[Academic Script]

Financial Analysis

Subject:	Business Economics
Course:	B. A. (Hons.), 1st Semester, Undergraduate
Paper No. & Title:	Paper – 103 Fundamentals of Business and Accounting
Unit No. & Title:	Unit – 4 Introduction to Corporate Accounts
Lecture No. & Title:	Lecture – 2 Financial Analysis

Academic Script

1. Introduction

Main branches of accounting are, Financial Accounting, Cost accounting and Management Accounting. Financial accounting deals of recording business transactions and preparing final accounts to measure financial performance and financial position of the business at the end of every accounting period. Cost accounting deals with calculating cost per unit of goods manufactured and services rendered. Management accounting uses data of cost and financial accounting for the purpose of analysis of business performance for the purpose of decision making. Analysis of financial statements is an exercise of management accounting for the purpose of analysis and decision making for management and other stake holders. As it is an analysis of financial performance and position for decision making of its user, it is purely voluntary in nature.

Concept of Financial Statements:

As per Section 2(40) of the Companies Act, 2013, 'Financial Statements' in relation to a company, include the following:

(i) A balance sheet as at the of end of the financial year,

(ii) A statement of profit and loss for the financial year,

(iii) Cash flow statement for the financial year,

(iv) A statement of changes in equity, if applicable, and

(v) Explanatory notes

Concept of Financial Analysis: Financial analysis is the analysis of financial statements with the help of various tools for financial analysis to assess the business or project from the view point of viability, stability, profitability, liquidity and solvency according to some definite plan.

2. Tools for Financial Analysis

1. Comparative Statements
2. Common Size Statements
3. Trend Analysis
4. Ratio Analysis
5. Cash Flow Analysis

1. Comparative Statements: When financial statements figures for two or more years are placed side by side to facilitate comparison, these are called 'Comparative Financial Statements.' It draws conclusions about the profitability and financial health of the business.

Such statement shows absolute figures of various years. It also indicates increase or decrease in figures from one year to another in percentage form in separate column. It provides opinion regarding the progress of the enterprise. When financial statements of two or more years of the same firm are presented and compared, it is known as inter-period comparison or intra-firm comparison. When financial statements of two or more firms are compared over a number of years known as inter firm comparison.

Case study-1 COMPARATIVE ANALYSIS:

Balance sheets of Beta Ltd as at 31st March, 2015 and 2014. You are asked to convert them into comparative balance sheet and analyse the same

Particulars	Note No.	31.3.2015 (INR in	31.3.2014

		Million)	(INR in Million)
I EQUITY AND LIABILITIES: **1. Shareholder's Funds**: a. Share Capital b. Reserve and Surplus **2. Non Current Liabilities**: Long term Borrowings **3.Current Liabilities:** Trade Payables		 2000 9000 6000 4800	 1000 6000 8000 5000
TOTAL		21800	20000
II ASSETS **1. Non Current Assets:** Fixed Assets: i. Tangible Assets ii. Intangible Assets **2. Current Assets** Inventories Trade Receivables Cash & Cash Equivalents		 9000 1800 3000 6000 2000	 8000 2000 4000 5000 1000
TOTAL		21800	20000

Solution:

COMPARATIVE BALANCE SHEET OF BETA LTD

As At 31^{ST} March, 2014 and 2015

Particulars	Not	31.3.2014 (INR in	31.3.2015	Absolute change	Percenta

	e N o.	Million)	(INR in Million)	(Increase or Decrease) (INR in Million)	ge change (Increase or Decrease) %
		2	3	4	5
		A	B	(B-A=C)	C/A x100=D
I EQUITY AND LIABILITIES: **3. Shareholder's Funds**: c. Share Capital d. Reserve and Surplus **4. Non Current Liabilities**: Long term Borrowings **3.Current Liabilities:** Trade Payables		1000 6000 8000 5000	2000 9000 6000 4800	1000 3000 (2000) (200)	100 50 (25) (4)
TOTAL		20000	21800	1800	9
II ASSETS **1. Non Current Assets:** Fixed Assets: iii. Tangible Assets iv. Intangible Assets **2. Current Assets** Inventories Trade Receivables Cash & Cash		8000 2000 4000 5000 1000	9000 1800 3000 6000 2000	1000 (200) (1000) 1000 1000	25 (10) (25) 20 100

Equivalents					
TOTAL		20000	21800	1800	9

Analysis: The Company has increased shareholders' funds and reduced outside liabilities, which ensures solvency and financial soundness. The Company has increased tangible fixed assets and cash and cash equivalent substantially and reduced intangible assets and inventories. It also shows growth in productive assets.

Comparative Income statement or profit and loss account can also be prepared in the same manner.

3. Common size Statements

In these statements, various figures are converted into percentages to some common base. In balance sheet total assets are taken at 100 and all assets are expressed as percentage of the total assets while in case of profit and loss account, net revenue from operations is taken as 100 and all other incomes and expenses are expressed as percentage of net revenue from operations.

This type of analysis is called Vertical Analysis since each accounting variable is analysed vertically.

Case Study-2 Balance sheets of Alpha Ltd as at 31st March, 2015 and 2014. You are asked to convert them into common size balance sheet and analyse the same

Particulars	31.3.2014 (INR in Million)	31.3.2015 (INR in Million)
Share Capital	4800	6000
Reserves & Surplus	5200	7500
Trade Payables	4000	6000
Trade Receivables	5000	6000
Short Term Borrowings	3000	4000
Fixed Assets- Tangible	4000	5000
Long Term loan	3000	1500
Non - Current Investments	6000	9000
Inventory	2000	3000
Cash and Cash Equivalents	3000	2000

Solution:

ALPHA LTD

COMMON SIZE BALANCE SHEET

As at 31st March, 2013 and 2014

Particulars	Note No.	31.3.2014 (INR in Million)	31.3.2015 (INR in Million)	Percentage of Total assets	
				31.3. 2014 %	31.3. 2015 %
I. **EQUITY AND LIABILITIES:** 1.**Shareholders' Funds**:					

(a) Share Capital		4800	6000	24 (4800/ 20000x 100)	24 (6000/ 25000x 100)
(b) Reserve and Surplus		5200	7500	26 (5200/ 20000x 100)	30 (7500/ 25000x 100)
2. Non Current Liabilities:					
Long term Borrowings		3000	1500	15 (3000/ 20000x 100)	6 (1500/ 25000x 100)
3. Current Liabilities:					
Trade Payables		4000	6000	20 (4000/ 20000x 100)	24 (6000/ 25000x 100)
Short term borrowings		3000	4000	15 (3000/ 20000x 100)	16 4000/ 25000x 100)
TOTAL		20000	25000	100	100
II. ASSETS					
1. Non Current Assets:					
Fixed Assets-Tangible		4000	5000	20	20
Non-Current Investments		6000	9000	30	36
2. Current Assets:					
Inventories		2000	3000	10	12
Trade Receivables		5000	6000	25	24
Cash & Cash Equivalents		3000	2000	15	8
TOTAL		20000	25000	100	100

Analysis: Compared to 2013-14, during the year 2014-15 percentage of reserves to total liabilities is increased while it is decreased in case of long term borrowings; which shows that long term solvency is improved. Percentage of non –current investment to total assets is increased to 36% which indicates inability of the management to deploy the funds in the business activities.

4. Trend Analysis

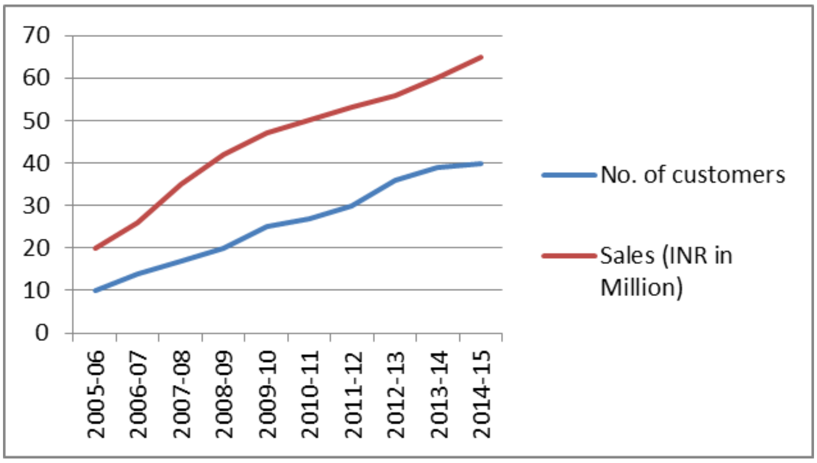
Trend analysis allows to predict what can happen in the business in future. Trend analysis is based on historical data about financial performance of an individual item or related items of financial statement. Change in percentage or absolute figures is calculated for a considerable long period of past which helps to predict future performance.

Case Study-3 Analyze the trend of Number of customers and sales of last ten years of Gama Ltd.

Year	No. of customers	Sales (INR in Million)
2005-06	10	20
2006-07	14	26
2007-08	17	35
2008-09	20	42
2009-10	25	47
2010-11	27	50
2011-12	30	53

2012-13	36	56
2013-14	39	60
2014-15	40	65

Solution



Analysis: The graph shows that sales increase more proportionate than increase in number of customers, hence more growth in sale can be can expected in future.

The trend can also be assessed by calculating percentage change every year compared to previous year.

5. RATIO ANALYSIS

A ratio expresses relationship between two amounts taken from financial statements in meaningful manner. An analysis of business from the viewpoints of liquidity, solvency, profitability and activity with the help of various ratios is known as 'ratio analysis'.

Classification of Ratios:

Liquidity	Solvency	Activity Ratios	Profitability Ratios

Ratios	Ratios		
Significance	**Significance**	**Significance**	**Significance**
Liquidity ratios are calculated to determine the short term solvency of the business. Analysis of current position of liquid funds determines the ability of the business to pay current liabilities.	These ratios are calculated to assess the ability of the firm to meet its long term liabilities. It discloses the firm's ability to meet long term debt at maturity and interest costs regularly.	These ratios measure the efficiency of turnover by utilising of the resources of the company, like inventory, fixed assets, working capital, trade receivables etc.	These ratios measure profitability and efficiency in managing business.
Ratios	**Ratios**	**Ratios**	**Ratios**
Current Ratio =Current Assets/Current Liabilities	Debt Equity Ratio= Debt/Equity	Inventory Turnover Ratio= Cost of revenue from operations/Average inventory	Gross profit ratio=Gross Profit/Revenue from Operationsx100
Liquid Ratio= Liquid Assets/Current Liabilities	Total Assets to Debt Ratio= Total Assets/ Long term Debts	Trade Receivable Turnover Ratio=Credit Revenue from Operations/Average Trade Receivables	Operating Rati = Cost of Reve from Operatior Operating Expenses /Revenue from Operationsx10
	Proprietary ratio= Equity/	Trade Payable Turnover Ratio=Net Credit	Operating Profit Ratio= Operating Profit/Revenu

	Total Assets	Purchases/Average Trade Payables	e from Operationsx100
	Interest Coverage Ratio= Profit before charging Interest and Income Tax/ Fixed Interest Charges	Working capital Turnover Ratio= Revenue from Operations/Working capital	Net Profit Ratio= Net Profit/ Revenue from Operationsx100
		Total Assets Turnover ratio= Revenue from Operations/Total Assets	Return on Capital Employed=Profit Before Interest and tax/capital Employedx100

6. Summary

Financial statements are accounting information which includes statement of profit and loss, Balance Sheet, Cash Flow statement, Statement of Change in equity and Notes to the accounts. Analysis of financial statements can be done by various tools. Financial Analysis helps to assess financial performance and financial position of the firm. Both inter firm as well as intra firm analysis can be made through financial analysis. It also helps to forecast future financial performance. Financial Analysis suffers from drawbacks of financial statements.