Financial Statement Analysis - it is not always Open and Shut

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On the day next after his appointment as a Finance Officer in PYRAMID QUARTILE REACH Ltd., Tanuj was asked to study the Balance Sheet of the company over the last three years and make observations therefrom. Tanuj was uncertain as to the extent to which this analysis should go and the nature of industry analysis that should be a part of the discussion. His CFO informed that he was only expected to make prima facie observations and not really bother about valuation and industry analysis.

Tanuj studied the Balance Sheet abstracts that were presented to him:

Balance Sheet as at 31 March 2012	Rs. In lakhs		
Particulars	As at 31-03-2012	As at 31-03-2011	As at 31-03-2010
I. EQUITY AND LIABILTIES			
(1) Shareholder's Funds			
(a) Share capital	4562.85	4244.85	4244.85
(b) Reserves and surplus	1261.30	1085.20	890.50
Sub total	**5824.15**	**5330.05**	**5135.35**
(2) Non-Current Lilibilities			
(a) Long-term borrowings	1000.50	950.50	950.50
(b)Other long term liabilities	540.25	300.80	300.80
Sub total	**1540.75**	**1251.30**	**1251.30**

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(3) Current Liabilities			
Trade payables	590.65	505.30	445.50
Sub total	590.65	505.30	445.50
Total Liabilities	7955.55	7086.65	6832.15
II. ASSETS			
(1) Non-current assets			
(a) Fixed assets	4890.50	4105.60	3850.50
(b) Non-current investments	1390.00	1175.00	1050.00
Sub total	6280.50	5280.60	4900.50
(2) Current assets			
(a) Inventories	365.00	345.00	325.00
(b) Trade receivables	740.50	720.50	840.25
(c) Cash and bank balances	569.55	740.55	766.40
Sub total	1675.05	1806.05	1931.65
Total	**7955.55**	**7086.65**	**6832.15**

He was also given the abstracts of the Income Statement for the last three years. These looked as follows:

Statement of Profit & Loss	Rs. In lakhs		
Particulars	**Year ended 31-03-2012**	**Year ended 31-03-2011**	**Year ended 31-03-2010**
I. Revenue from operations (gross)	12130.00	10590.00	11200.00
II. Other Income	15.28	36.15	24.8
III. Total Revenue	**12145.28**	**10626.15**	**11224.80**
IV. Expenses:			
Cost of materials and components consumed	6597.65	5500.65	5750.25
Administrative expenses	2038.345	2740.826	2609.745

Interest	120.06	114.06	114.06
Depreciation and amortization expense	929.195	780.064	731.595
Total Expenses	**9685.25**	**9135.6**	9205.65
V. Profit before tax	2460.03	1490.55	2019.15
VI. Tax expense:	738.01	447.17	605.75
VII. Profit after tax	**1722.02**	**1043.39**	**1413.41**

Tanuj set out to do the analysis. He recalled from his lessons in the Management Program that he had done that several key ratios need to be worked out, and analyzed across the years. He could sense that without this exercise the statements of accounts do not give any clues as to the degree of improvement in performance.

He also recalled that he could perform a DuPont Analysis on these figures to see the relative efficiency across the years.

That evening, the CFO sent him another set of figures which were labelled, "the average of the most important competitors for the last three years". Tanuj realized that he would now have to revise his judgements based on just the figures of PYRAMID QUARTILE REACH Ltd, and actually see how these measured against the industry figures. He saw that the industry figures related to a totally different scale of operation, and decided to convert the figures of PYRAMID QUARTILE REACH Ltd, and those of the industry into a uniform scale.

The industry competitors' average Balance Sheet appears as under:

Competitors Balance Sheet as at 31 March 2012	Rs. In lakhs
Particulars	**As at 31-03-2012**
I. EQUITY AND LIABILTIES	
(1) Shareholder's Funds	
(a) Share capital	6975.25
(b) Reserves and surplus	3990.50
Sub total	**10965.75**
(2) Non-Current Libilities	
(a) Long-term borrowings	750.35
(b)Other long term liabilities	200.55
Sub total	950.90
(3) Current Liabilities	
Trade payables	1030.50
Sub total	1030.50
Total Liabilities	**12947.15**
II. ASSETS	
(1) Non-current assets	
(a) Fixed assets	8980.55
(b) Non-current investments	2600.65
Sub total	11581.20
(2) Current assets	
(a) Inventories	150.55
(b) Trade receivables	900.65
(c) Cash and bank balances	314.75
Sub Total	1365.95
Total	**12947.15**

The competitors' average Income statement appears as follows:

Statement of Profit & Loss for the year ended 31 March 2012	Rs. In lakhs
Particulars	**Year ended 31-03-2012**
I. Revenue from operations (gross)	20988.65
II. Other Income	5.55
III. Total Revenue (I+II)	**20994.20**
IV. Expenses:	
Cost of materials and components consumed	9654.78
Administrative expenses	5876.82
Interest	86.29
Depreciation and amortization expense	1347.08
Total Expenses	**16964.97**
V. Profit before tax (III - IV)	4029.23
VI. Tax expense:	1208.77
VII. Profit after tax (V-VI)	**2820.46**

Tanuj knew that he will be required to brush up basis concepts from Analysis of Financial Statements. Strategically, he would be required to comment on the following aspects:

Profits over the Planning Horizon

The profits over the planning horizon will depend on the sustainable growth rate that the firm is likely to achieve and the extent of expenditure as a result of the continuation/ expansion of activities. The estimation of future profits will also depend upon other economic and marketing factors like the demand for the product/s of the company, the marketing price for the product apart from corporate strategy as regards the product sustainability.

The future profits estimated as per various scenarios will then have to be studied for their adequacy. The interconnection between various heads of expenditure and the sale price has to be studied. This will also involve an analysis of the operational activities of the organization and the cost structure. The extent of assets required for the projected activities would also constitute an important criterion.

After the gross profits are arrived at, we have to take into account factors like depreciation, taxation and interest. While depreciation is a non-cash item not involving an outlay, taxes are directly related to the extent of profits. The interest factor would depend upon the extent of leverage that the company has. This aspect will be discussed in a later section.

Payout Ratio

Payout ratio refers to the extent of profits distributed to shareholders as dividends. The payout ratio is basically a policy decision of the organization based on the general expectations of shareholders and the past record of the Company. Most companies will not be able to take a decision on the extent of the payout ratio in an inconsistent manner because of the repercussions from the shareholders and the signals that the move gives regarding the financial position of the company. The extent of dividend payout would, in turn, determine the amount that can be ploughed back for business development. The growth the company achieves in future would depend on the amount so redeployed into the business.

Capital Structure

Every Company is confronted with the question of how to finance its assets. Some companies do not have any borrowing at all and all their capital requirements are met by equity capital and accumulated reserves. There are a number of Companies on the other extreme, like leasing companies and financial services companies that have only a token equity and rely heavily on borrowings for financing their needs. The method of financing is known by the broad term Capital

Structuring. A number of factors influence the formulation of the structure.

All Companies must necessarily have equity capital. Equity capital is raised by the promoters, their friends and relatives, and in many cases by public issues of shares inviting the public to subscribe the shares of the Company. Equity shareholders are rewarded by dividends paid by the Company. Equity capital constitutes the owner's funds of the Company.

Based on the financial statements and also taking into account reasonable assumptions, Tanuj will be required to be ready with clear strategic suggestions. He will, of course have to answer the following issues as well:

1. What are the principles governing financial statement analysis? Explain the rationale.

2. What is Du Pont analysis? What is its significance?

3. Is the Asset Turnover Ratio important? Explain the rationale.

4. What are the critical working capital ratios? How do they suggest the level of efficiency?

5. When do we use the Common Size statement?

6. Based on financial statements can a future plan be drawn up?

7. What factors govern payout?

8. How is capital structure decided upon?