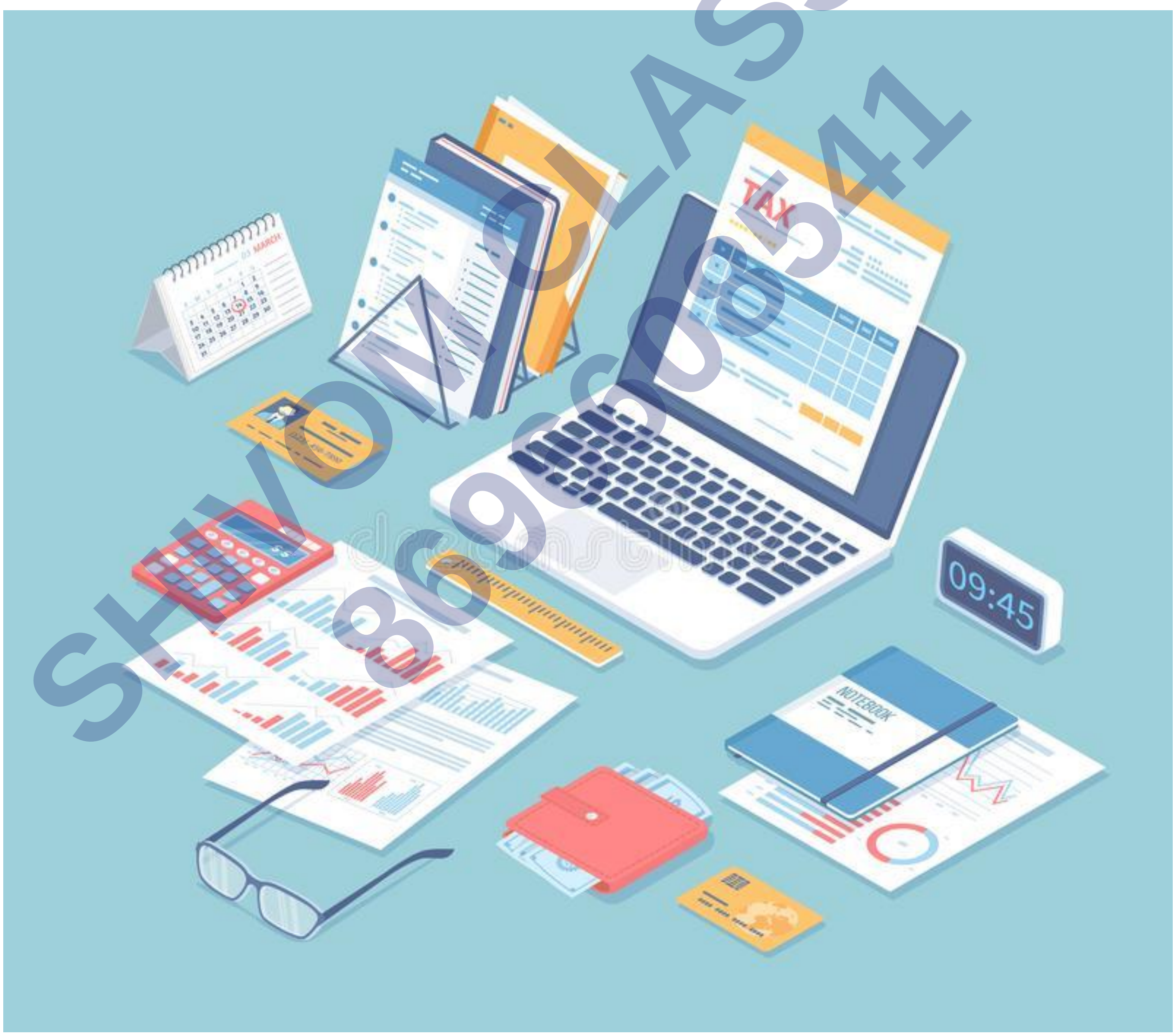
ACCOUNTANCY

Chapter 9: Analysis Of Financial Statements



ANALYSIS OF FINANCIAL STATEMENTS

Introduction to Financial Statement Analysis

Meaning and Definition:

- **Meaning:**
  i. It is a systematic process of dividing the financial information into simple and valuable elements, establishing relationships between inter-related elements and interpreting the same to understand the working and financial position of an enterprise from its financial statements.
  ii. It includes analysis of Statement of Profit and Loss, Balance Sheet and Cash Flow Statement of an enterprise.
  iii. It provides information to understand complex financial data and helps in taking appropriate financial decisions.
- **Understanding Analysis and Interpretation:** These two terms in understanding the meaning of financial statement analysis are complementary to each other and therefore, analysis cannot be complete without interpretation.
  i. **Analysis:** It is concerned with simplification of financial data by proper classification of given in the financial statement.
  ii. **Interpretation:** It is concerned with explaining the meaning and significance of the financial data.
- **Definition of Financial Statement Analysis:**
  i. **As per Myer:** Financial Statement Analysis is largely a study of relationships among the various financial factors in a business, as disclosed by a single set of statements, and a study of trends of these factors, as shown in a series of statements.
- **Objectives of Financial Analysis:**

  Following are the Purposes (Objectives) and Significance of Financial Analysis:

  i. **To Assess the Earning Capacity or Profitability:** Earning Capacity and Profitability of the enterprise can be assessed from the financial statement analysis. It also facilitates forecasting of the same for the future years. External users are interested in earnings and hence, this is their prime objective of analysing financial statement.
  ii. **To Assess the Managerial Efficiency:** This assessment is possible because financial

statement analysis identifies the areas where managers have been efficient and where not. Favourable and unfavourable variations can be identified to pinpoint the managerial inefficiency.

iii. **To Assess the Short-term and Long-term Solvency of the Enterprise:** This assessment is possible by analysing the financial statements minutely. Creditors or suppliers are interested to know the ability of the entity to meet the short-term liabilities and Debentureholders and lenders are interested to know the long term and short term solvency of the enterprise to assess the ability of the company to repay the principal and interest thereon.

iv. **To facilitate Inter-firm Comparison:** Inter-firm Comparison helps an enterprise to assess its own performance as well as that of others if mergers and acquisitions are to be considered.

v. **To Forecast and Prepare Budgets:** Analysis of historical data in the financial statements helps in assessing developments in future. It facilitates forecasting and preparing budgets for the future years.

vi. **To Understand Complicated Matter:** Financial Statement analysis helps the users in understanding the complicated matter. This can be facilitated by using charts, graphs and diagrams which are easy to explain and understand.

- **Uses of Financial Analysis:**

Financial Statements Analysis assists in making accurate decisions in various areas which are as follows:

i. **Security Analysis:** It is a process used by the investor to identify whether the firm is fulfilling his expectations with regard to dividends, capital appreciation, etc. Such analysis is done by a security analyst who is interested in cash generating ability, dividend pay-out policy and the behaviour of share prices.

ii. **Credit Analysis:** It is useful when a firm or bank offers credit to a new customer or a dealer. Management is always interested to know credit worthiness of client so as to take decisions regarding whether to allow or extend credit to them or not.

iii. **Debt Analysis:** It is useful when a firm wants to know its borrowing capacity.

iv. **Dividend Decision:** It is useful in determining the rate of dividend in order to decide how much of the earnings are to be distributed in the form of dividends and how much is to be retained. Dividend decisions have a direct impact on profitability of the firm and behaviour of its share prices so are to be taken wisely using Financial Statement Analysis.

v. **General Business Analysis:** It is useful in identifying the key profit drivers and business risks in order to assess the profit potential of the firm and also assist in future growth scenarios.

- **Parties Interested in Financial Analysis:**

Following are the parties interested in the analysis of Financial Statements:

i. **Management:** Financial analysis helps the management to ascertain overall as well as segment- wise efficiency of the business. It also helps in decision making, controlling and self-evaluation.

ii. **Employees and Trade Unions:** Financial Analysis is considered helpful for employees to get a clear idea of the emoluments, bonus, working conditions and security of their jobs by analysing profitability, sustainability and financial position of the enterprise from its financial statements. In order to take proper decisions and enter into beneficial wage agreements, trade unions also analyse financial statements to determine the degree of profitability of the enterprise based on which they can further negotiate.

iii. **Shareholder or Owners or Investors:** These are the investors who invest or contribute their savings in the form of capital. Therefore, they are interested in the returns of the business which can be ascertained from the profitability of the business. Also, growth potential helps in investment appreciation.

iv. **Potential Investors:** These are those who are interested to know the present profitability and the financial position as well as future prospects to make their mind on investment into business concern.

v. **Suppliers or Creditors:** This set of interested users are concerned whether the enterprise can make timely payments of the amounts due on account of credit transactions done with them and also whether to extend further credit to such enterprise. Such decision is based on the short term solvency of the enterprise which can be determined by analysing the financial statements of the enterprise.

vi. **Bankers and Lenders:** These are those parties to an enterprise who provide funds in the form of loans which is repayable at the end of a pre-determined term. In order to identify the repaying capacity of the enterprise, such parties should have a clear idea of the long-term solvency of the enterprise. Such information is obtained by analysing financial statements of respective enterprise.

vii. **Researchers:** Parties engaged into research activity and wish to perform the same over the business entities so as to analyse the profitability, growth and financial position of an enterprise. To gather information on such areas, they are interested in analysing respective aspects of such areas which includes data related to business operations, finance, human resource, etc.

viii. **Tax Authorities:** Tax Authorities are interested in ensuring proper assessment of tax liabilities of the enterprise as per the tax laws in force from time to time.

ix. **Customers:** Customers have an interest in information about the continuance of an enterprise. This is particularly when they are either dependent on the enterprise or they have a long term involvement with the enterprise.

Types of Financial Statement Analysis

Classification of Financial Statement Analysis:

- **Financial Statement Analysis is of 4 types as follows:**

  i. **External Analysis:** This type of analysis is done by investors, credit agencies, researchers, etc. who do not have access to the confidential and complete records of an enterprise and therefore, have to depend on information published in various statements or reports which shall comprise of Statement of Profit and Loss, Balance Sheet, Auditor's Reports etc.

  ii. **Internal Analysis:** This is a detailed and accurate type of analysis done by the management of the enterprise to determine the financial position and operational efficiency of the organisation. Since, management has access of complete information, they perform an extensive type of analysis which is more detailed and accurate.

  iii. **Horizontal Analysis:** It is also known as Dynamic Analysis. It is done to review and analyse financial statement for a number of years and hence, is also known as time series analysis. It facilitates comparison of financial data for several years against a chosen base year.

  iv. **Vertical Analysis:** It is also known as Static Analysis. It is done to review and analyse the financial statements of one year only. It is useful in comparing the performance of several companies of the same type or divisions or departments in one enterprise.

- **Differences between Horizontal Analysis and Vertical Analysis:**

  Following are the points of differences between Horizontal Analysis and Vertical Analysis:

Basis	Horizontal Analysis	Vertical Analysis
1. Period	It requires comparative financial statements of two or more accounting periods.	It requires financial statement of one period.
2. Components or items	It deals with same item of different period.	It deals with different items of same period.
3. information	Information is provided in absolute and percentage terms.	It provides information in percentage terms.
4.Usefulness	It is useful for Time Series Analysis.	It is generally used for Cross Sectional Analysis.

- **Understanding Inter-firm and Intra-firm Analysis:**

    i. **Inter-firm Analysis:** It facilitates a comparison of two or more firms based on the various financial factors or variables that will help decide the competitiveness of the respective firms. A comparison of a single set of statements of two or more firms is termed as Cross-sectional Analysis.

    ii. **Intra-firm Analysis:** It facilitates a comparison of the various financial variables of an enterprise over a period of time and therefore, it is also known as Time Series Analysis or Trend Analysis. It helps analysing performance of an enterprise over a period of time.

Process of Financial Statement Analysis

Following are the main functions that are used in the process of analysis and interpretation of Financial Statement.

i. **Rearrangement of Financial Statements:** It is necessary to reclassify the complex data contained in the financial statement into purposive classes so that maximum desired information from every data for analysis can be obtained.

ii. **Comparison:** Once the classification of the complex data is done, it is necessary to obtain comparative data of the same enterprise of the past periods if it is a time series analysis. If it is a cross sectional analysis, it is necessary to obtain comparative data of the same accounting period of similar or comparable enterprises.

iii. **Analysis:** The comparative financial data is then analysed with reference to financial characteristics like profitability, solvency and liquidity.

iv. **Interpretation:** This is the concluding part of the financial statement analysis. The interpretation should be precise and directed towards indicating the movement if various financial characteristics.

Tools or Techniques of Financial Statement Analysis

Following are the Tools or Techniques used to Analyse Financial Statements:

- **Comparative Statements:**
  i. It means a comparative study of individual components or elements or items of Balance Sheet and Statement of Profit or Loss for two or more years.
  ii. At first, the value of each component or element or item of two or more financial years is placed alongside each other.
  iii. After this, differences between the two amounts is determined.
  iv. Lastly percentage change in the amount from the base year is ascertained.
  v. Such comparative statements can be Intra-Firm or Inter-Firm Comparisons.
- **Common Size Financial Statements:**
  i. It is a vertical analysis of Financial Statements in which amounts of individual items of Balance Sheet or Statement of Profit or Loss are written. These amounts are further converted into percentages to a common base.
  ii. These percentages can be compared with the corresponding percentages in other periods and meaningful conclusions can be drawn.
  iii. Such statements may be prepared for intra-firm and inter-firm comparison.
  iv. Such statements may be prepared for Balance Sheet as well as Income Statement.
- **Ratio Analysis:**
  i. It is a study of relationship among various financial factors in a business.
  ii. It is a technique of analysing the financial statements with the help of accounting ratio.
  iii. It is a process of determining and interpreting relationships between items of financial statements to provide a meaningful understanding of the financial performance and position of an enterprise.
- **Cash Flow Statement:**
  i. It is a statement that shows the inflows and the outflows of Cash and Cash Equivalents during the period.
  ii. Inflows are those transactions that increase the Cash and Cash Equivalents and

outflows are those transactions that decrease the Cash and Cash Equivalents.

iii. Such statement is prepared in accordance with the Accounting Standard-3(Revised) on Cash Flow Statement. As per this accounting standard, cash flows are showed under the following 3 heads:

   a. Cash Flow from Operating Activities;

   b. Cash Flow from Investing Activities; and

   c. Cash Flow from Financing Activities.

Limitations of Financial Statement Analysis

Following are the limitations of Financial Statement Analysis:

i. **Historical Analysis:** Financial Statements are prepared using the historical information of the financial transactions that have already taken place. As a result financial statements are correctly termed as a historical records of financial transactions. Analysis of such transactions is therefore, a historical analysis. Therefore, the statement is incorrect as it makes reference to use of future data.

ii. **Price Level Changes are not considered:** If there is a change in the price level, analysis of financial statements of different accounting years become invalid as accounting records ignore change in value of money.

iii. **Qualitative Aspect Ignored:** Financial Statements record only monetary transactions which are quantitative in nature. Other important qualitative elements which affect the financial statements are not considered.

iv. **Financial Statements Limitations:** Financial Statements are not always accurate and are subject to some limitations. Since, analysis is based on the information provided by financial statements, such limitations will therefore, have an impact on the decisions taken based on the analysis of information provided by such financial statement.

v. **Not free from bias:** Financial statements are the outcome of accounting concepts and conventions combined with estimates. Estimates cannot be relied upon completely as there are chances that the amounts may fluctuate and hence, are not free from bias. Therefore, the financial statements are not completely reliable.

vi. **Accounting Practices:** In order to compare the profitability and the financial position of different firms, it is necessary that these firms follow same accounting practices. If different accounting practices are followed, inter-firm comparison is not possible.

vii. **Window Dressing:** It refers to the presentation of a better financial position than what it actually is by way of manipulating the books of accounts. Such false representation will provide misleading information for analysis which will result in wrong decision making.

viii. **Symptoms:** Financial statements analysis facilitates identifying symptoms or problems but it fails to provide solution or remedy for the same. Rectification of the error or problem has to be taken care of by the management based on their respective analysis.

Introduction to Comparative Statements

Meaning, Objectives, Importance, Tools for Comparison and Limitations:

- **Meaning:** Comparative Statements or Comparative Financial Statements:
  i. It means a comparative study of components or elements or items of Balance Sheet and Statement of Profit or Loss for two or more years.
  ii. At first, the value of each component or element or item of two or more financial years is placed alongside each other.
  iii. After this, differences between the two amounts is determined.
  iv. Lastly percentage change in the amount from the base year is ascertained.
  v. Such comparative statements can be Intra-Firm or Inter-Firm Comparisons.
- **Objectives:** Following are the Purposes or Objectives of Comparative Financial Statements:
  i. **Data Presentation becomes Simple and Comparable:** It is a statement with data for two or more years in a tabular form. Such tabular representation makes the data simple, understandable and comparable for drawing appropriate conclusions from the complex information.

  ii. **Indicates Trend:** It gives information about the changes affecting financial position and performance of an enterprise. It helps in forecasting by the way of indicating the trend.

  iii. **Indicates Strengths and Weaknesses:** It indicates the strengths and weaknesses of the enterprise with respect to liquidity, profitability and solvency.

  iv. **Comparison with other Firms and Industry Performance:** It helps in comparison of an enterprise's performance with that of other enterprises or with that of the industry.

  v. **Forecasting and Planning:** Analysing changes and trend in the financial data of previous years helps the management in forecasting and planning.

- **Importance:** Comparative Financial Statements is a tool of financial analysis that shows change in each item from the base year in absolute amount and in percentage, taking the amounts for the preceding or previous accounting period as the base. Therefore, preparation of such statement is important because for the following different reasons:

  i. **Shareholders:** It provides meaningful information to the shareholders. Such statements are important to the shareholders being the owners of the company in making the timely decisions whether to hold the shares or sell them.

  ii. **Decisions and Plans:** Such statements are important to the management of the company to take proper decisions and to formulate plans and policies accordingly.

  iii. **Lenders:** These are the funds providers in the form of loan. In order to evaluate as to whether the loan is safe, whether any further loan is to be made and at what rate, such statements are important information providers to the lenders.

  iv. **Investment Decision:** Such statements are important to the potential investors to decide whether to invest in the company's share. From such statements they can obtain the useful information to take appropriate investment decisions.

- **Limitations of Comparative Statements:** These are same as limitations of financial statements which are as follows:

  i. **Historical Records:** Financial Statements provide information which is historical in nature and therefore, it is not useful for the potential investors or lenders as it does not provide any information of the future business or its future financial position.

  ii. **Affected by Estimates and Personal Judgement:** Financial Statements are the outcome of accounting concepts and conventions combined with estimated and are therefore, not free from bias.

  iii. **Different Accounting Practices:** Financial Statements can be drawn up on the basis of different accounting practices. Profitability determined by each of these practise will be different and hence, there is no standard practice which can be followed by all.

  iv. **Qualitative Elements are ignored:** Financial Statements are based completely on monetary items and therefore, many non-monetary important factors which affect the profitability of the business are ignored.

  v. **Price Level Changes are ignored:** Financial Statements follow the historical cost concept for showing assets at their historical cost. Because of such practices, current market value is not taken into consideration.

vi. **Cannot Meet the Purpose of all Parties:** Financial Statements for a period are used by a number of interested users for various purposes and interests. It is not possible to meet the purpose of all interested parties.

vii. **Aggregate Information:** Financial Statements show aggregate information and not detailed information and hence, it is not that useful for the users in decision making.

- **Tools or Techniques for Comparison of Financial Statements:** In order to compare the financial statements of any entity, following tools or techniques are to be used:

  i. Comparative Statement of Profit and Loss (Income Statement),

  ii. Comparative Balance Sheet,

  iii. Common-size Statement of Profit and Loss (Income Statement), and

  iv. Common-size Balance Sheet.

Introduction to Comparative Balance Sheet

Meaning, Advantages, Preparation and Format of Comparative Balance Sheet:

- **Meaning:**

  i. It is a statement which is used for comparing the assets, liabilities and capital and ascertaining increase or decrease in those items.

  ii. It is horizontal analysis of Balance Sheet in which each item of assets, equity and liabilities is analysed horizontally for two or more accounting periods.

- **Advantages:**

  i. **Realistic Approach:** This statement not only shows the balances of accounts at different dates but also the extent of their increase and decrease between these different dates.

  ii. **Tracks Changes:** It gives more importance to the changes that are tracked between different dates rather than the figures derived on a particular date.

  iii. **Shows Trends:** It helps in identifying an increasing or decreasing trend over a period of time along with the nature, size and direction of change in various items.

  iv. **Assists in Planning:** It shows an increasing or decreasing trend in the assets, liabilities and capital of the entity over a period of time which helps in designing effective plans for the entity as a whole.

v. **Links Income statement and Balance Sheet:** It shows the impact of various business operations on the assets, liabilities and capital of an entity over a period of time.

- **Preparation:** A Comparative Balance Sheet has six columns as follows:

i. **First Column:** In this column, the components or elements or items of Balance Sheet are written.

ii. **Second Column:** In this column, the Note No. given against the line item in Balance Sheet is written.

iii. **Third Column:** In this column, amounts of previous year are written.

iv. **Fourth Column:** In this column, amounts of current year are written.

v. **Fifth Column:** In this column, differences i.e., increase or decrease in amounts between the current and previous year are shown.

vi. **Sixth Column:** In this column, the difference of amount in column 5 (increase or decrease) is expressed as a percentage, taking column 3 (previous year's amount) as the base.

$$\text{Percentage Change} = \frac{\text{Absolute Change}}{\text{Amount of Previous Year}} \times 100 = \underline{\quad\quad}\%$$

- **Format:**

COMPARATIVE BALANCE SHEET AS AT….

Particulars	Note No.	Previous Year ₹	Current Year ₹	Absolute Change ₹	Percentage Change %
		(A)	(B)	(C=B-A)	(D=C/A*100)
(1)	(2)	(3)	(4)	(5)	(6)
I. EQUITY AND LIABILITIES					
1. Shareholders' Funds					
a) Share Capital:					
i. Equity Share Capital		…	…	…	…
ii. Preference Share Capital		…	…	…	…
b) Reserves and Surplus		…	…	…	…
2. Non-Current Liabilities					
a) Long-term Borrowings		…	…	…	…
b) 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:					
i. Tangible Assets		…	…	…	…
ii. Intangible 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		…	…	…	…

Introduction to Comparative Statement of Profit and Loss

Meaning, Objectives, Preparation and Format of Comparative Statement Profit and Loss:

- **Meaning:**

i. It is a horizontal analysis of Income Statement which shows the operating results for more than one accounting period so that changes in absolute amounts and percentages from one period to another are known.

ii. It will consist of all the items that are present in the normal Income statement like revenue from operations, cost of materials consumed, employee benefit expenses, etc. The methodology or formulae used to compute all these amounts also remains the same.

- **Objectives:** Following are the objectives of preparing Comparative Statement of Profit and Loss:

i. To analyse every item of income and expense of two or more years.

ii. To analyse the increase or decrease in every item of income and expense in absolute and percentage terms in order to identify the trend.

iii. To determine the reasons for such change and improve the trends accordingly to enhance its performance.

- **Preparation of Comparative Statement of Profit and Loss:**

i. **First Column:** In this column, items of revenues and expenses are written.

ii. **Second Column:** In this column, Note No. is given against the item in the Statement of Profit or Loss is written.

iii. **Third Column:** In this column, the amounts of previous year are written.

iv. **Fourth Column:** In this column, the amounts of current year are written.

v. **Fifth Column:** In this column, differences (increase or decrease) in amounts between the current and previous period are recorded.

vi. **Sixth Column:** In this column, the above difference in column 5 (increase or decrease) is expressed as a percentage of column 3 (previous year's amount).

$$\text{Percentage Change} = \frac{\text{Absolute Change}}{\text{Amount of Previous Year}} \times 100 = \underline{\quad\quad} \%$$

- **Format:**

COMPARATIVE STATEMENT OF PROFIT AND LOSS for the years ended…

Particulars	Note No.	Previous Year ₹	Current Year ₹	Absolute Change ₹	Percentage Change %
		(A)	(B)	(C=B-A)	(D=C/A*100)
(1)	(2)	(3)	(4)	(5)	(6)
I. Revenue from Operations II. Other Income		…	…	…	…
III. **Total Revenue (I+II)**		…	…	…	…
IV. **Expenses**					
Cost of Materials Consumed		…	…	…	…
Purchases of Stock-in-Trade		…	…	…	…
Changes in Inventories (Finished goods, Work-in-Progress and Stock-in-Trade)		…	…	…	…
Employee Expenses					
Finance Costs		…	…	…	…
Depreciation Expenses					
Amortisation Expenses		…	…	…	…
Other Expenses		…	…	…	…
Total Expenses		…	…	…	…
V. **Profit before Tax (III-IV)**		…	…	…	…
VI. *Less*: Tax		…	…	…	…
VII. **Profit or Loss for the period (V-VI)**		…	…	…	…

Introduction to Common-Size Statement of Profit and Loss

Meaning of Common Size Financial Statements:

i. It is a vertical analysis of Financial Statements in which amounts of individual items of Balance Sheet or Statement of Profit or Loss are written. These amounts are further converted into percentages to a common base.

ii. These percentages can be compared with the corresponding percentages in other period sand meaningful conclusions can be drawn.

iii. Such statements may be prepared for intra-firm and inter-firm comparison.

iv. Such statements may be prepared for Balance Sheet as well as Income Statement.

Meaning, Objectives, Preparation and Format of Common-Size Statement of Profit and Loss:

- **Meaning of Common Size Statement of Profit and Loss:** A Common-size Statement of Profit and Loss may be prepared for different periods of the firm or for the same period of two firms. It shows the relative efficiency in operating the business.

- **Objectives:** Following are the Objectives of Common-size Statement of Profit and Loss:

  i. To analyse change in individual items of Income Statement.

  ii. To study the trend in different items of Incomes and Expenses.

  iii. To assess the efficiency.

- **Preparation:** Preparation of Common-size Statement of Profit and Loss: Such statement is prepared with the following six columns:

  i. **First Column:** In this column, the items of Statement of Profit and Loss are written.

  ii. **Second Column:** In this column, Note no. given against the item in the Statement of Profit and Loss is written.

  iii. **Third Column:** In this column, amounts of previous year are written if the statement is prepared for different periods of the same firm. If the statement is prepared for two firms, amounts relating to the first firm are written.

  iv. **Fourth Column:** In this column, amounts of current year are written if the statement is prepared for different periods of the same firm. If the statement is prepared for two firms, amounts relating to the other firm are written.

  v. **Fifth Column:** In this column, percentage of different items of Statement of Profit and Loss of the previous year to Revenue from Operations i.e., Net Sales, is written.

  vi. **Sixth Column:** In this column, percentage relation of different items of Statement of Profit and Loss of the Current Year to Revenue from Operations, i.e. Net Sales is written.

- **Format:**

COMMON-SIZE STATEMENT OF PROFIT AND LOSS for the years ended…

Particulars (1)	Note No. (2)	Absolute Amounts		Percentage of Revenue from Operations (Net Sales)	
		Previous Year ₹ (3)	Current Year ₹ (4)	Previous Year % (5)	Current Year % (6)
I. Revenue from Operations (Net Sales)		…	…	100	100
II. Other Income		…	…	…	…
III. **Total Revenue (I+II)**		…	…	…	…
IV. **Expenses**					
Cost of Materials Consumed		…	…	…	…
Purchases of Stock-in-Trade		…	…	…	…
Changes in Inventories (Finished goods, Work-in-Progress and Stock-in-Trade)		…	…	…	…
Employee Expenses		…	…	…	…
Finance Costs		…	…	…	…
Depreciation Expenses		…	…	…	…
Amortisation Expenses		…	…	…	…
Other Expenses					
Total Expenses		…	…	…	…
V. **Profit before Tax (III-IV)**		…	…	…	…
VI. *Less*: Tax		…	…	…	…
VII. **Profit or Loss for the period (V-VI)**		…	…	…	…

Introduction to Common-Size Balance Sheet

Meaning, Objectives, Preparation and Format of Common-Size Balance Sheet:

- **Meaning:**

  i. It shows the percentage relation of each asset/liability to total assets/total liabilities including capital i.e., equity and liabilities.

  ii. In this statement, total assets or total equity and liabilities are taken as 100 and all the figures are expressed as percentage of the total.

iii. If such statement is prepared for different periods, it helps in highlighting the trends in different items.

iv. If it is prepared for different firms in an industry, it facilitates to assess the relative financial soundness and helps in understanding their financial strategy.

- **Objectives:** Following are the Objectives of Common-size Balance Sheet:

i. To analyse the changes in individual items of Balance Sheet.

ii. To see the trend of different items of assets, equity and liabilities.

iii. To assess the financial soundness and understand financial strategy.

- **Preparation:** Following 6 columns are required in preparation of Common-size Balance Sheet:

i. **First Column:** In this column, items of Balance Sheet are written.

ii. **Second Column:** In this column, Note No. given against the line item is written.

iii. **Third Column:** In this column, amounts of different items (assets/liabilities) of previous year are written.

iv. **Fourth Column:** In this column, amounts of different items (assets/liabilities) of current year are written.

v. **Fifth Column:** In this column, percentage relation of different items of previous year's Balance Sheet to total Equity and Liabilities/Total Assets (taken as 100) are written.

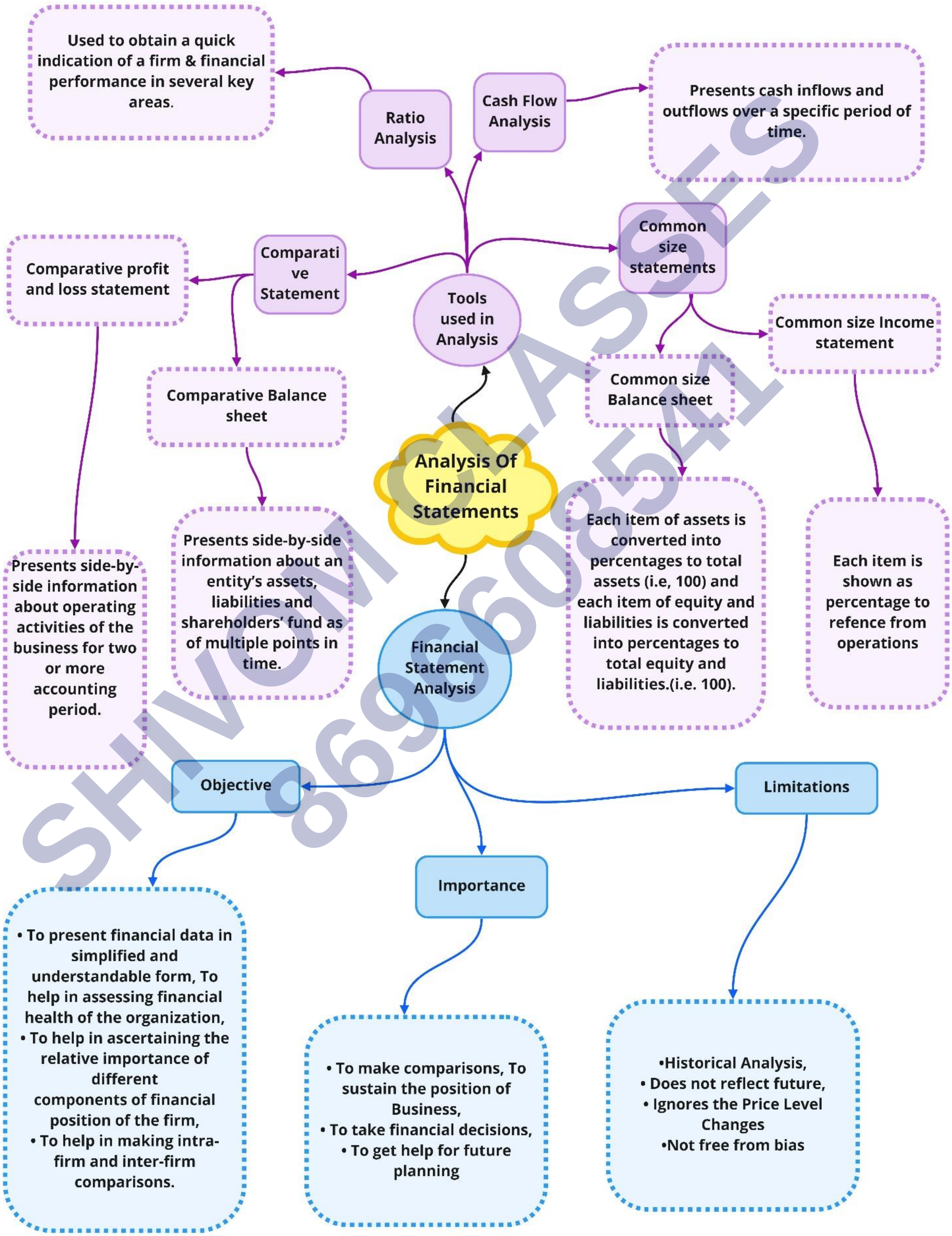
vi. **Sixth Column:** In this column, percentage relation of different items of current year's Balance Sheet to total Equity and Liabilities/ Total Assets (taken as 100) are written.

- **Format:**

COMMON-SIZE BALANCE SHEET as at ….

Particulars (1)	Note No. (2)	Absolute Amounts		Percentage of Revenue from Operations (Net Sales)	
		Previous Year ₹ (3)	Current Year ₹ (4)	Previous Year % (5)	Current Year % (6)
I. EQUITY AND LIABILITIES					
1. Shareholders' Funds					
a) Share Capital					
i. Equity Share Capital		…	…	…	…
ii. Preference Share Capital		…	…	…	…
b) Reserves and Surplus		…	…	…	…
2. Non-Current Liabilities					
a) Long-term Borrowings		…	…	…	…
b) Long-term Provisions		…	…	…	…
3. Current Liabilities					
a) Short-term Borrowings		…	…	…	…
b) Trade Payables		…	…	…	…
c) Other Current Liabilities		…	…	…	…
d) Short-term Provisions		…	…	…	…
Total		**…**	**…**	**100**	**100**
III. ASSETS					
1. Non-Current Assets					
a) Fixed Assets:					
i. Tangible Assets		…	…	…	…
ii. Intangible 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		**…**	**…**	**100**	**100**

Class : 12th Accountancy
Chapter-9 : Analysis Of Financial Statements



Important Questions

Multiple Choice questions-

Question 1. Which of the following is not recognized as tool for the analysis of financial statements?

(a) Cash Flow Statement

(b) Funds Flow Statement

(c) Trend Analysis

(d) Statement showing distribution of dividends

Question 2. Which of the following is the objective of comparative statement?

(a) To making data simple

(b) To make data comparative

(c) To help in forcasting

(d) To detect financial irregularities

Question 3. Which of the following is not a tool of financial statement analysis?

(a) Cash Flow Statement

(b) Statement showing distribution of dividend

(c) Ratio Analysis

(d) Comparative Financial Statements

Question 4. Which of the following objectives is not met by comparative statement of Profit and Loss?

(a) It helps to compare the figures of atlest two years

(b) It helps to assess absolute changes

(c) It helps to know the changes in the financial position

(d) It helps to know the percent changes in the statement of Profit and Loss

Question 5. Financial analysis can be done with which of the following tool?

(a) Ratio Analysis

(b) Cash Flow Statement

(c) Comparative Statements

(d) All of the above

Question 6. Analysis of financial statements for two or more years is known as

(a) Horizontal analysis

(b) External analysis

(c) Vertical analysis

(d) Internal analysis

Question 7. Which of the following is not an objective of financial statement analysis?

(a) Efficiency of the Management

(b) Price Level Changes

(c) Profitability of the Enterprise

(d) Solvency of the Enterprise

Question 8. Who of the following has no financial interest in the analysis of financial statements?

(a) Management

(b) Debtor

(c) Creditor

(d) Investor

Question 9. Who has the interest in long-term solvency position of the firm?

(a) Creditors

(b) Bankers providing overdraft facilities

(c) Financial Institutions

(d) Short-term money lenders

Question 10. Which of the following is not a limitation in the analysis of financial statements?

(a) Ignores Price Level Changes

(b) Window Dressing

(c) Financial performance of the firm

(d) Bias of the Analyst

Very Short Questions-

1. State any one limitation of Financial Statement Analysis.
2. State any one objective of analysis of financial statements.
3. State the type of Financial Statement Analysis in which figures of the same items of various years are compared.

4. Which type of financial statement analysis helps a company to establish the relationship between different items financial statement of a same year?

5. "One of the objectives of Financial Statement Analysis is to assess solvency of business". What does the term 'solvency' mean here ?

6. Define financial statement?

7. Which are the statement that is included in the financial statement?

8. What do you mean by gross profit?

9. State the formula to calculate the cost of goods sold?

10. What do you mean by gross profit?

Short Questions-

1. List the techniques of Financial Statement Analysis.
2. Distinguish between Vertical and Horizontal Analysis of financial data.
3. State the meaning of Analysis and Interpretation.
4. State the importance of Financial Analysis?
5. What are Comparative Financial Statements?
6. What do you mean by bills payable?
7. Describe fixed assets?
8. What are the needs to prepare a trading account?
9. From the Balance Sheets for the year ended March 31, 2013 and 2014. prepare the Comparative Balance Sheet of Omega Chemicals Ltd.:

₹ in Lakhs

Particulars	Note No.	2013 (₹)	2014 (₹)
I. EQUITY AND LIABILITIES			
1. Shareholder's Fund			
(a) Share Capital		5	10
(b) Reserves and Surplus		3	2
2. Non-current Liabilities			
(a) Long-term borrowings		5	8
3. Current Liabilities			
Trade Payable		2	4
Total		**15**	**24**

II. ASSETS			
1. Non-current Assets			
(a) Fixed Assets			
– Tangible Assets		14	8
– Intangible Assets		3	2
2. Current Assets			
(a) Inventories		5	4
(b) Cash and Cash Equivalents		2	1
Total		**24**	**15**

Long Questions-

1. Describe the different techniques of financial analysis and explain the limitations of financial analysis.
2. Explain the usefulness of trend percentages in interpretation of financial performance of a company.
3. What is the importance of comparative statements? Illustrate your answer with particular reference to comparative income statement.
4. What do you understand by analysis and interpretation of financial statements? Discuss its importance.
5. State any four limitations of analysis of financial statements.
6. Discuss the need of preparing a balance sheet.
7. What are the objectives of preparing financial statements?

Assertion Reason Questions-

1. For two statements are given-one labelled Assertion and the other labelled Reason. Select the correct answer to these questions from the codes (a), (b), (c) and (d) as given below.
   a. Assertion and Reason both are correct and Reason is the correct explanation of assertion
   b. Assertion and Reason both are correct but Reason is not correct explanation of assertion
   c. Only Assertion is correct.

d. Reason is correct but Assertion is not correct.

Assertion (A): When financial statements of several years are compared against a chosen base year, it is called Dynamic Analysis.

Reason (R): Horizontal analysis is made to review and analyze the financial Statements for a number of years and it is also known as Time Series Analysis.

2. For two statements are given-one labelled Assertion and the other labelled Reason. Select the correct answer to these questions from the codes (a), (b), (c) and (d) as given below.
    a. Assertion and Reason both are correct and Reason is the correct explanation of assertion
    b. Assertion and Reason both are correct but Reason is not correct explanation of assertion
    c. Only Assertion is correct.
    d. Reason is correct but Assertion is not correct

Assertion: Vertical or static Analysis is made to review and analyse the financial statements of one year only, to compare the performance of other firms of the same type or divisions or departments of one firm.

Reason (R): It is a Time Series Analysis

MCQ Answers-

1. Answer: (d) Statement showing distribution of dividends
2. Answer: (d) To detect financial irregularities
3. Answer: (b) Statement showing distribution of dividend
4. Answer: (c) It helps to know the changes in the financial position
5. Answer: (d) All of the above
6. Answer: (a) Horizontal analysis
7. Answer: (b) Price Level Changes
8. Answer: (b) Debtor
9. Answer: (c) Financial Institutions
10. Answer: (c) Financial performance of the firm

Very Short Answers-

1. Answer: Historical Analysis of financial Statement.

2. Answer: To measure earning capacity of business.

3. Answer: Horizontal analysis.
4. Answer: Vertical analysis.
5. Answer: Solvency means ability to pay the debts.
6. Answer: Financial statement is a statement which presents financial profit data and financial status of a company.
7. The two statements that are included in the financial statements are:
    - Balance Sheet
    - Income Statement (Trading and Profit and Loss A/c)
8. Gross profit is the surplus of a selling price of a product over the cost of goods sold.
9. Cost of goods sold = Sales – Gross Profit.
10. Gross profit is the surplus of a selling price of a product over the cost of goods sold

Short Answers-

1. **Most commonly used techniques are:**

   i. Common Size Financial Statements
   ii. Trend Analysis
   iii. Comparative Financial Statements
   iv. Cash Flow Statement
   v. Fund Flow Statement
   vi. Ratio Analysis

2.

Basis of Comparison	Horizontal Analysis	Vertical Analysis
Meaning	It is the comparative evaluation of a financial statement of two or more periods, for calculating relative and absolute variances for every line of item	It is the analysis of financial data which is independent of time and items relating to financial information of company and its impact on the performance of the company.

Purpose	To specify changes in financial performance between two comparable accounting periods	To compare a financial item as a percentage of base figure
Comparison of	Intra-firm comparison	Both intra and inter firm comparison
Usefulness	Growth or decline of an item is represented here	Is useful in predicting and determining the relative proportion of an item of the financial statement to a common item in the financial statement

3. It is a critical and systematic examination of the financial statement. It presents the financial data in a systematic manner and also establishes a cause and effect relationship with all the items of financial statements. Analysis and interpretation is all about presenting financial data which is self-explanatory and easy to understand. It helps users of accounting information in assessing the status of financial performance of the business for a time period and enables them to take proper decision regarding finance policy of the firm.

4. Financial analysis is of great importance for the various users of accounting information. Financial statements such as Balance Sheets, Income sheets and other sources of financial data provide ample information on the various expenses and sources of profit, loss and income which is helpful in determining the financial status of a business. Financial data is not making any meaningful contribution until it is analysed. There are various methods which help in analysing financial statement and make it useful for various accounting users.

   Following reasons are essential for performing financial analysis:

   i. It is very helpful in determining the financial viability and profit earning capacity of the firm.

   ii. It is helpful in evaluating the business solvency in the long term.

   iii. It is useful in comparing the financial status of a firm in comparison to other competitor firms.

   iv. It helps management in decision making, drafting plan and also establish a robust and effective control mechanism.

5. Comparative financial statements refer to statements which enable comparison that is both intra and inter firm and is based over a period of time. These statements help various users of accounting information in evaluating financial progress of a firm in relative terms. These statements express the data in absolute figures or as percentage change and

absolute change that occurs in the item of the financial statement over a period of time. The data presented in financial statements are self-explanatory and easy to understand. When items of the financial statement are treated with the same accounting policies and practices over a fixed period of time, then the comparative data derived from such statements bear meaningful comparisons.

Two common types are:

i. Comparative Income Statement

ii. Comparative Balance Sheet

6. It displays how much money a company has received in credit for services or commodities. This is the amount that the business must pay to the service provider or the supplier of the goods within the stipulated time.
7. Fixed assets are assets that are expected to stay with the company for a long time and are not likely to be transformed into cash quickly. They are employed to generate capital revenue for the company. Land development, plant, machinery, equipment, furniture, and automobiles are only a few examples.
8. The following are the reasons for keeping a trading account:
   i. To keep track of the company's gross profit and gross loss.
   ii. To obtain information on the company's equity.
   iii. It contains information about factory expenses.
   iv. It also informs the company about the direct costs associated with the activity.
9.

Comparative Balance Sheet of Omega Chemicals Ltd.
For the year ending March 31, 2013 and 2014

S. No.	Particulars	March 31, 2013 (₹)	March 31, 2014 (₹)	Absolute Change (Increase or Decrease) (₹)	% Change (Increase or Decrease)
I.	**EQUITY AND LIABILITIES**				
	1. Shareholders' Funds				
	(*a*) Share Capital	5	10	5	50
	(*b*) Reserves and Surplus	3	2	1	33.3
	2. Non-Current Liabilities				
	(*a*) Long-term borrowings	5	8	3	60
	3. Current Liabilities				
	(*a*) Trade Payable	2	4	2	100
	Total	**24**	**15**	**9**	**37.5**
II.	**ASSETS**				
	1. Non-current Assets				
	(*a*) Fixed Assets				
	• Tangible Assets	14	8	6	42.8
	2. Current Assets	3	2	1	33.3
	(*a*) Inventories	5	4	1	20
	(*b*) Cash and Cash Equivalents	2	1	1	50
	Total	**24**	**15**	**9**	**37.5**

Long Answers-

1. **Following different techniques are used for financial analysis:**

   i. **Cash Flow Analysis:** This analysis focuses on the inflow and outflow of cash and cash equivalents from the various activities of a business namely, investing, operating and financing activities during an accounting period. This helps in analysing cash payments and reason of receipt and the respective changes in cash balances during the accounting year.

   ii. **Ratio Analysis:** This method highlights the relationship between items of Balance Sheet and Income Statements. It is helpful in determining efficiency, profitability and solvency of a firm. This analysis expresses the financial items as fraction, percentage or proportion. Also, it determines the qualitative relationship among different financial variables. It also serves as a source of information regarding the performance, viability and financial position of a firm.

iii. **Trend Analysis:** This technique studies the trends in operating performance and financial position of the business over a period of many years in succession. In such study, any particular year is considered as base year and the rest years are expressed as percentage of the base year's figures. It helps in identifying problems and inefficiency along with detecting operating efficiency and financial position of the firm.

iv. **Comparative Statements:** These statements use figures from two accounting periods that helps determine financial position and profitability. It also enables to do intra and inter firm comparison and therefore determine the efficiency of firm in relative terms. It uses both percentage as well as absolute terms. This analysis is known as Horizontal analysis.

v. **Common size Statements:** Common Size Statements are those statements where the items are displayed as percentages of a common base figure instead of absolute figures. It is helpful for proper analysis between companies (inter-firm comparison) or between time periods of the same company (intra-firm comparison). In these statements the relationship between items present in financial statements and common items like balance sheet total and net sales are highlighted in percentage. The analysis based on these statements is called as Vertical Analysis.

It has following limitations:

i. It fails to depict changes in accounting policy and procedures

ii. These statements provide the interim report and hence have incomplete information.

iii. These statements lack the qualitative aspect like growth prospects, managerial efficiency and express only in monetary terms

iv. Financial analysis is based on accounting concepts and conventions and hence are not reliable as it does not take the current market value of items.

v. It involves personal biasness and judgements of the accountant for example in case of depreciation different methods can be charged for same item.

vi. It does not take into account the change in price level. Only nominal values are considered.

2. Trend analysis is a form of analysing financial data and it is expressed as percentage for each year. It helps the accounting user in evaluating financial performance of the business and also form opinion of various tendencies by which businesses can predict future trends.

Importance of trend analysis:

i. Predicting of the trends of business which is forecasting of future trends in business.
ii. Trends are expressed as percentages which is less time consuming and easy to follow.
iii. It becomes a popular financial analysis method due to trends being expressed in percentages which makes evaluating financial performance and operating efficiency of the firm relatively simpler.

iv. It presents a broader picture of the performance of company in terms of finance, viability and efficiency.

3. **Comparative statements have the following importance:**

   i. It presents financial data in a simple form, with year wise data being presented in side by side fashion making the presentation neat and enabling intra and inter-firm comparisons more conclusive.

   ii. Presentation is very effective for drawing insights quickly and easily.

   iii. It assists the management in drafting future plans and forecast trends which is acheived by analysing profitability and operating efficiency of a business over time.

   iv. Comparative analysis helps easy detection of problems. Early detection helps take corrective measures and align the business in meeting the desired target.

4. Financial analysis is of great importance for the various users of accounting information. Financial statements such as Balance Sheets, Income sheets and other sources of financial data provide ample information on the various expenses and sources of profit, loss and income which is helpful in determining the financial status of a business. Financial data is not making any meaningful contribution until it is analysed. There are various methods which help in analysing financial statement and make it useful for various accounting users.

   Following reasons are essential for performing financial analysis:

   i. It is very helpful in determining the financial viability and profit earning capacity of the firm.
   ii. It is helpful in evaluating the solvency of the business in the long term.
   iii. It is useful in comparing the financial status of a firm in comparison to other competitor fims.

   v. It helps management in decision making, drafting plan and also in establishing a robust and effective control mechanism.

5. Limitations of 'Financial Statements Analysis':

   a) Different Accounting Principles and Practices. Financial analysis is subject to limitations inherent in the financial statements like following different accounting principles or practices regarding depreciation methods, inventory valuation and pricing, etc.
   b) Ignores the Quality Elements. Financial statements contain only financial data and exclude from the preview of qualitative information, which cannot be expressed in money terms. Thus, analysis of such financial statements will also lack quality element.
   c) Ignores Price Level Changes. Transactions, in financial statements, are recorded on historical cost basis and generally no adjustment is made for price level changes. Thus, the analysis of

financial statement will not yield comparable results due to lack of adjustments for the price level changes.

d) Affected by Window Dressing. Some firms may resort to window dressing (showing better picture) to cover-up bad financial position. For example, closing stock may be overstated. In such case, the results of analysis will also be misleading.

6. The need and importance of preparing a balance sheet is stated in the following points

i. It helps to ascertain the true financial position of the business at a particular point of time.
ii. It helps in ascertaining the nature and cost of various assets of the business such as the amount of closing stock, amount owing from debtors, amount of fictitious assets, etc.
iii. It helps in determining the nature and amount of various liabilities of the business.
iv. It gives information about the exact amount of capital at the end of the year and the addition or deduction made into it in the current year.
v. It helps in finding out whether the firm is solvent or not. The firm is solvent if the assets exceed the external liabilities. It would be insolvent if opposite is the case.
vi. It helps in preparing the opening entries at the beginning of the next year.

7. The basic objectives of preparing financial statements are

i. To present a true and fair view of the working of the business.
ii. To help to judge the effectiveness of the management.
iii. To provide sufficient and reliable information to various users interested in financial statements.
iv. To facilitate efficient allocation of resources.
v. To disclose various accounting policies.
vi. To provide information about the cash flows.
vii. To provide information about the earning capacity.
viii. To provide financial data on assets (economic resources) and liabilities (obligations) of an enterprise.

Assertion Reason Questions-

1. (a) Assertion and Reason both are correct and Reason is the correct explanation of assertion.
2. (c) Only Assertion is correct.