

Chapter 12: Analysis of Financial Statements

Question: 1

State whether following statement are true or false :
Financial statements include only balance sheet.

Options

- True
- False

Solution

False

Explanation: Financial statements are the statements that report the operating results and the financial position of the business at the end of the accounting period. It consists of two statements, namely, Balance Sheet (i.e. Position statement) and Income Statement (i.e. Trading and Profit and Loss Account). Balance sheet reflects the financial position of the business, whereas, Trading and Profit and Loss Account reflects the operating results, i.e. gross and net profit of the business.

Question: 2

State whether following statement are true or false :
Analysis of financial statement is a tool but not a remedy.

Options

- True
- False

Solution

True

Explanation: Financial statements record financial transactions. However, the process of reviewing and drawing conclusions by evaluating Balance sheet and Profit and Loss Account is done through the analysis of financial statements. It is not a remedy; rather, it is a tool to evaluate results of business and helps in decision-making activity of the management. Analysis of financial statement gives the management an insight into the business and helps them in taking rational decisions.

Question: 3

State whether following statement is true or false :
Analysis of financial statement is a tool but not a remedy.

Options

- True
- False

Solution**True**

Explanation: Financial statements record financial transactions. However, the process of reviewing and drawing conclusions by evaluating Balance sheet and Profit and Loss Account is done through the analysis of financial statements. It is not a remedy; rather, it is a tool to evaluate results of business and helps in decision-making activity of the management. Analysis of financial statement gives the management an insight into the business and helps them in taking rational decisions.

Question: 4

State whether following statement is true or false :
Purchase of fixed asset is operating cash flow.

Options

- True
- False

Solution**False**

Explanation: Purchase of fixed asset is an investing cost for the business. Therefore, it is an investing cash outflow for the business. On the other hand, operating cash flow consists of those activities of business that are related to the operations of the business.

Question: 5

State whether following statement is true or false :
Gross profit depends upon net sales.

Options

- True
- False

Solution

True

Explanation: Gross profit is ascertained by preparing a Trading Account. In this account, all the direct costs incurred are deducted from the net sales (sales less sales return), i.e. revenue, to arrive at gross profit. Hence, it is correct to say that gross profit depends on net sales.

Question: 6

State whether following statement is true or false :

ROI is calculated on ownership capital only.

Options

- True
- False

Solution

False

Explanation: ROI, i.e. return on investment, is calculated on total capital employed which is total of ownership capital and debt capital.

Capital Employed = Share Capital + Reserves & Surplus + Long-Term Loans + Debentures – Preliminary Expenses
Alternatively,

Capital Employed = Net Fixed Assets + Long-Term Investments + Working Capital.

Question: 7

State whether following statement is true or false :
Net profit shows quick ratio.

Options

- True
- False

Solution

False

Explanation: Net profit depicts the overall performance of the business and the efficiency with which business is operating. On the other hand, quick ratio is an indicator of a firm's short-term liquidity.

Question: 8

State whether following statement is true or false :
Government is not interested in analysis of financial statement.

Options

- True
- False

Solution

False

Explanation: It is incorrect to say that government is not interested in the analysis of financial statements. Government uses these statements to study the profit margins and the trends to provide concessions/subsidies or to withdraw or increase/decrease excise and other duties.

Question: 9

State whether following statement is true or false.

Ratio Analysis is useful for inter-firm comparison.

Options

- True
- False

Solution

True

Explanation: Ratio analysis helps an organisation to compare the results of the business with other firms, industries and also helps in appraising the progress and growth of the organisation over the years. It facilitates comparison and helps in determining whether the business is doing better

than other firms and if it is not, what are the improvement areas and the reasons for them.

Question: 10

Select the appropriate answer from the alternatives given below & rewrite the completed statement:

The methodical classification of financial statement is called _____.

Options

- an interpretation
- an analysis
- ratio
- profit and loss A/c

Solution

The methodical classification of financial statement is called **an analysis**.

Explanation: The classification of financial statement is done to evaluate the health of a business concern. The methodical classification of the items in the financial statements helps to analyse and draw various conclusions regarding profitability, efficiency, liquidity and financial position of the business.

Question: 11

Select the appropriate answer from the alternatives given below & rewrite the completed statement :

The common size statement requires _____.

Options

- choose of common base
- journal entries
- cash and flow
- current ratio

Solution

The common size statement requires **choose of common base**.

Explanation: Common size statements require choosing a common base for drawing conclusions. All the items in the balance sheet or the income statement are converted as a percentage of a common base and compared to the previous year or for the same period with different firms. The common base is an aggregate such as total of balance sheet or total of net sales.

Question: 12

Select the appropriate answer from the alternatives given below & rewrite the completed statement :

The short term deposits are _____.

Options

- net cash
- cash equivalent
- cash flow
- cash outflow

Solution

The short term deposits are **cash equivalent**.

Explanation: Cash equivalents are those that can be converted into cash immediately. They are highly liquid in nature. For example, marketable securities, short-term deposits etc.

Question: 13

Select the appropriate answer from the alternatives given below & rewrite the completed statement

Cash proceeds from issue of debentures is _____.

Options

- financial activity
- non financial activity
- operating activity
- trading activity

Solution

Cash proceeds from issue of debentures is **financial activity**.

Explanation: Cash proceeds from issue of debentures are classified as financial activity for the business, as it relates to arrangement of funds for the business.

Question: 14

Select the appropriate answer from the alternatives given below & rewrite the completed statement

Bills payable is _____.

Options

- Long term loan
- Current liability
- Liquid asset
- Net loss

Solution

Bills payable is **current liability**.

Explanation: Bills payable are drawn in case of credit purchases. So, it is a liability to be paid in the near future, i.e. a short-term liability. It is generally payable within a period of 12 months, i.e. a year.

Question: 15

Select the appropriate answer from the alternatives given below & rewrite the completed statement

Generally current ratio should be _____.

Options

- 2:1
- 1:1
- 3:1
- 1:2

Solution

Generally current ratio should be **2:1**

Explanation: The ideal current ratio should be 2:1. That is, the assets of a firm must be twice its liabilities. This ensures that the firm would not default in meeting its short-term obligations.

Question: 16

Select the appropriate answer from the alternatives given below & rewrite the completed statement

The relationship between net profit before Tax, interest and dividend and capital employed is known from _____.

Options

- Current Ratio
- Quick Ratio
- ROI
- ROCE

Solution

The relationship between net profit before Tax, interest and dividend and capital employed is known from **ROI**.

Explanation: Return on investment, i.e. ROI, is based on capital employed, i.e. net profit before tax, interest and dividend divided by capital employed, where capital employed reflects the total amount invested in the business.

While quick ratio and current ratio reflect the liquidity of the business, ROI reflects the profitability.

Question: 17

Select the appropriate answer from the alternatives given below & rewrite the completed statement

From financial statement analysis, the creditors are interested to know _____.

Options

- liquidity

- profit
- sale
- share capital

Solution

From financial statement analysis, the creditors are interested to know **liquidity**.

Explanation: The analysis of financial statements helps creditors in assessing the short-term liquidity position of a business. Such analysis helps them in judging the firm's ability to repay the debts and interest obligations timely. Analysis of financial statements helps creditors in gaining insight about the solvency and profitability of business concerns and, thereby, its liquidity position.

Question: 18

Give one word/term/ phrase for the following statement
Critical evaluation of financial statement to measure profitability.

Solution

Analysis of financial statement

Explanation: It is the process of analysing the business results and the efficiency of the business via various tools. Analysis of financial statement provides an insight into the efficiency with which a business is operating, what is the profitability and what is the present financial position of the business. It facilitates comparison of business results of different firms and over the years.

Question: 19

Give one word/term/ phrase for the following statement
The statement showing profitability of two different period and its percentage change.

Solution

Comparative income statement

Explanation: A statement that compares financial data of different years is known as comparative income statement. Generally, the current year figures are compared with the previous year figures. Basically, it shows how the revenue and expenses have increased in relation to the previous year or year of comparison.

Question: 20

Give one word/term/ phrase for the following statement
The tool for analysis of financial statement where, individual figures of balance sheet is converted into percentage.

Solution**Common size balance sheet**

Explanation: In a common-size balance sheet, the individual items (both assets and liabilities) are expressed as a percentage of some common aggregate.

Question: 21

Give one word/term/ phrase for the following statement
The tool for analysis of financial statement where, individual figures of balance sheet is converted into percentage.

Solution**Common size balance sheet**

Explanation: In a common-size balance sheet, the individual items (both assets and liabilities) are expressed as a percentage of some common aggregate.

Question: 22

Give one word/term/ phrase for the following statement
The type of activity in cash flow analysis, involving purchase of fixed asset.

Solution**Investing activity**

Explanation: Investing activity is the business activity that involves inflow or outflow of cash for purchase or sale of fixed assets and investments.

Question: 23

Give one word/term/ phrase for the following statement
A particular mathematical number showing relationship between two accounting figures.

Solution

Accounting Ratio

Explanation: Accounting ratio expresses the relationship between two accounting variables. It is one amongst the various tools available for financial analysis. Financial ratios are calculated from the financial statements to derive conclusions regarding liquidity, profitability and solvency of a business. They are used to measure the efficiency and profitability of a company based on the financial reports prepared by the business. They facilitate the decision-making task of the management.

Question: 24

Give one word/term/ phrase for the following statement
An asset which can be converted into cash immediately.

Solution

Liquid asset

Explanation: Those assets of the business that can be converted into cash immediately are known as liquid assets. They are highly liquid in nature and are also known as quick assets.

Question: 25

Give one word/term/ phrase for the following statement
The ratio measuring the relationship between gross profit and net sales.

Solution

Gross profit ratio

Explanation: It is the ratio based on net sales and gross profit earned. It is used to assess the profitability of the core business. It reflects the efficiency with which a firm produces its products. Higher the gross profit, better is its financial performance.

Question: 26

Give one word/term/ phrase for the following statement
The ratio measuring the relationship between net profit and ownership capital employed.

Solution

ROCE

Explanation: Return on capital employed reflects the company's profitability and the efficiency with which its capital is employed.

Algebraically,

$$\text{ROCE} = \text{Earnings Before Interest and Tax (EBIT)} / \text{Capital Employed}$$

A higher ROCE indicates more efficient use of capital. ROCE should be higher than a company's capital cost. Lower ROCE indicates that the company is not employing its capital effectively and is not adding to the shareholder value.

Question: 27

Answer the following in brief :

What do you mean by analysis of financial statements?

Solution

It is a process by which financial statements, i.e. Balance Sheet and Income Statement, are analysed to study the business results and the efficiency of the business operations. Also, it helps in the comparison of profitability and financial position of the business over the years or with different firms. Such analysis also facilitates decision-making.

Question: 28

Answer the following in brief :

State any three limitations of Analysis of financial statement.

Solution

Limitations of analysis of financial statements:

- a. The analysis is done for past information, while the users are more concerned about current and future information.
- b. It ignores the non-monetary transactions that are also very useful and relevant for decision-making.
- c. Such analysis is subject to personal bias and judgement. The conclusions drawn from the financial statements are based on the ability and experience of the accountant.

Question: 29

Answer the following in brief :

What is comparative financial statement?

Solution

A statement that compares financial data of different years is known as comparative financial statement. It helps determine business trends and assess a company's success or failure over a period of time.

Question: 30

Answer the following in brief :

What are the different cash inflows and cash outflows of operating activity?

Solution

1. Cash inflows of operating activity:

- a. Receipts from the sale of goods or services
- b. Receipts from the sale of debt or equity instruments in a trading portfolio
- c. Interest received on loans

2. Cash outflows of operating activity:

- a. Payments to suppliers for goods and services
- b. Payments to employees or on behalf of employees
- c. Interest payments
- d. Taxes paid

Question: 31

Answer the following in brief :

What is cash equivalent?

Solution

Cash equivalents are the assets, such as marketable securities and short-term investments, which are readily convertible into cash. They are regarded as highly liquid assets.

Question: 32

Answer the following in brief :

What are the components of current ratio?

Solution

There are two components of current ratio, i.e. current assets and current liabilities. It is calculated as the ratio of current assets to current liabilities. This ratio shows the liquidity position of the business, i.e. the ability of a company to pay off its current liabilities.

Question: 33

Explain the following :

Operating profit.

Solution

It is also known as EBIT, i.e. earnings before interest and taxes. It is the difference between operating income and operating expenses. All the non-operating items (i.e. income and expenses) are ignored.

Question: 34

Explain the following :
Quick assets

Solution

They are highly liquid assets that can be easily converted into cash. It includes cash and other assets, such as marketable securities and accounts receivable, which can be converted easily into cash. However, prepaid expenses and stock are not included in quick assets.

Question: 35

Explain the following :
ROI.

Solution

ROI is calculated to know the return on investment in a business. It is ascertained by dividing the net profit earned with the total capital employed in the business. Higher the ROI, the better it is. It helps in knowing the efficiency and profitability of the business compared to other businesses and also the efficiency with which the capital is employed.

Question: 36

Explain the following :
Comparative income statement

Solution

It is a statement that compares the revenue and expenses of the current and previous year of a business and helps in knowing the trends in the business. It reflects the increase/decrease in the revenue and expenses and explains the trends in the financials and how the business reacts to the changes in the market.

Question: 37

Explain the following :
Common size balance sheet.

Solution

It is a statement that reflects the items of the Balance Sheet as a percentage of some common bases (total assets or total liabilities). It helps in easy analysis of performance during various years (intra-firm comparison) or between different companies (inter-firm comparison).

Question: 38

Explain the following :
Operating activities in cash flow.

Solution

These are the routine and recurring activities of a business, i.e. activities related to core operations of the business. They reflect the result of net cash flow (used or generated) of the company's normal business operations. All the inflows, such as receipt from sale of goods/services etc and outflows, such as payment to suppliers, form part of operating activities, and the net result depicts whether the business is operating efficiently or not.

Question: 39

Solve the following:

In common size balance sheet fixed assets are Rs 50,000 and balance sheet total as Rs 1,50,000. Find out percentage of fixed assets to total assets.

Solution

Fixed Assets = Rs 50000 (Given)
Total Assets = Rs. 150000 (Given)
Fixed Assets to Total Assets = $\text{Fixed Assets} / \text{Total Assets} \times 100$
 $= 50000 / 150000 \times 100$
 $= 33.33 \%$

Question: 40

Solve the following:
If current assets are Rs 2,50,000 and current liabilities are Rs 1,25,000. What will be current ratio?

Solution

Current Assets = Rs. 250000 (Given)
Current Liabilities = Rs. 125000 (Given)
Current Ratio = $\text{Current Assets} / \text{Current Liabilities} = 250,000 / 125,000 = 2 : 1$

Question: 41

Solve the following:

If gross profit as Rs 2,20,000 and operating expenses are Rs 85,000 and non operating expenses are Rs 30,000, find out operating profit.

Solution

Gross profit = Rs. 220,000(Given)

Operating Expenses = Rs. 85,000(Given)

Non-Operating Expenses = Rs. 30,000(Given)

Operating Profit = Gross Profit - Operating Expenses

Operating Profit = 220,000 - 85,000 = Rs. 135,000

Question: 42

Solve the following:

If total capital invested by company is Rs 5,00,000 and net profit before interest, tax and dividend is Rs 1,60,000, what is ROI?

Solution

Net Profit before Interest, Tax and Dividend = Rs. 160,000 (Given)

Total Capital Invested (Net Capital Employed) = Rs. 50,000(Given)

Return on Investment (ROI) = Net Profit before Interest, Tax and Dividend/Total Capital Invested (Net Capital Employed) x 100

= 160,000/500,000×100

= 32 %

Question: 43

If office expenses of two different periods are Rs 4,000 and Rs 5,000 respectively and sales for same two periods are Rs 1,00,000 and Rs 2,00,000 respectively then what is absolute change and percentage?

Solution

Absolute Change in Office Expenses = Office Expenses of Current Year - Office Expenses of Previous Year

Absolute Change in Office Expenses = 5,000 - 4,000 = Rs.1,000

% Change in Office Expenses = Absolute Change in Office Expenses/Expenses of Previous Year x 100

% Change in Office Expenses = 1,000/4,000 x 100

% Change in Office Expenses = 25%

Absolute Change in Sales = Sales Of Current Year - Sales Of Previous Year

Absolute Change in Sales = 200,000 - 100,000 = Rs. 100,000

% Change in Sales = Absolute Change in Sales/Sales Of Previous Year x 100

% Change in Sales = 100,000/100,000 x 100

% Change in Sales = 100%