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ABM MODULE – C

Chapter 18: ANALYSIS OF FINANCIAL STATEMENTS (PART-I)

What we will study?

*What is financial statement?

*Who are users of financial statement?

*What is Legal Position of financial statement?

INTRODUCTION:

Whenever a bank considers a loan proposal, apart from the integrity and KYC aspects, it has a keen interest in knowing the financial details of the prospective borrower.

The extent of these details depends upon the type of loan, type of borrower, purpose of the loan etc.

In case of security based lending like loans against fixed deposits, shares etc., these financial details may be few or may not be required at all.

But, in all cases, such details are invariably collected with a view to assessing the following:

(a) The Net Worth of the Applicant:

For an individual, the excess of his assets over his liabilities is his net worth.

The same thing applies to any business entity as well but, prima facie, its financial statement shows assets and liability to be equal as business is considered to be separate legal entity and its net worth is added to liabilities considering that this is the amount payable to the promoters by the business entity.

The networth of an applicant helps the bank in deciding the level of activity which may be desirable by that applicant and the amount of money which can be lent to him.

(b) Repayment Capacity:

In case of an individual, the bank collects information like his income (salary,interest, dividend, etc.) as also his expenditure, including repayments of existing borrowings, if any, to assess the surplus available for repayment of installment and interest on bank's loan.

In case of a business enterprise, this information is available from its financial statements.

(c) Viability:

Bank loan may or may not result in increased earnings for a borrower.

For example, a loan for consumer durables will not increase the income while a home loan may result in increased income from rent or reduced expenditure by way of savings on rent.

In case of a business enterprise, bank loan is normally intended to increase the income level. A scrutiny of the financial records of the existing activity helps bank in assessing whether the proposed bank loan will result in a viable increase in operations or not.

(d) Availability of Unencumbered Securities:

In case of individuals, where normally no formal statements of their financial position are available, the bank asks questions to find out about their assets, liabilities, sources of income, expenditure, terms of repayment of existing loans, need for the loan, use of the loan, etc., to address the above mentioned questions.

In case of other applicants, such information is normally available from the financial statements, which they are required to prepare as per the law.

The statutory provisions regarding preparation and audit of financial statements are mostly applicable to corporate entities but these provide the directions to the non-corporate entities as well.

WHICH ARE THE FINANCIAL STATEMENTS :

There are basically two financial statements which every business enterprise is required to prepare. These are:

(a) Balance sheet

(b) Profit & Loss account (Income & Expenditure statement in case of non-profit organizations)

Apart from these, the auditors' report, explanatory schedules and notes on accounts, if applicable, provide useful information to the bankers.

A funds flow statement also provides useful information but, this is only a mathematical analysis of changes in the structure of two consecutive balance sheets and can be easily prepared by the banker/ analyst himself if the basic statements, i.e. the balance sheets, are available.

Accounting Standard-3 makes it mandatory for some enterprises to prepare Cash Flow statement for the accounting period (these enterprises are those whose equity or debt is listed or is in the process of being listed on a recognized stock exchange and also all other commercial, industrial and business enterprises whose turnover for the accounting period exceeds Rs. 50 crore. These enterprises are also required to do segment-wise reporting as per AS-17).

USERS OF FINANCIAL STATEMENTS

Apart from bankers, the other users of financial statements are:

(a) Other creditors and lenders

(b) Investors

(c) Government agencies

(d) Rating agencies

(e) Customers

(f) Employees

(g) General public (h) analysts

BASIC CONCEPTS USED IN PREPARATION OF FINANCIAL STATEMENTS:

The important concepts are as under:

Entity Concept

Money Measurement Concept

Stable Monetary Unit Concept

Going Concern Concept

Cost Concept Conservatism Concept

Dual Aspect Concept

Accounting Period Concept

Accrual Concept

Realisation Concept

Matching Concept

LEGAL POSITION REGARDING FINANCIAL STATEMENTS

(a) Format:

The Companies Act 2013 has prescribed the formats of both balance sheet and Profit & Loss account.

Earlier, format of only the balance sheet was prescribed.

The Companies Act 2013 mentions the following in respect of financial statements.

The financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III.

(b) Accounting Period:

As per Income Tax rules, April-March is considered as the financial year for tax purposes.

To align with the provisions of the Income Tax Rules, in the Companies Act 2013 also, It has been defined as the period ending on the 31st day of March every year.

(C) For incomplete Projects/no Activity:

Every company has to prepare the financial statements even if there is no activity during the accounting period or the project is not completed.

(d) Consolidated financial statements:

The 2013 Act mandates consolidated financial statements for all companies having a subsidiary or an associate or a joint venture, to prepare and present consolidated financial statements in addition to stand alone financial statements.

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Chapter 18: ANALYSIS OF FINANCIAL STATEMENTS (PART-II)

What we will study?

***What is balance sheet?**

BALANCE SHEET:

It is a statement of assets (what is owned, and liabilities (what is owed to others) of an entity at a particular moment.

Assets : What firm owns

Liability :What firm owes

It is like a snapshot of assets and liabilities and just as one picture may be different from another taken anytime earlier, the balance sheet may also be different at different moments of the same day.

Therefore, every balance sheet must indicate the date at the end of which it is prepared.

Normally, the balance sheet is prepared at the end of the accounting period for which the P&L account is prepared.

P & L account is prepared for a period.

Balance Sheet is prepared for a particular date i.e as on a date.

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Format of Balance Sheet :

LIABILITIES (Source of fund)	ASSETS(Use of fund)
Long term liabilities	Current Assets
Current liabilities	Fixed Assets
Net worth	Intangible Assets
	Non Current Assets
Total ==	==Total
Foot note	Contingent Liability
Bank Guarantee	Letter of credit

Assets:

1- Current Assets 2-Non Current Assets

3-Fixed Assets 4- Intangible Assets

1-Current Assets :

Those assets which are likely to be either consumed or converted into cash within 1 year from the date of balance sheet are called Current Assets.

Example :

1-Bank Balance	5-Debtors
2-Inventory/stock	6-Accrued Income
3-Cash	7-Prepaid Expenses (Insurance, Advance Tax, Advance Rent)
4-Bill Receivable	

2-Intangible Assets or Fictitious Assets:

The assets which do not have physical existence are called Intangible Assets.

Ex-

(a) Goodwill, (b) Brands/trademarks,

(c) Computer software, (d) Mining rights,

(e) Copyrights, and patents and other intellectual property rights,

3-Fixed Assets :(net block)

(tangible assets :which can be touched)

Those assets which will be used for long of time.

Or Those assets which are not meant to be sold.

(a) Land, (b) Buildings,

(c) Plant and Equipment, (d) Furniture and Fixtures,

(e) Vehicles,

4-Non Current Assets:

Those assets which can not be classified as

Either fixed assets

Or current assets

Or Intangible assets

Are called Non current Assets.

Liability:

1-Long term liability

2-Current liability

3-Net worth

1-Current Liability :

Amount payable to outsider WITHIN 1 year from the date of balance sheet is called Current liability.

Example :

1-Installments of term loan payable within one year.

2-Bills payable

3-Sundry Creditors

4-Provision for tax

5-Outstanding expenses

6-Bank Borrowing in form of CC and OD

2-Long term liability :

Amount payable to outsider AFTER 1 year from the date of balance sheet is called long term liability.

Example :

1-Unsecured Loan

2-Debentures (which are maturing after 12 months)

3-Term loan

(installment which are payable after 1 year)

3-Net worth or Owner's Equity :

Amount contributed by Owner + Profit retained in the business is called the net worth.

Example:

1-Capital or share capital

2-Reserves and surplus

3-Share premium

Example:

Capital =500 Cr

Stock =100 Cr

Furniture =50 Cr

Term loan =400 Cr

Good will= 40 Cr

Debtors=100 Cr

Creditor =400 Cr

Identify assets & liability?

LIABILITIY	ASSET
Capital	Stock
Term loan	Furniture
Creditors	Good will
	Debtors

A-Find current assets?

B- Find current liability?

C-Find Intangible Assets?

D-Find Fixed Assets?

E- Find Net worth?

F-Find long term liability?

Solution :

A-Current Assets : Stock, Debtors=100+100=200 Cr

B- Current Liability :Creditors =400 Cr

C-Intangible Assets : Good will =40 Cr

D-Fixed Assets : Furniture =50 Cr

E-Net worth = capital +reserve +Share Premium

=500 Cr

F-Long term Liability : Term Loan=400 Cr

Thanks

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Chapter 18: ANALYSIS OF FINANCIAL STATEMENTS (PART-III)

What we will study?

*What is Ratio Analysis?

*What is Current Ratio?

*What is Quick Ratio?

TECHNIQUES USED IN ANALYSIS OF FINANCIAL STATEMENTS:

Bankers mostly use three methods for analysis of financial statements

(a) Funds Flow Analysis

(b) Trend Analysis

(c) Ratio Analysis

Ratio Analysis:

This is the most favourite method of bankers for analysis of financial statements.

A ratio is comparison of two figures and can be expressed as a percentage (e.g., profitability is 23.7 per cent), as a number (e.g., current ratio is 1.33) or simply as a proportion (e.g., debt equity is 1:2).

Both the figures,used in calculation of a ratio, can be from either P&L account, or balance sheet or one can be from P&L account and the other from balance sheet.

Ratios help in comparison of the financial performance and financial position of an entity with other entities, as also for comparison with its own status over the years.

While different users of financial statements are interested in different ratios, the ratios which interest a banker most, are the following:

(A) Profitability Ratios

1-Operating Profit Margin

2-Net Profit Margin

(B) Liquidity Ratios:

1-Current Ratio

2-Quick Ratio or Acid test ratio

(C) Capital Structure Ratios

1-Debt Equity Ratio

(D) Ratios Indicating Ability to Service Interest and Instalments

1-Debt Service Coverage Ratio

(E) Turnover Ratios

1-Debtor Turnover Ratio

Liquidity Ratios:

1-Current Ratio

2-Quick Ratio or Acid test ratio

1- Current Ratio(CR) :

CR=Current assets/Current liabilities

CR=CA/CL

*Ideal 1.33:1

*Current Ratio indicates Financial Stability of firm

or

Ability of firm to pay current liabilities.

2- Quick Ratio(CR) :(Acid test ratio)

CR=Quick assets/Current liabilities

CR=QA/CL

Quick Asset = Current assets - Inventory & prepaid expenses

*Ideal 1:1

Capital Structure Ratios:

1-Debt Equity Ratio :

Long-term liabilities/Tangible Net Worth

Tangible Net Worth is also called Shareholders fund

Tangible Net Worth =Net Worth - Intangible Assets

Net Worth =Capital +Reserves+Surplus +share premium

Debt Equity Ratio indicates Owners stake in the business compared to stake of outsiders.

*Ideal ratio should be 1:1 but 2:1 is also acceptable.

Question:

Capital =1000 Cr

Debtors: 500 Cr

Creditors:200 Cr

Stock:100 Cr

Provision for tax : 600 Cr

Term loan:2000 Cr

Goodwill:300 Cr

Now calculate

1 Current Ratio

2 Quick Ratio

3 Debt Equity Ratio

Solution:

1-Current Ratio CR=CA/CL

Current Assets(CA) : Debtors +Stock

=500+100 =600

Current liabilities= Creditors + Provision for tax

=200+600=800

CR=CA/CL =600/800=3:4

2- Quick Ratio = Quick Assets/Current liabilities

QR=QA/CL

QA =Current assets – Inventory & prepaid expenses
QA=600-100=500

CL=800

QR=500/800 =5:8

3- Debt Equity Ratio =

Long-term liabilities/Tangible Net Worth

Long-term liabilities(Term Loan)= 2000 Cr

Tangible Net Worth =Net Worth - Intangible Assets

Intangible Assets (Goodwill)=300

Net Worth =Capital +Reserves +Surplus =1000

DER = LTL/Intangible NW =2000/1000=2:1

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Chapter 18: ANALYSIS OF FINANCIAL STATEMENTS (PART-IV)

What we will study?

***What is Debt Service Coverage Ratio?**

***What is Inventory Turnover Ratio?**

***What is Debtor Turnover Ratio?**

(A) Profitability Ratios:
1-Operating Profit Margin

2-Net Profit Margin

(B) Liquidity Ratios:
1-Current Ratio

2-Quick Ratio or Acid test ratio

(C) Capital Structure Ratios:
1-Debt Equity Ratio

(D) Ratios Indicating Ability to Service Interest and Instalments

1-Debt Service Coverage Ratio

(E) Turnover Ratios

1-Inventory Turnover Ratio

2-Debtor Turnover Ratio

Ratios Indicating Ability to Service Interest and Instalments

1-Debt Service Coverage Ratio :

DSCR=(Profit after Tax +Depreciation +Interest on term loan)/(Annual installment of term loan +Interest on term loan)

DSCR= (PAT+Dep+interest)/(instalment +interest)

*It is used for section of term loan

*DSCR Indicates the ability of a firm to pay Term Loan Instalments on time.

Example:

Depreciation =10 Cr

Profit after tax=20 Cr

Annual installment =5 Cr

Interest on term loan = 20 Cr

Calculate DSCR?

Solution:

DSCR=PAT+DEP+INT/ INSTAL+INT

=20+10+5/20+5=35/25=7:5

Turnover Ratios

1-Inventory Turnover Ratio:

ITOR=COST OF GOODS SOLD /AVG Inventory

COST OF GOODS SOLD=Inventory in beginning - inventory at the end+ goods purchased + wages

Avg Inventory =1/2*(inv at beginning +inv at end)

Example:

Inventory at beginning =20000

Inventory at the end=12000

Wages =4000

Purchase =6000

Now calculate Inventory Turnover Ratio?

Solution:

Cost of goods sold=Inventory in beginning - Inventory at end+wages +purchase

=20000-12000+4000+6000=18000

Avg Inventory =(Inv at beginning +Inv at end)/2

=20000+12000=32000

Inventory Turnover Ratio =

cost of goods sold/Avg Inventory =18000/32000=9:16

2-Debtor Turnover Ratio:

DTOR=CREDIT SALES/AVG ACCOUNT RECEIVABLES

Credit sales=Total Sale - Cash Sale

Account Receivables =Debtors + Bill Receivables

Example:

Total sale in year 2020 =80000

Total cash sale in year 2020=20000

Bill Receivables as on 1 December =10000

Debtors as on 1 December =40000

Bill Receivables as on 30 December =30000

Debtors as on 30 December =50000 Now calculate Debtor turn over ratio?

Solution:

Credit Sale=Total Sale-Cash Sale

=80000-20000=60000

Bill Receivables =30000+10000=40000

Debtors =40000+50000=9000

Avg account Receivables =1/2*(40000+90000)=65000

DTOR=CREDIT Sale/ Avg Account Receivables

=60000/65000=12:13

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Chapter 18: ANALYSIS OF FINANCIAL STATEMENTS (PART-V)

What we will study?

Some numerical based on Ratio Analysis.

Question on Ratio Analysis

CA – Current Assets
CL – Current Liability
CR – Current Ration

Q-1 if CA = 500 Cr
CL = 400 Cr

then Calculate Current Ratio ?

Solⁿ

$$CR = \frac{CA}{CL} = \frac{500}{400} = \frac{5}{4}$$

$$\boxed{CR = 5:4}$$

Q-2 if CA = 500 Cr & CR = 2:3

then calculate CL ?

Solⁿ

$$CR = \frac{CA}{CL} \Rightarrow \frac{2}{3} = \frac{CA}{CL}$$

$$\Rightarrow \frac{2}{3} = \frac{CA}{CL} \Rightarrow \quad CA = 2x, \quad CL = 3x$$

$$\Rightarrow CA = 2x = 500 \qquad \boxed{x = 250}$$

$$CL = 3x = 3 \times 250 = 750$$

$$\boxed{CL = 750}$$

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Q-3 CR = 3:1 , CA = 9000 , CL = ?

Soln

$CR = \frac{CA}{CL} = \frac{3}{1}$ ⇒ $CA = 3x$, $CL = x$

$CA = 3x = 9000$

$x = \frac{9000}{3} = 3000$

$x = 3000$

⇒ $CL = x$ ⇒ $\boxed{CL = 3000}$

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Q-4 Profit after tax = 200
tax paid = 20
Depriciation = 60
Annual instalment of term loan = ·50

Interest on TL = 10

Now calculate DSCR ?

Soln $DSCR = \frac{PAT + Depri + Interest}{Installment + Interest}$

$DSCR = \frac{200 + 60 + 10}{·50 + 10} = \frac{270}{60} = \frac{\cancel{27}\ 9}{\cancel{6}\ 2}$

$\boxed{DSCR = 9:2}$

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Q-5

Profit before tax = 400
Annual installment = 100
Interest on TL = 40

Depreciation = 40
tax paid = 100

Now calculate DSCR?

Solⁿ-

$$DSCR = \frac{PAT + Dep + Int}{Install + Int}$$

PAT = PBT - Tax

PAT = 400 - 100

PAT = 300

$$DSCR = \frac{300 + 40 + 40}{100 + 40} = \frac{380}{140} = \frac{38}{14}$$

$$= \frac{19}{7}$$

$\boxed{DSCR = 19:7}$

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Chapter 18: ANALYSIS OF FINANCIAL STATEMENTS (PART-VI)

What we will study?

***Some more Numericals based on Ration Analysis**

Ratio Analysis

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(I) $\boxed{NWC = CA - CL}$

Networking Capital = NWC
Current Asset = CA
Current Liability = CL

(II)

L	A
CL	CA
LTL	FA
NW	IA
	MA / NCA
Total	= Total

LTS ← (LTL + NW)
Long term sources

L	A
CL	CA
LTS	LTU
Total	= Total

* LTU → Long term uses
* LTS → Long term sources

* NW = Networth = Capital + Reserve
  ↓
  [owner's equity]

* LTL → Long term liability
* CL → Current liability
* CA → Current Assets
* FA → Fixed Asset (Net Block)
* IA → Intangible Assets
* MA → m/s' Assets
* NCA → Non Current Assets

Chapter - 27 Ratio Analysis

Q-1 : Networking Capital (NWC) = 400 Cr

Current Assets (CA) = 1400 Cr

* Calculate Current Liability (CL) ?
* Calculate CR?

Soln

(I) $\boxed{NWC = CA - CL}$

$400 = 1400 - CL$

$CL = 1400 - 400 = 1000$ lac

(II) $CR = \frac{CA}{CL} = \frac{1400}{1000} = \boxed{1.4 : 1}$

Q-2 . $CA = 90$

$CL = 150$

$CR = ?$ (Current Ratio)

Soln – $CR = \frac{CA}{CL} = \frac{90}{150} = \frac{3}{5} = 3:5$

$\boxed{CR = 3:5}$

Q-3 A Company have total Asset of Rs 450 Cr.
Current liability of Company is 50 Cr.
Debt equity ratio = 3 : 1
Calculate equity or networth of company?

Sol^n

$$D/E = \frac{\text{Long term liability}}{\text{tangible N/W}} = \frac{3}{1}$$

$$\frac{LTL}{NW} = \frac{3}{1} \Rightarrow \boxed{LTL = 3NW} \quad -(1)$$

B/S

Liability	Asset
CL	CA
LTL	FA
NW	IA
	MA
total =	total

Long term Sources: LTL, NW

⇒

L	A
CL	
LTL	
NW	
450	450

$$\Rightarrow CL + LTL + NW = 450$$

$$50 + LTL + NW = 450$$

$$LTL + NW = 450 - 50 = 400$$

$$3NW + NW = 400$$

$$4NW = 400$$

$$NW = 100\ Cr$$

NW or equity = 100 Cr

Q-4

CR = 2:1

CL = 10 lac

total Liability = 200 lac

Intangible Asset = 0

Non current Asset = 0

or

Mis. Asset

Calculate Fixed Asset ?

Soln

$$CR = \frac{CA}{CL} = \frac{2}{1}$$

$$\frac{CA}{10} = \frac{2}{1}$$

$$\boxed{CA = 20 \text{ lac}}$$

L	A
	CA
	FA
	IA
	MA
200	= 200

$$CA + FA + IA + MA = 200$$

$$20 + FA + 0 + 0 = 200$$

$$FA = 200 - 20$$

$$\boxed{FA = 180 \text{ Lac}}$$

Q-5

Total Assets = 400 Cr

Long term Sources = 220

CR = 1.5 : 1

NWC = ?

CA = ?

Soln:

L	A
CL	CA
LTL	FA
NW	IA
	MA / NCA
400	= 400

Long term Sources (LTS) → LTL + NW

total Liability = 400

$\underbrace{CL + LTL + NW}$ = 400

CL + LTS = 400

CL + 220 = 400

CL = 400 − 220

$\boxed{CL = 180}$

⇒ CR = 1.5 : 1

$$\frac{CA}{CL} = \frac{1.5}{1} \Rightarrow \frac{CA}{180} = \frac{1.5}{1}$$

$\boxed{CA = 270}$

NWC = CA − CL = 270 − 180 = 90

$\boxed{NWC = 90}$

Q-6 $CR = 2:1$

$NWC = 60{,}000/-$

$CL = ?$

Solⁿ

$$\boxed{NWC = CA - CL}$$

$$CR = \frac{CA}{CL} = \frac{2}{1}$$

$CA = 2x$

$CL = x$

$NWC = 2x - x = x$

$NWC = x = 60000$

$\Rightarrow x = 60{,}000/-$

$CA = 2x = 2 \times 60000 = 120{,}000/-$

$CL = x = 1 \times 60000 = 60{,}000/-$

Ques-7 : A firm has following B/S figures:

Capital & reserv = 10 lac

Long term loss = 20 lac

C L = 5 lac

Long term loan = 20 lac

Now calculate CR?

Solⁿ

L	A
LTL	LTU
CL	CA
NW or capital & Reserv	

⇒

L	A
20	20
5	CA
10	
35	35

$LTU + CA = 35$

$20 + CA = 35$

$CA = 35 - 20 = 15$

$CA = 15$

$CL = 5$

$$CR = \frac{CA}{CL} = \frac{15}{5} = 3:1$$

$\boxed{CR = 3:1}$

Q-8

CR = 2:1

QR = 1:3

CA = 36 Lac

QA = ?

Soln

$$\boxed{QR = \frac{QA}{CL}}$$

$$\boxed{QA = CA - (\text{Invtr \& Prepaid})}$$

$$CR = \frac{CA}{CL} = \frac{2}{1}$$

$$CA = 2CL$$

↓

$$36 = 2CL \Rightarrow CL = 18 \text{ lac}$$

$$QR = \frac{QA}{CL}$$

↓

$$\frac{1}{3} = \frac{QA}{18} \Rightarrow QA = \frac{18}{3} = 6$$

$$\boxed{QA = 6 \text{ Lac}}$$

Q-9 : B/S of A firm shows that long term sources are 300 lakh & Long term uses are 200 lac total of B/S is 500 lac. Now Calculate NWC and current Ratio?

Solⁿ

L	A
LTS	LTU
CL	CA
500 lac	500 lac

L	A
300	200
CL	CA
500	500 lac

$200 + CA = 500$

$\boxed{CA = 300}$

$300 + CL = 500$

$CL = 500 - 300$

$\boxed{CL = 200}$

$\boxed{NWC = CA - CL}$

$NWC = 300 - 200$

$\boxed{NWC = 100}$

$CR = \frac{CA}{CL}$

$CR = \frac{300}{200}$

$\boxed{CR = 1.5 : 1}$