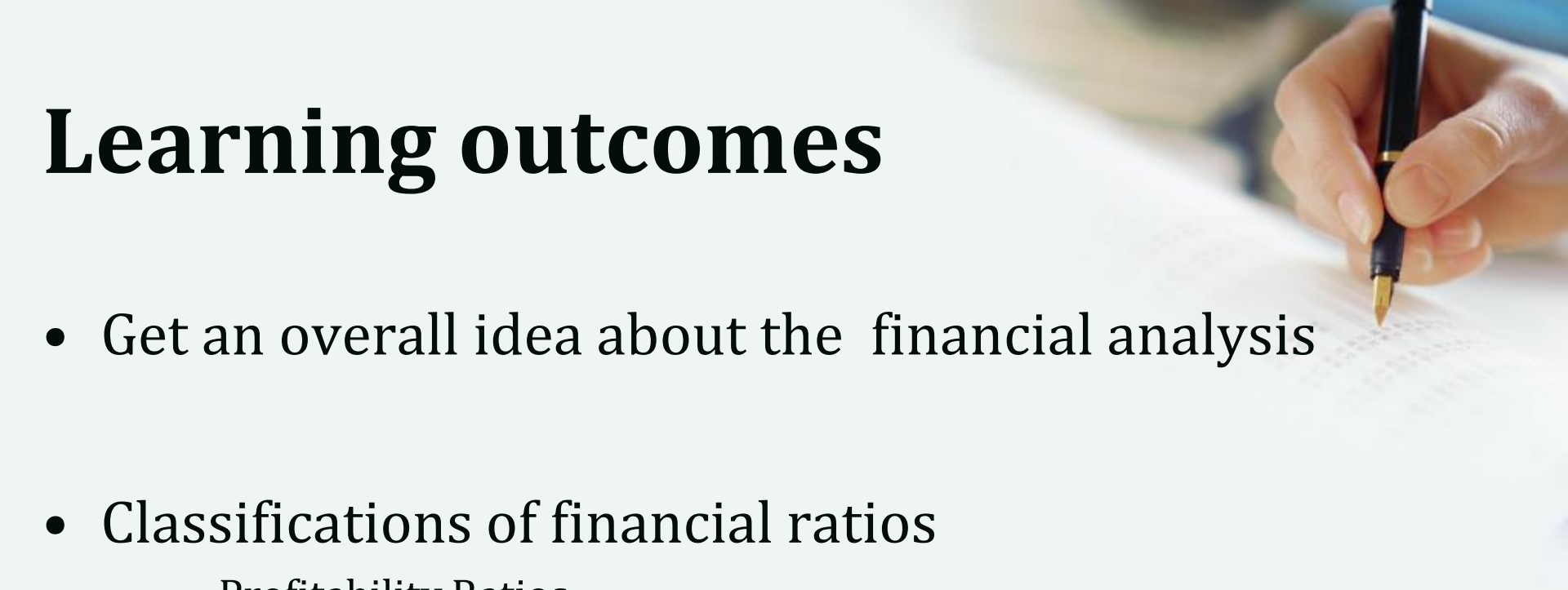
Business Management for IT (IT3090)

Financial Statement Analysis

Lesson-8

Ms.Chalani Kuruppu
MLRHRM-UOC, BBA(Hons) in Business Management (UK)

Learning outcomes

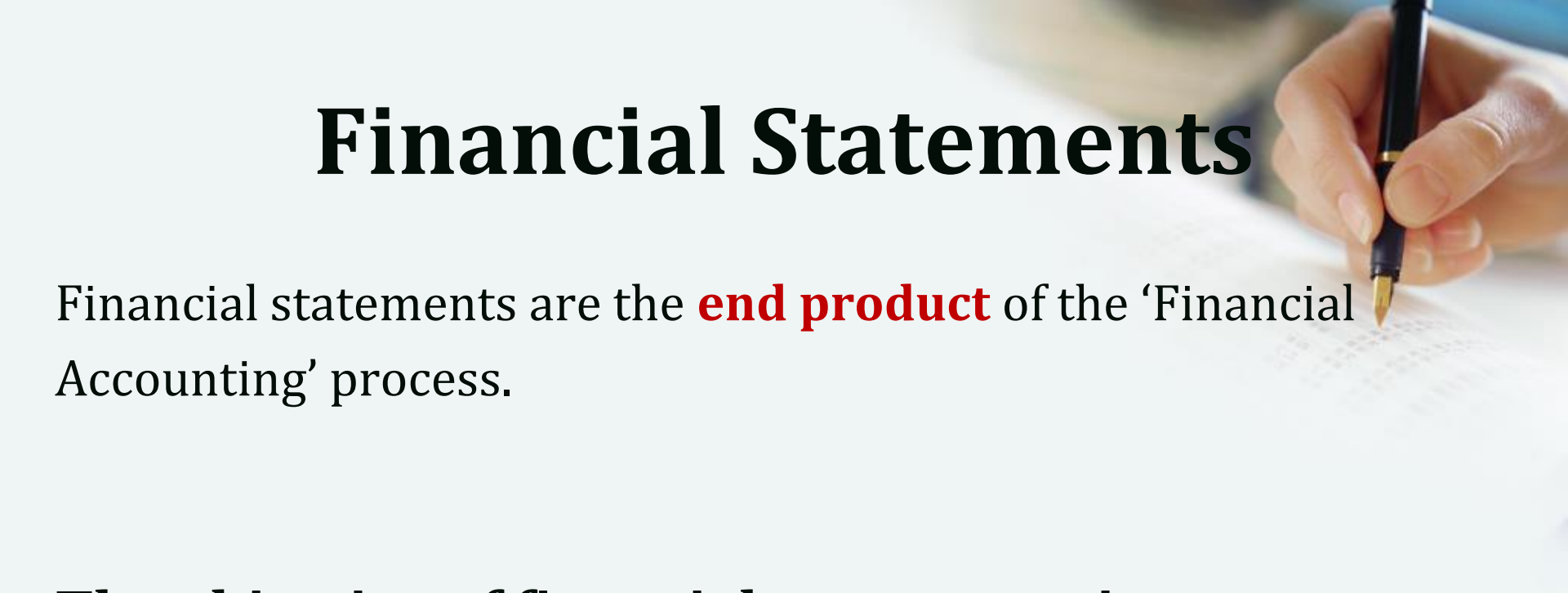


- Get an overall idea about the financial analysis

- Classifications of financial ratios
  - -Profitability Ratios
  - -Liquidity Ratios
  - -Activity Ratios (Efficiency Ratios)
  - -Debt Ratios

- Interpretation of ratio analysis.

Financial Statements



Financial statements are the **end product** of the 'Financial Accounting' process.

The objective of financial statements is,

Provide information about the ***financial position, performance and changes in financial position of an entity*** that is useful to a wide range of users in making economic decisions.

Financial Statement analysis

Financial analysis is the process of **identifying the financial strengths and weaknesses of a firm by properly establishing relationship between the items in financial statements.**

'Financial Statement Analysis' is a part of large information processing system on which informed decisions can be based.

The type of analysis varies according to the specific interests of the party involved.

Ratio Analysis

'**Ratio analysis**' is a study of various relationships between different items reported in a set of financial statements.

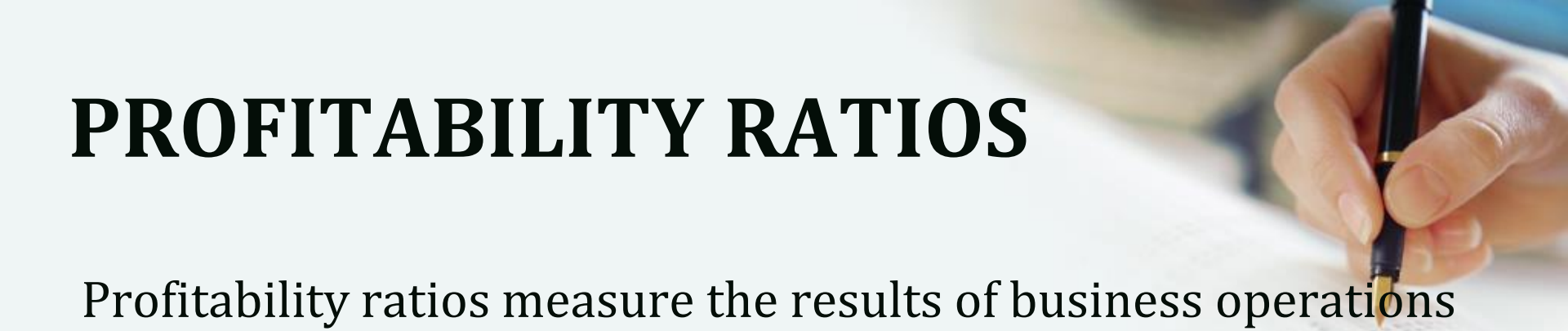
Objective:

Ratios enable an analyst to make a **comparison** of a firm's ***financial condition over a time or in relation to other firms.***

Classification of Financial Ratios

- Profitability Ratios
- Liquidity Ratios
- Activity Ratios (Efficiency Ratios)
- Debt Ratios

PROFITABILITY RATIOS



Profitability ratios measure the results of business operations or ***overall performance and effectiveness*** of the firm.

It evaluates a firm's effectiveness in using its resources to generate profits.

- ✓ **Gross profit Rate**
- ✓ **Net profit Rate**

Gross profit Rate

Gross profit margin measures the percentage of each sales rupee remaining after the firm has paid for its goods.

The higher gross profit margin is better for the company.

$$\text{Gross Profit Rate} = \frac{\text{Gross Profit}}{\text{Net revenue}} \times 100$$

Kuruwita Textile Ltd
Income Statement
For the year ended 31st March 2007

	31st March 2007 (000')	31st March 2006 (000')
Sales	6891	5279
Cost of sales	(6138)	(4793)
Gross Profit / Loss	**753**	**486**
Other operating income	9	1
Sales & administrative expenditure	(222)	(391)
Operation Profit/ loss	**540**	**96**
Financial Income	118	2
financial expenditure	(111)	(49)
Profit / loss before tax	**547**	**49**
Tax	(17)	(10)
Net profit	**530**	**39**

Calculation

2007

Gross Profit Rate=753/6891*100

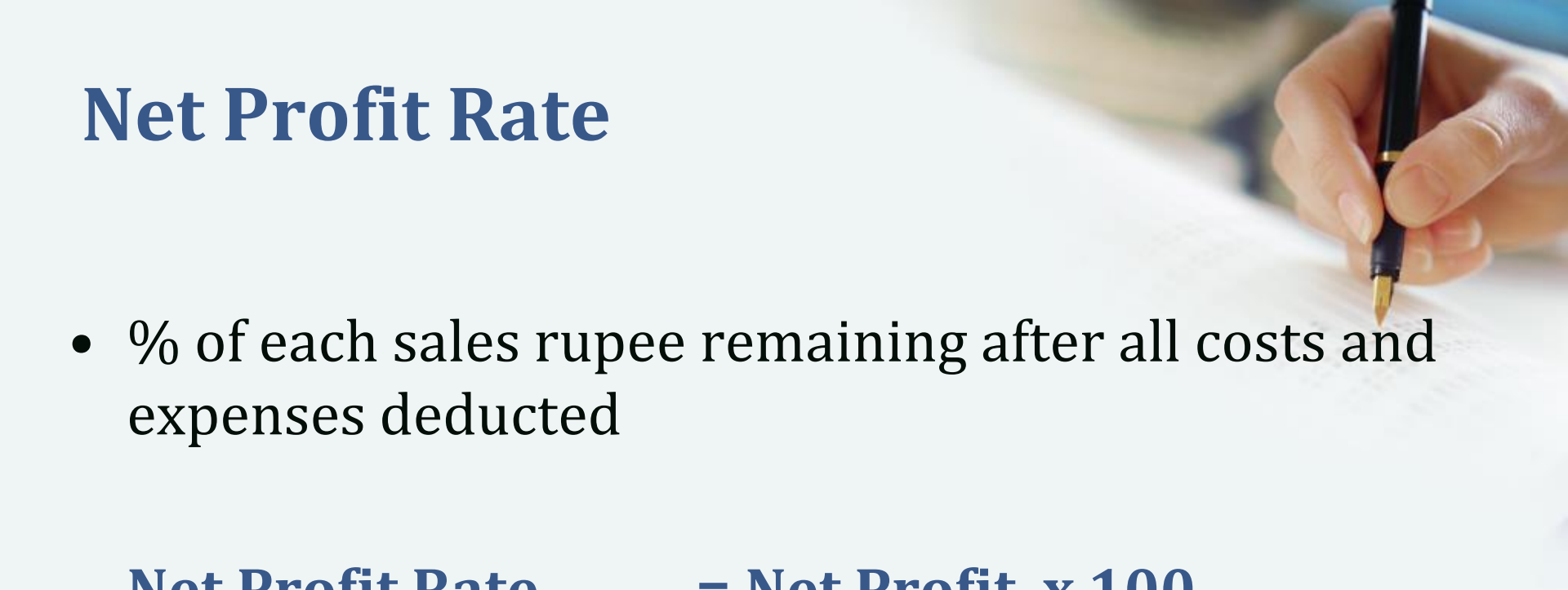
= **10.93%**

2006

Gross Profit Rate=486/5279*100

=**9.21%**

Net Profit Rate



- % of each sales rupee remaining after all costs and expenses deducted

$$\text{Net Profit Rate} = \frac{\text{Net Profit}}{\text{Net Revenue}} \times 100$$

Kuruwita Textile Ltd
Income Statement
For the year ended 31st March 2007

	31st March 2007 (000')	31st March 2006 (000')
Sales	6891	5279
Cost of sales	(6138)	(4793)
Gross Profit / Loss	**753**	**486**
Other operating income	9	1
Sales & administrative expenditure	(222)	(391)
Operation Profit/ loss	**540**	**96**
Financial Income	118	2
financial expenditure	(111)	(49)
Profit / loss before tax	**547**	**49**
Tax	(17)	(10)
Net profit	**530**	**39**

Calculation

2007

Net Profit Rate=530/6891*100

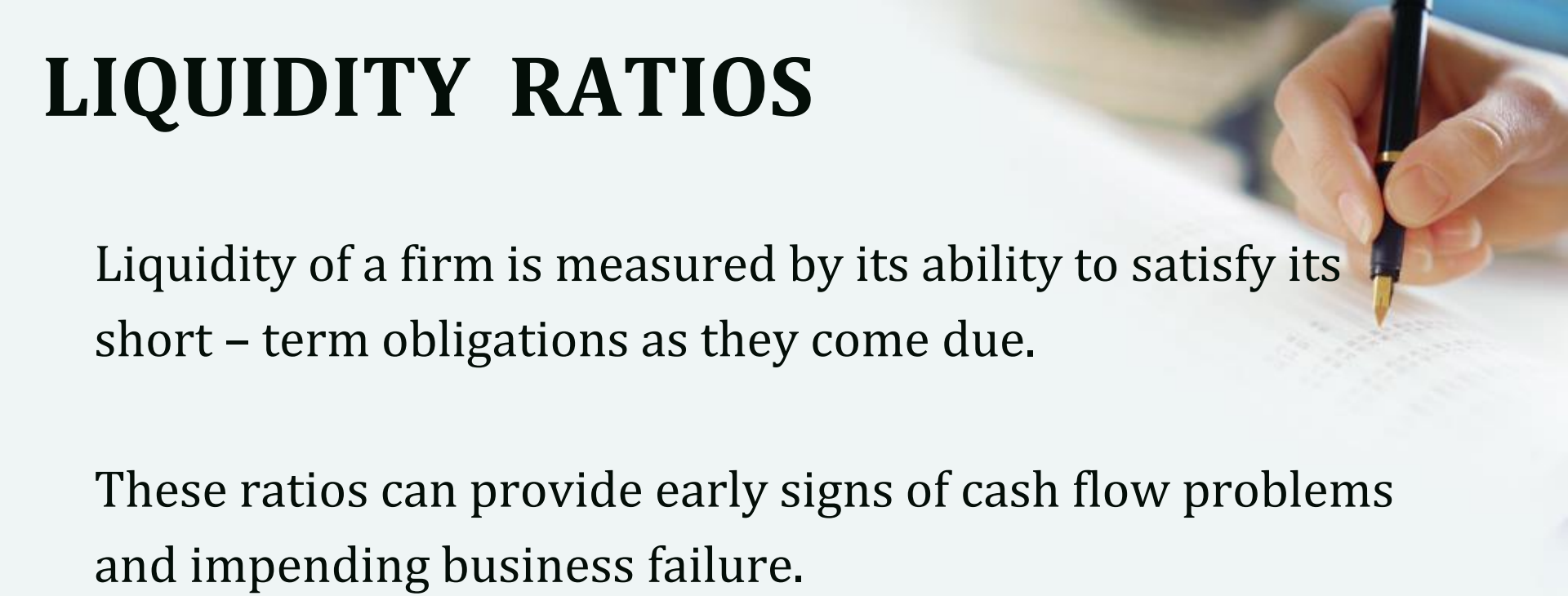
= **7.69%**

2006

Net Profit Rate=39/5279*100

=**0.74%**

LIQUIDITY RATIOS



Liquidity of a firm is measured by its ability to satisfy its short – term obligations as they come due.

These ratios can provide early signs of cash flow problems and impending business failure.

- ✓ **Current Ratio**
- ✓ **Quick (Acid – Test) Ratio**

Current Ratio

Current ratio compares the company's current assets with its current liabilities.

The higher the current ratio, the more liquid the firm is considered to be.

A current ratio of 2.0 is occasionally cited as acceptable

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

Kuruwita Textile Ltd. Balance sheet as at 31st March 2007

Assets	31st March 2007 (000')	31st March 2006 (000')
Non - current assets		
Property, Plant and equipments	1558	1348
Good will	-	39
Investment in subsidiary	16	-
	1574	1387
Current assets		
Inventories	1288	1225
Current tax receivables	25	12
Trade debtors	356	337
Cash	241	137
	1910	1711
Total assets	**3484**	**3098**
Equity and liabilities		
Capital and reserve		
Ordinary Shares	250	250
Share premium	99	99
Revenue reserves	40	40
Exchange equivalent reserve	260	162
Retained earning	574	215
Minority interest	455	306
	1678	1072
Non current liability		
Long term borrowings	265	274
Define benefit obligation	44	30
	309	304
Current liabilities		
Trade and other payables	1484	202
Short term borrowings	13	1520
	1497	1722
Total liabilities	1806	2026
Total equity and liabilities	**3484**	**3098**

Calculation

2007

Current ratio = 1910/1497

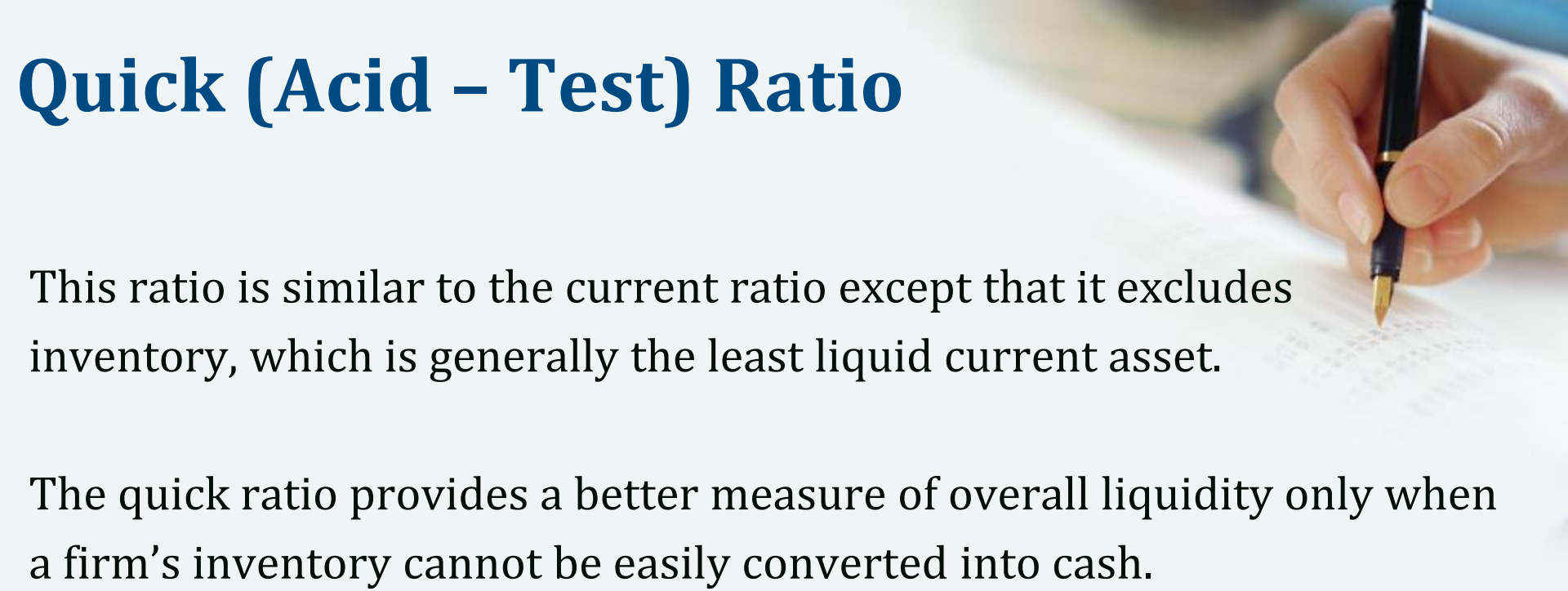
= **1.28 : 1**

2006

Current ratio = 1711/1722

= **0.99 : 1**

Quick (Acid – Test) Ratio



This ratio is similar to the current ratio except that it excludes inventory, which is generally the least liquid current asset.

The quick ratio provides a better measure of overall liquidity only when a firm's inventory cannot be easily converted into cash.

A quick ratio of 1.0 or greater is occasionally recommended.

$$\text{Quick ratio} = \frac{\text{Current assets – Inventory (Closing Stocks)}}{\text{Current liabilities}}$$

Kuruwita Textile Ltd. Balance sheet as at 31st March 2007

Assets	31st March 2007 (000')	31st March 2006 (000')
Non - current assets		
Property, Plant and equipments	1558	1348
Good will	-	39
Investment in subsidiary	16	-
	1574	1387
Current assets		
Inventories	1288	1225
Current tax receivables	25	12
Trade debtors	356	337
Cash	241	137
	1910	1711
Total assets	**3484**	**3098**
Equity and liabilities		
Capital and reserve		
Ordinary Shares	250	250
Share premium	99	99
Revenue reserves	40	40
Exchange equivalent reserve	260	162
Retained earning	574	215
Minority interest	455	306
	1678	1072
Non current liability		
Long term borrowings	265	274
Define benefit obligation	44	30
	309	304
Current liabilities		
Trade and other payables	1484	202
Short term borrowings	13	1520
	1497	1722
Total liabilities	1806	2026
Total equity and liabilities	**3484**	**3098**

Calculation

2007

Quick ratio = 1910-(1288) /1497

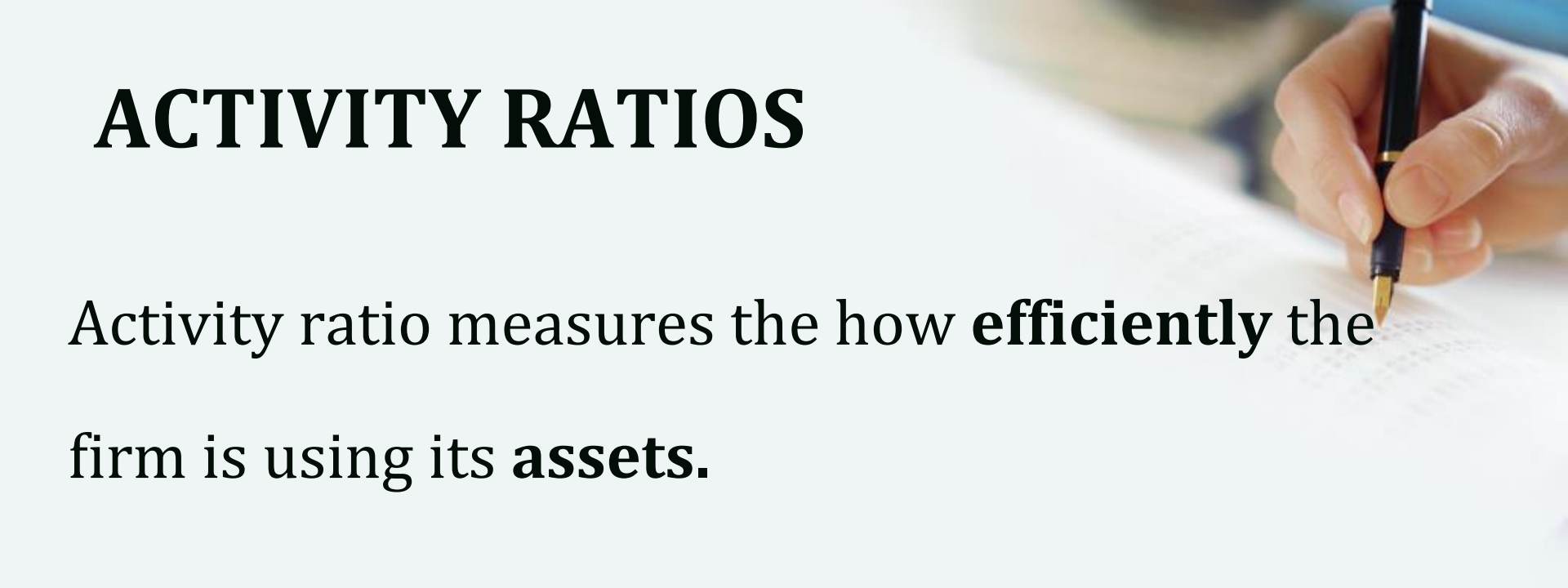
= **0.42 : 1**

2006

Quick ratio = 1711- (1225) /1722

= **0.28 : 1**

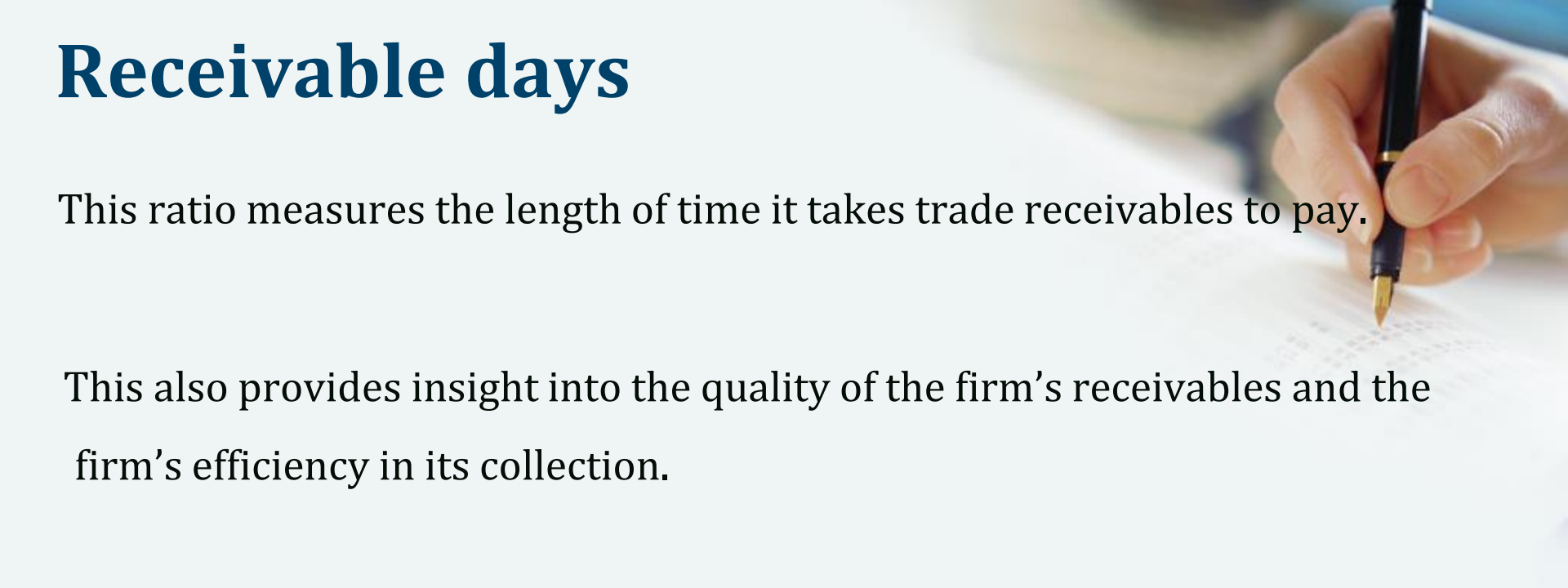
ACTIVITY RATIOS



Activity ratio measures the how **efficiently** the firm is using its **assets.**

- ✓ **Receivable days**

Receivable days



This ratio measures the length of time it takes trade receivables to pay.

This also provides insight into the quality of the firm's receivables and the firm's efficiency in its collection.

The length of time taken to pay the dues represents a cost to a business .

(It's like giving free credits).

Less time period is better for the business

$$\text{Receivable days} = \frac{\text{Closing trade receivables}}{\text{Revenue}} \times 365$$

Kuruwita Textile Ltd. Balance sheet as at 31st March 2007

Assets	31st March 2007 (000')	31st March 2006 (000')
Non - current assets		
Property, Plant and equipments	1558	1348
Good will	-	39
Investment in subsidiary	16	-
	1574	1387
Current assets		
Inventories	1288	1225
Current tax receivables	25	12
Trade debtors	356	337
Cash	241	137
	1910	1711
Total assets	**3484**	**3098**
Equity and liabilities		
Capital and reserve		
Ordinary Shares	250	250
Share premium	99	99
Revenue reserves	40	40
Exchange equivalent reserve	260	162
Retained earning	574	215
Minority interest	455	306
	1678	1072
Non current liability		
Long term borrowings	265	274
Define benefit obligation	44	30
	309	304
Current liabilities		
Trade and other payables	1484	202
Short term borrowings	13	1520
	1497	1722
Total liabilities	1806	2026
Total equity and liabilities	**3484**	**3098**

Calculation

2007

Receivable days = 356/6891*365

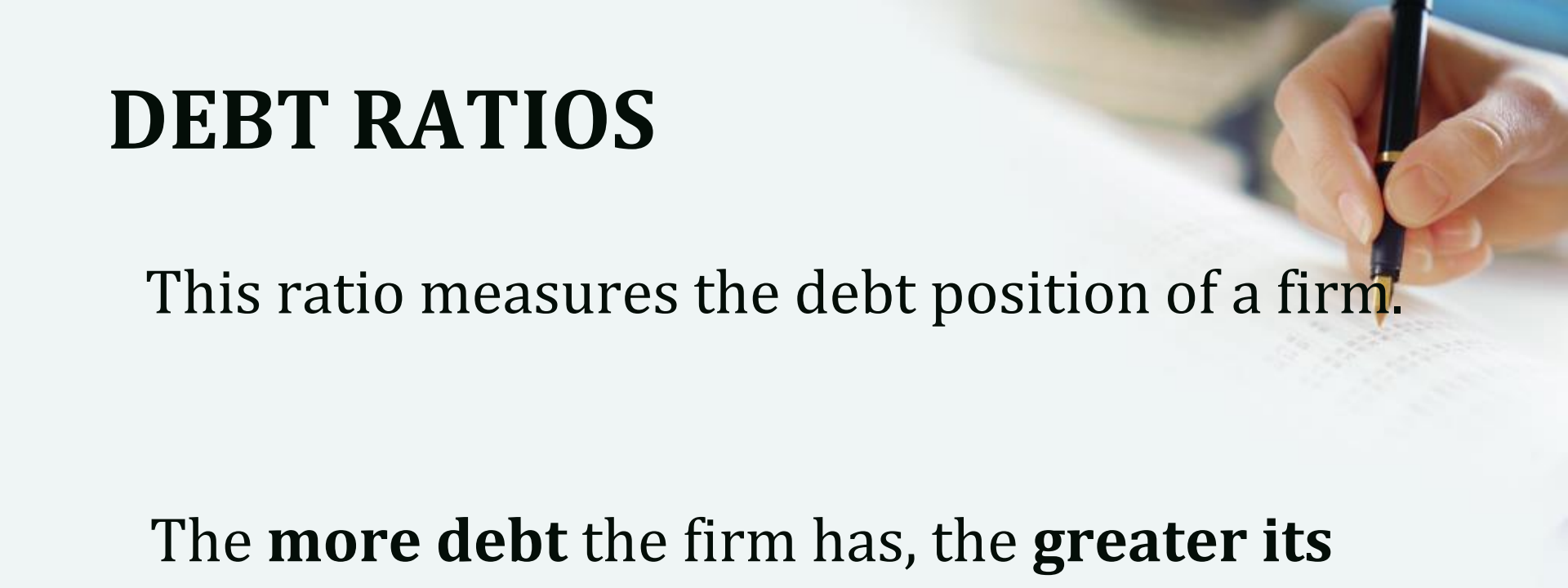
= **19 days**

2006

Receivable days = 337/5279*365

= **23 days**

DEBT RATIOS

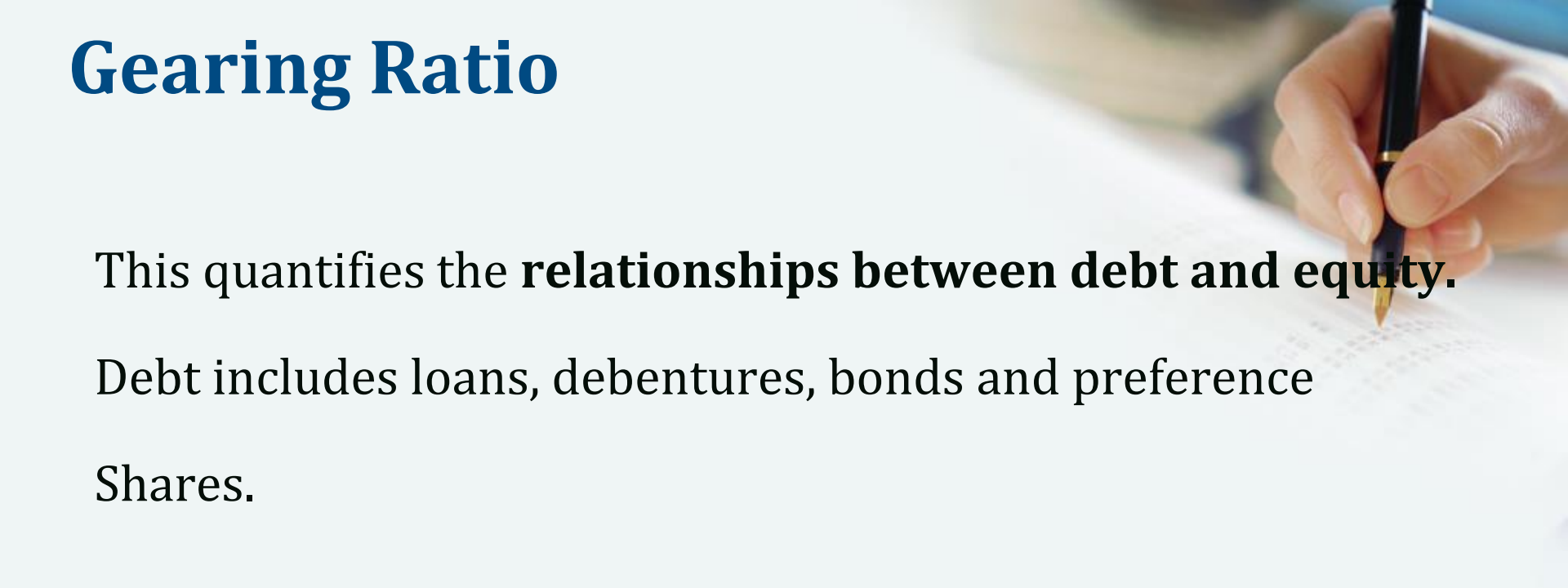


This ratio measures the debt position of a firm.

The **more debt** the firm has, the **greater its risks** of being unable to meet its contractual debt payments and becoming bankrupt.

- ✓ **Gearing Ratio**

Gearing Ratio



This quantifies the **relationships between debt and equity.**

Debt includes loans, debentures, bonds and preference

Shares.

Higher proportion of debt indicates high risk.

$$\textbf{Gearing Ratio} = \frac{\textbf{Debt}}{\textbf{Equity}} \times 100$$

Kuruwita Textile Ltd. Balance sheet as at 31st March 2007

Assets	31st March 2007 (000')	31st March 2006 (000')
Non - current assets		
Property, Plant and equipments	1558	1348
Good will	-	39
Investment in subsidiary	16	-
	1574	1387
Current assets		
Inventories	1288	1225
Current tax receivables	25	12
Trade debtors	356	337
Cash	241	137
	1910	1711
Total assets	**3484**	**3098**
Equity and liabilities		
Capital and reserve		
Ordinary Shares	250	250
Share premium	99	99
Revenue reserves	40	40
Exchange equivalent reserve	260	162
Retained earning	574	215
Minority interest	455	306
	1678	1072
Non current liability		
Long term borrowings	265	274
Define benefit obligation	44	30
	309	304
Current liabilities		
Trade and other payables	1484	202
Short term borrowings	13	1520
	1497	1722
Total liabilities	1806	2026
Total equity and liabilities	**3484**	**3098**

Calculation

2007

Gearing ratio = 309/1678*100

= **18.41%**

2006

Gearing ratio = 304/1072*100

= **28.36%**

END