs.
Freight Outward	20,000	10,000
Wages (office)	10,000	5,000
Manufacturing Expenses	50,000	20,000

Stock adjustment	(60,000)	30,000
Cash purchases	80,000	60,000
Credit purchases	60,000	20,000
Returns inward	8,000	4,000
Gross profit	(30,000)	90,000
Carriage outward	20,000	10,000
Machinery	3,00,000	2,00,000
Charge 10% depreciation on machinery	10,000	5,000
Interest on short-term loans	20,000	20,000
10% debentures	20,000	10,000
Profit on sale of furniture	20,000	10,000
Loss on sale of office car	90,000	60,000
Tax rate	40%	50%

Answer:

Comparative Income Statement
for the year ended March 31, 2016 and 2017

Particulars	Note No.	2015-16 (Rs)	2016-17 (Rs)	Absolute Change (Rs)	Percentage Change
1. Revenue from Operations		2,16,000	92,000	(1,24,000)	(57.4)
2. Other Income		10,000	20,000	10,000	100
3. Total Revenue (1 + 2)		2,26,000	1,12,000	(1,14,000)	(50.44)

4. Expense				
s				
a. Purchases of Stock-in-Trade	80,000	1,40,000	60,000	75
b. Change in Inventories	30,000	(60,000)	(90,000)	(300)
c. Employee Benefit Expenses	5,000	10,000	5,000	100
d. Finance Costs	21,000	22,000	1,000	4.54
e. Depreciation and Amortisation Expenses	5,000	10,000	5,000	100
f. Other Expenses	80,000	1,30,000	50,000	62.5
Total Expenses	2,21,000	2,52,000	31,000	14.03
5. Profit before Tax (3 – 4)	5,000	(1,40,000)	(83,000)	16.6

<i>Less:</i> Income Tax	2,500	-	(2,500)	(100)
6. Profit After Tax	2,500	(1,40,000)	(1,37,500)	55

Working Notes:

1. Calculation of Net Sales

Net Sales = Cost of Goods Sold + Gross Profit - Sales Return

or, Net Sales = Purchases + Manufacturing Expenses + Change in Inventory + Gross Profit - Sales Return

Net Sales (2016) = 80,000 + 20,000 + 30,000 + 90,000 - 4,000 = Rs 2,16,000

Net Sales (2017) = 1,40,000 + 50,000 - 60,000 - 30,000 - 80,000 = Rs 92,000

2. Calculation of Finance Cost

Finance Cost = Interest on short-term loans + Interest on 10% Debentures

Finance Cost (2016) = 20,000 + 1,000 = Rs 21,000

Finance Cost (2017) = 20,000 + 2,000 = Rs 22,000

3. Calculation of Other Expenses

Other Expenses = Freight Outward + Carriage Outward + Loss on sale of office car

Other Expenses (2016) = 10,000 + 10,000 + 60,000 = Rs 80,000

Other Expenses (2017) = 20,000 + 20,000 + 90,000 = Rs 1,30,000

Question 4

Prepare Comparative Statement of Profit and Loss from the following information:

Particulars	2015-16 Rs.	2016-17 Rs.
Manufacturing expenses	35,000	80,000
Opening stock	30,000	60% of closing stock
Sales	9,60,000	4,50,000
Returns outward	4,000 (out of credit purchase)	6,000 (out of cash purchase)
Closing stock	150% of opening stock	1,00,000
Credit purchases	1,50,000	150% of cash purchase
Cash purchases	80% of credit purchases	40,000
Carriage outward	10,000	30,000
Building	1,00,000	2,00,000
Depreciation on building	20%	10%
Interest on bank overdraft	5,000	-
10% debentures	2,00,000	20,00,000*
Profit on sale of copyright	10,000	20,000
Loss on sale of personal car	10,000	20,000

Other operating expenses	20,000	10,000
Tax rate	50%	40%

Answer:

Comparative Income Statement
for the years ended March 31, 2016 and 2017

Particulars	Note No.	2015-16 (Rs)	2016-17 (Rs)	Absolute Change (Rs)	Percentage Change
1. Revenue from Operations		9,60,000	4,50,000	(5,10,000)	(53.13)
2. Other Income		10,000	20,000	10,000	100
3. Total Revenue (1 + 2)		9,70,000	4,70,000	(5,00,000)	(51.55)
4. Expenses					
a. Purchases of Stock-in-Trade		2,66,000	94,000	(1,72,000)	(64.7)
b. Change in Inventories		(15,000)	(40,000)	(55,000)	(366.7)

c. Finance Costs	25,000	20,000	(5,000)	(20)
d. Depreciation and Amortisation Expenses	20,000	20,000	-	-
e. Other Expenses	30,000	40,000	10,000	33.33
Total Expenses	3,26,000	1,34,000	(1,92,000)	58.90
5. Profit before Tax (3 – 4)	6,44,000	3,36,000	(3,08,000)	47.83
<i>Less:</i> Income Tax	3,22,000	1,34,400	(1,87,600)	58.26
6. Profit After Tax	3,22,000	2,01,600	1,20,400	37.39

Working Notes:

1. Calculation of Net Purchases and Change in Inventory

2. Calculation of Finance Cost

Finance Cost = Interest on Bank Overdraft + Interest on Debentures

Finance Cost (2016) = 5,000 + 20,000 = Rs 25,000

Finance Cost (2017) = 0 + 20,000 = Rs 20,000

3. Calculation of Other Expenses

Other Expenses = Carriage outward + Other operating expenses

Other Expenses (2016) = 10,000 + 20,000 = Rs 30,000

Other Expenses (2017) = 30,000 + 10,000 = Rs 40,000

Question 5

Prepare a Common-size statement of profit and loss of Shefali Ltd. with the help of following information:

Particulars	2015-16 Rs.	2016-17 Rs.
Sales	6,00,000	8,00,000
Gross profit	50% of sales	45% of sales
Indirect expense	25% of gross profit	25% of gross profit
<i>Less: Cost of goods sold</i>	4,28,000	7,28,000
Other incomes	10,000	12,000
Income tax	30%	30%

Answer:

Common Size Income Statement

for the years ended March 31, 2016 and 2017

Particulars	Note No.	2015-16 (Rs)	2016-17 (Rs)	Percentage of Sales	
				2015-16	2016-17

1. Revenue from Operations	6,00,000	8,00,000	100	100
2. Other Income	10,000	12,000	1.67	1.5
3. Total Revenue (1 + 2)	6,10,000	8,12,000	101.67	101.5
4. Expenses				
a. Cost of Goods Sold	4,28,000	7,28,000	71.33	91
b. Other Expenses	75,000	90,000	12.50	11.25
Total Expenses	5,03,000	8,18,000	83.83	102.25
5. Profit before Tax (3 – 4)	1,07,000	(6,000)	17.83	(0.75)
<i>Less:</i> Income Tax	32,100	-	5.35	-
6. Profit After Tax	74,900	(6,000)	12.48	(0.75)

Working Notes:

1. Calculation of Other Expenses

Other Expenses = Indirect Expenses = % of Gross Profit

2016 = $6,00,000 \times 50\% \times 25\% = \text{Rs } 75,000$ 2017 = $8,00,000 \times 45\%$

$\times 25\% = \text{Rs } 90,000$ 2016 = $6,00,000 \times 50\% \times 25\% = \text{Rs } 75,000$ 201

7 = $8,00,000 \times 45\% \times 25\% = \text{Rs } 90,000$

Question 6

Prepare a Common Size balance sheet from the following balance sheet of Aditya Ltd. and Anjali Ltd.:

Particulars	Aditya Ltd. Rs.	Anjali Ltd. Rs.
I. Equity and Liabilities		
a) Equity share capital	6,00,000	8,00,000
b) Reserves and surplus	3,00,000	2,50,000
c) Current liabilities	1,00,000	1,50,000
Total	10,00,000	12,00,000
II. Assets		
a) Fixed assets	4,00,000	7,00,000
b) Current assets	6,00,000	5,00,000
Total	1,00,0000*	12,00,000

*The total of Liabilities side must be equal to the total of Assets side, therefore, it should be 10,00,000.

Answer.

Common Size Balance Sheet

Particulars	Aditya Ltd. (Rs)	Anjali Ltd. (Rs)	% of Total	
			Aditya Ltd.	Anjali Ltd.
I. Equity and Liabilities				

1. Shareholder's Fund				
a. Equity Share Capital	6,00,000	8,00,000	60	66.67
b. Reserves and Surplus	3,00,000	2,50,000	30	20.83
2. Current Liabilities	1,00,000	1,50,000	10	12.5
Total	10,00,000	12,00,000	100	100
II. Assets				
1. Non-Current Assets				
a. Fixed Assets	4,00,000	7,00,000	40	58.33
2. Current Assets	6,00,000	5,00,000	60	41.67
Total	10,00,000	12,00,000	100	100