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WORKSHEET 16

School: Ba Sangam College

Year: 1201

Name _____

Subject: Accounting

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|--------------------------------|---|
| Strand -5 | Analysis And Interpretation Of Financial Statements |
| Sub Strand -5.1 | Analysing Accounting Reports |
| Content Learning Outcome 5.1.2 | Compare and comment ratios of a sole proprietor business. |

Financial Statement Analysis

It is the process of identifying the financial strengths and weaknesses of a business by properly establishing the relationships between the items of Statement of Financial Performance and Statement of Financial Position.

Ratios are tools that can be applied to all the users of accounting information to have a value added approach to financial statements and carry out “*Strengths- Weakness- Opportunities and Trend Analysis*” SWOT.

Need for preparing Comparative Statements

It enables us to compare budgeted results with the actual results of the business.

Able to see the progress of the business in comparison to the past results.

Identify the areas of weakness.

Techniques of Financial Statement Analysis

The following types of analysis may be undertaken when analysing financial statements:

Vertical Analysis - analysis of relationship between items or group of items within the financial statement for one accounting period.

Horizontal Analysis - analysis of relationship between items or group of items within the financial statement for consecutive accounting period.

Trend Analysis - analysis of relationship between items or group of items within the financial statement for a period of three or more years.

Ratio Analysis - is an arithmetic term which describes a simple relationship between two numbers. Accountants use ratio analysis to make financial decisions.

Ratios can be analysed in percentages, time and dollar amounts under the following categories:

Profitability Ratios or Earning Capacity

Liquidity Ratios or Measures of Financial Stability

Measures of Management Effectiveness

Overtrading

Occurs when business is selling large amount of stock with a lower mark-up, or on credit, resulting in an increase in profit but does not have adequate funds to meet the current obligations.

It may increase debtors and profits but the business will be unable to pay for its expenses which may cause liquidity problems in the business.

Over Capitalisation

Means too much capital is invested in fixed assets that provide no income.

Over-investment in fixed assets not only ties up cash but it also becomes unproductive and there is a risk of obsolescence.

Under Capitalisation

Owners' investment is insufficient for the size of the business. It could be due to payment of excessive interests on borrowed funds, use of out dated equipment and machines because of the inability to purchase a new one and increased cost of production.

Limitations of Ratio Analysis

1. Items that cannot be quantified in monetary terms are not included in the ratio analysis.
2. Single year's figures are meaningless unless compared to the previous year of the business trend.
3. Calculations are based on historical cost ignoring the changes in the price level.
4. Different businesses may have different accounting policies which make comparison rather difficult in the same industry. For example, one firm may charge depreciation on straight line basis and the other on diminishing value method.
5. Ratio analysis explains the relationships between past information while users are more concerned about current and future information.

Note: Students are requested go over the example activity on pages (136-146) to complete the following activities.

Activity Questions

The following information analysis relates to Tara and Sons for the year 2017 and 2018.

| Information | 2017 | 2018 |
|---------------------------|---------|---------|
| Gross Profit percentage | 20% | 15% |
| Current ratio | 2.27: 1 | 1.35: 1 |
| Liquid Capital ratio | 1.59: 1 | 0.77: 1 |
| Debt to Equity percentage | 35% | 79% |
| Proprietorship ratio | 0.60: 1 | 0.43 :1 |

Required

Study the analysed information given above and answer the questions that follow:

- (a) What does the Liquid Capital ratio of 1.59: 1 mean to the end user? **(1 mark)**

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- (b) Comment on the following ratios:

- (i) Current ratio

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- (ii) Debt to Equity ratio **(2 marks)**

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- (c) Give **one** reason for the decline in the gross profit percentage. **(1 mark)**

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(d) State the purpose of Proprietorship ratio. (1 mark)

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