9. Analysis of Financial Statement

Objective Questions

A. Select the most appropriate alternative from those given below and rewrite the sentences :

1. Gross Profit Ratio indicates the relationship of gross profit to the ....

a. Net-Cash

<u>b. Net-Sales</u>

c. Net Purchases

d. Gross Sales

2. Current Ratio = ...

Current Liabilities

a. Quick Assets

b. Quick Liabilities

<u>c. Current Assets</u>

d. None of these

3. Liquid Assets = ...

a. Current Assets + Stock

<u>b. Current Assets-Stock</u>

c. Current Assets - stock + prepaid Expenses

d. None of these

4. Cost of goods sold ....

<u>a. Sales - Gross profit</u>

b. Sales - Net Profit

c. Sales Proceeds

d. None of these

5. Net-Profit Ratio is equal to ....

<u>a. Operating ratio</u>

b. Operating net-profit ratio

c. Gross Profit Ratio

d. Current Ratio

6. The Common Size Statement requires ....

<u>a. Common base</u>

b. Journal Entries

c. Cash Flow
d. Current Ratio

7. Bill Payable is ....
a. Long term loan
<u>b. Current Liabilities</u>
c. Liquid Assets
d. Net Loss

8. Generally Current Ratio should be ....
<u>a. 2:1</u>
b. 1:1
c. 1:2
d. 3:1

9. From financial statement analysis the creditors are specially interested to know ....
<u>a. Liquidity</u>
b. Profits
c. Sale
d. Share Capital

B. Give one word/term/phrase for each of the following statement.

1. The statement showing profitability of two different periods.
Ans: Comparative income statement

2. The ratio measures the relationship between Gross Profit and Net Sales.
Ans: Gross Profit Ratio

3. Critical evaluation of financial statement to measure profitability.
Ans: Analysis of Financial Statement

4. A particular mathematical number showing relationship between two accounting figures.
Ans: Ratio

5. An asset which can be converted into cash immediately.
Ans: Liquid Asset

6. The ratio measuring the relationship between net profit and ownership Capital Employed.
Ans: ROCE

7. The statement showing financial position for different periods or previous year and current year.
Ans: Comparative Balance Sheet

8. Statement showing changes in cash and cash equivalent during a particular period.
Ans: Cash Flow Statement

9. Activity related to acquisition of long term assets and investment.
Ans: Financing Activities

10. The ratio that establishes relationship between Quick Assets and Current Liabilities.
Ans: Liquid Ratio

(C) State whether the following statements are True or False with reasons.

(1) Financial statements include only Balance Sheet.

Ans. This statement is False.
Financial statements include Balance Sheet and Profit and Loss A/C. This is because financial statements are prepared by business organisations to find out efficiency. solvency, profitability, growth, strength and status of the business. For this they need information from balance sheet as well as from Profit and Loss A/c.

(2) Analysis of financial statement is a tool but not a remedy.

Ans. This statement is True.
Based on analysis of financial statement one can get idea of financial strengh and weakness of the business. However, based on this one cannot take decision about the business on various issues. Hence analysis of financial statement is a tool but not a remedy.

(3) Purchase of fixed assets is operating cash flow.

Ans. This statement is False.
Purchase of fixed assets is cash flow from investing activities. It is not a day to day operations activities like office/selling/ distribution finance expenses/activities.

(4) Dividend paid is not a source of fund.

Ans. This statement is True.
Dividend is always paid on shares issued by a company is an expense. Shares itself is

a source of fund. In payment of dividend cash goes out from the company. It is an out flow of cash and not a source of fund.

(5) Gross profit depends upon net sales.

Ans. This statement is True.
Gross profit ratio discloses the relation between gross profit and total net sales. Gross profit ratio is an income based ratio, where gross profit is an income. There is direct relation between net sales and gross profit. Higher the net sales higher the gross profit.

(6) Payment of cash against purchase of stock is use of fund.

Ans. This statement is True.
Cash payment for purchase of stock is made from cash balance or/and from bank balance which is a part of business fund. When stock or materials we purchase we use cash for payment.

(7) Ratio Analysis is useful for inter firm comparision.

Ans. This statement is True.
The comparison of the operating performance of a business entity with the other business entities is known as inter firm comparision. This ratio analysis assist to know how and to what extent a business entity is strong or weak as compared to other business entity.

(8) The short-term deposits are considered as cash equivalent.

Ans. This statement is True.
The short-term deposits are liquid assets. It means deposits kept for some period (usually less than one year) and they are kept with an intention to get money quickly as and when required. They are as good as cash and considered as cash equivalent.

(9) Activity ratios and Turnover ratios are same.

Ans. This statement is True.
Turnover ratio is an efficiency ratio to check how efficiently company is using different assets to extract earnings from them. Activity ratio are financial analysis tools used to measure a business ability to convert its assets into cash. From both these definitions we can say that Activity ratios and Turnover ratios are same.

(10) Current ratio measures the liquidity of the business.

Ans. This statement is True.
Current ratio shows relation between current assets and current liabilities. If the proportion of current assets is higher than current liabilities, liquidity position of business entity is considered good. More liquidity means more short-term solvency. From the above it is proved that current ratio measures the liquidity of the business.

(11) Ratio analysis measures profitability efficiency and financial soundness of the business.

Ans. This statement is True.
With the help of profitability ratios (Gross profit, Net profit and Operating profit) one can get the idea of profitability efficiency of the firm and with the help of liquidity ratios (Current ratio and liquid ratio) one can get the idea of solvency or financial soundness of the business.

(12) Usually current ratio should be 3:1.

Ans. This statement is False.
Usually current ratio should be 2:1. It means current assets are double of current liabilities. It shows the short-term solvency of business enterprises.

(D) (1) Answer in one sentence only:

(1) Mention two objectives of comparative statement.

Ans. Objectives of comparative statements are:
(i) Compare financial data at two points of time and

(ii) Helps in deriving the meaning and conclusions regarding the changes and operating results,

(2) State three examples of cash inflows.
Ans. Examples of cash inflows are:

(1) Interest received.

(2) Dividend received,

(3) Sale of asset / investment,

(4) Rent received.

(3) State three examples of cash out flows.

Ans. Examples of cash outflows are:
(1) Interest paid.

(2) Loss on sale of asset.

(3) Dividend paid.

(4) borrowings.

(4) Give the formulas of Gross Profit Ratio.

Ans:
$$\text{Gross Profit Ratio} = \frac{\text{Gross profit}}{\text{Net sale}} \times 100$$

Where Gross Profit = Net Sale – Cost of goods sold

Cost of Good Sold = Opening Stock + Purchase – Purchase return + Direct expenses – closing stock

Net sales = Sales – Sales return

(5) Give formula of Gross Profit.

Ans: Gross Profit = Net sales – Cost of goods sold.

Cost of goods sold = Opening stock + Purchase – Purchase return + Direct expense – Closing stock

Net sales = Sales – Sales return

(6) Give any three examples of current assets.

Ans: Cash or cash equivalent short-term lending and advances, expenses paid in advance, taxes paid in advance, etc. are the examples of current assets.

(7) Give the formula of Current Ratio.

Ans:

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

(8) Give the formula of quick assets.
Ans: Quick assets = Current assets – (Stock + Prepaid expense)

(9) State the formula of Cost of goods sold.
Ans: Cost of Goods sold = Opening stock + Purchase – Purchase return + Direct expense – Closing stock.

(10) State the formula of Average Stock.
Ans:

$$\text{Average stock} = \frac{\text{Opening stock of goods} + \text{Closing stock of goods}}{2}$$