CHAPTER II

Theoretical frame work of Financial Analysis

2.1 Introduction

2.2 Objectives of Financial statements

2.3 Significance of Financial statements

2.4 Role of Financial statements

2.5 Users of Financial Statements

2.6 Limitations of Financial statements

2.7 Analysis and Interpretation of Financial statements

2.8 Objects of Analysis and Interpretation of Financial statements

2.9 Methods and devices used in Financial Analysis of Financial statements.

CHAPTER II

Theoretical frame work of Financial Analysis

2.1 Introduction

Finance is defined as the provision of money at a time when it is required. Every enterprise needs timely finance to carry on its operations and achieve its targets. Finance being an indispensable input, is rightly called 'life blood' of the business. It is all pervading and all encompassing.

Basically financial statements refer to the Balance Sheet, Profit and Loss account (Income statement), and the supporting statements, schedules, annexures, supplementary statements, explanatory notes, footnotes, etc. Some Companies give accounting policy statement also. All these form part of the 'Annual report'.

The Financial Statements are the end results of the business transactions as mentioned above. It is sufficient to say that once the transactions are captured and properly classified, a large number of statements according to the needs of the business can be prepared – both financially and quantitatively

According to the American Institute of Certified Public Accountant Financial Statements reflect " a combination of recorded facts, accounting conventions and personal judgments and postulates applied". These affect them materially.

2.2 Objectives Of Financial Statements

The Accounting Principles Board of America (APB) states the following objectives of Financial Statements:

- To provide adequate information about the financial performance, Assets & liabilities position of the entity.
- To provide information about changes in economic resources and obligations.
- To provide information about changes in net resources (resources obligations) – arising out of business activities.
- To provide financial information that assists in estimating the earning potential of business.
- To disclose, to the extent possible, the information related to the financial statements that is relevant to the needs of the users of these statements.

These statements capture whole gamut of operations for the period (normally one year). In a going concern the results from year to year give a good insight into the financial health or otherwise of the organization. The Statements can be re-grouped to suit particular needs. For certain analysis unusual items and temporary aberrations may have to be eliminated so that the data is not influenced by such items which are perhaps one time affairs and also the statements becomes comparable from one period to another period. Based on such modified data inferences can be drawn about the strengths and weaknesses in a meaningful way.

2.3 Significance of Financial Statements

1. Income Statement or Profit & Loss Account

It is generally considered to be the most useful of all financial statements. It explains as to what has happened to a business as a result of operations between two dates - (usually called two Balance Sheet dates). For this purpose it matches the revenues and costs incurred in the process of earning revenues and shows the net result i.e. profit or loss during the period under consideration. Since the P & L A/c. reflects the result of operations for a period of time, it is a flow statement.

2. Balance Sheet or (Position Statement)

It is statement of financial position of a business at a specified moment of time. It represents all assets owned by the business and claims of the owners and outsiders against the business on that particular time.

The American institute of Certified Public Accountant define Balance sheet as " A tabular statement of summary of balances (debits and credits) carried forward after one actual and constructive closing of books of account and kept according to principles of accounting."

The important information given by the balance sheet is:

a. A concise summary of the firm's resources (assets) and obligations (liabilities and owners' equity).

b. It is a measure of the firm's liquidity.

c. It is a measure of the firm's solvency.

2.4 Role of Financial Statements

Financial Statements provide:

- Internal financial control;
- Systematic and definite information on the topics needed for decision-making.
- Data on liquidity of funds, solvency of firm, corporate debt capacity, profitability, etc.
- Data to suppliers, financial institutions, investors and revenue authorities, potential creditors and investors.

2.5 **Users of Financial Statements:**

It is through the Financial Statements that accounting information is communicated. There are two types of users viz.

External Agencies	Internal Management
1.Shareholders	1. Board of Directors
2. Creditors	2. Audit Committees
3. Labour Unions	3. And for various departments
4. Revenue Authorities	Production, Sales etc.
5. Banks	
6. Insurance authorities	

1. To the Functional Executives – The first party interested in the financial statement analysis is the finance department itself.

2. To the Top Management – It helps them in reaching conclusion regarding –

a. Performance appraisal of overall business activities.

b. Inquiring about the current financial position.

c. Question concerning the relationships of earnings to trend in sales, etc.

d. Question concerning the relationship of earning to investment.

3. To the Creditors – The analysis of these statements is very useful to the Creditors also. Some of the aspects of an enterprise's operations, which are of interest to the creditors.

4. To the Investors and Others – Investors present as well as prospective are also interested in the measurement of earning capacity of the securities. Investors have been increasingly concerned with cash generation capability of an enterprise primarily in terms of the flexibility available to such enterprises to acquire other business and new assets on advantageous basis.

2.6 Limitations of Financial Statements.

For the reasons & assumptions mentioned above, the financial statements have certain limitations. Persons analyzing these must keep in mind these limitations. Some of the limitations are as follows:

1. Only Interim reports – These statements do not give a final picture of the concern. The data given in these statements is only approximate.

2 Fulfillment of statutory requirements – In most of the cases the financial statements are prepared more as a formality to comply with legal requirements than to give exact information.

3 Do not give exact position – Certain items - like the value of fixed assets in the balance sheet, neither represents the value for which assets can be sold nor the amount which will be required to replace them

4. Historical Cost – The financial statements are prepared on the basis of historical costs. The current value of asset does not figure into account.

5 Impact of non-monetary factors ignored – These factors have a bearing on the operating results of the business but they do not figure in the statements as they cannot be measured in monetary terms, nor there are any conventions to include these in the accounts.

6. No precision_– Valuation of closing stock, obsolete stores, debtors' status, etc. cannot be precisely stated.

7. Emphasis on Monetary Information – Most of the Financial statements are in terms of money.

8. Generally Accepted Accounting Principles – The preparation of financial statements are governed by the GAAP of the Country.

9. Personal Judgment – Many items are left to the personal judgment of the Accountant for example, the method of calculating depreciation, mode of amortization of fixed assets, treatment of deferred revenue expenditure, etc., which depend upon his competency and integrity.

10. The analysis of financial statements is only a means to reach conclusion and not conclusion itself. So it cannot work as a substitute for sound judgment.

Despite many uncertainties and limitations detailed above, the Financial Statements still play useful role and do provide valuable insight and guide in understanding the business and in the process of decision making. Therefore, well-prepared and well-audited financial statements do have their use. Moreover , there is no other alternative.

2.7 Analysis and Interpretation of Financial Statements

Analysis refers to the proper arrangement of data wherein the total figures in the financial statements are regrouped into desired blocks.

Interpretation refers to the comparison of various components and the examination of their content so that useful and definite conclusions may be drawn about the earning capacity, efficiency, profitability, liquidity, solvency, trend, etc. Comparison is therefore a prerequisite for meaningful interpretation. E.g. under the Current Assets - debtors, cash, year-end inventories, bills receivable, etc., grouped.

According to Metcaff and Tetard defined it as, " is a process of evaluating the relationship between component parts of a financial statement to obtain a better understanding of a firm's position and performance".

2.8 Objects of Analysis and interpretation of Financial Statements

Some of the common objects of analysis and interpretation;

1. To examine the earning capacity and efficiencies of various business activities from income statements.

2. To estimate the performance, efficiency and managerial ability of the business.

3. To determine short term and long term solvency of the concern from the Balance Sheet.

4. To enquire about the financial position and ability to pay of the loans and liabilities and creditors.

5. To determine the profitability and future prospects.

6. To investigate the future potential of business

7. To make comparative study of operational efficiency of similar concerns – inter firm comparison.

2.9 Methods and devices used in Analysis of Financial Statements

The analytical methods or devices listed below are used to ascertain or measure the relationships among the financial statement. Fundamental objective of any analytical method is to simplify or reduce the data under review in more understandable terms.

The various methods and devices used in analyzing financial statements are as follows:

1. Common size statement;

2. Comparative statements;

3. Trend Analysis;

4. Statement of changes in working capital;

5. Funds flow and cash flow analysis;

6. Ratio Analysis;

7. Cost / Volume – Profit analysis

1. Common size statement:

Statements that give vertical percentages or ratios for financial data without giving rupee value are known as common size statements. They are also known as percentage statements. It is called a common size Balance Sheet. Common size statements include common size Profit and Loss Account, Common size Balance sheet, Common size Income statement and Comparative utility of common size financial statement. Common size financial statements when read horizontally do not give information about the trend of individual items but give the trend of real relationship to total.

2. Comparative Statements

The comparative financial statements are financial positions at different period of time. The elements are shown in a comparative form so as to give an idea of financial position at two or more periods. Comparative financial statement (i.e. both P & L A/c. and Balance Sheet) are prepared by providing columns not only of the years just ended (for the purpose of convenience this year may be called current year) but also for the years preceding the year just ended.

The changes in different items represent the outcome of operations, interaction amongst assets, liabilities and capital. The comparative statement may show Absolute figures (rupee amount) , Changes in absolute figures, Absolute data in terms of percentages, and increase or decrease in terms of percentages. The two comparative statements are Balance Sheet and Income Statement.

3. Trend Analysis

In this method the profit and loss account and the balance sheet of an accounting year are taken as the base. This base year may be the earliest year involved in the comparison or the latest year or any intervening year. The financial statement may be analyzed by computing trends of series of information. This method determines the direction upwards or downwards and involves the computation of the percentage relationship that each statement item bears to the same item in base year. (Here write the turnover of various years and compare the trends)

Procedure for calculating trends

1. One year is taken as a base year. Generally the first or the last is taken as base year.
2. The figures of base year are taken as 100.
3. Trend percentages are calculated in relation to base year.

4. Statement of changes in working capital

To discuss the increase or decrease in working capital over a period of time the preparation of a statement of changes in working capital is also very useful.

The main objective of this statement preparation is to derive a fairly accurate summary of the events that affected the amount of working capital. The amount of net working capital is determined by deducting the total of current liabilities from the total of the current assets.

But it does not explain the detailed reasons for the changes in working capital and methods of financial additional requirement of working capital.

5. Fund flow and cash flow analysis

Funds flow analysis is a valuable aid to the financial executives and creditors for evaluating the uses of funds by the firm and in determining how these uses were financed. A funds flow statement indicates where funds come from and where it was used during the period under review.

These statements can be prepared separately as funds flow and cash flow statements. They are important tools of communication and very helpful for financial executives in planning the intermediate and long turn financing of the firm.

6. Ratio Analysis

Ratio analysis is an important and widely used tool of analysis of financial statements. It is essentially an attempt to develop meaningful relationships between individual items (or group of items) in the balance sheet or profit and loss account.

The objects and the utility of ratio analysis as a technique of financial analysis is confined not only to the internal parties but also to the credit suppliers, banks and lending institutions. It functions as a sort of health test. In a nut shell ratio analysis gives the answers to the following problems related to enterprise's financial position, capital structure, profitability, credit policy, liquidity, solvency, profitability and capital gearing etc.

Financial ratios are classified various groups. They are statements wise classification, Functional wise classification, Classification by Relative importance, Classification by Accounting Significance, Classification by purpose.

Uses of Ratios

According to J. Batty some of the possible uses of accounting ratios are as follows:

Ratios play an important role in imparting knowledge within the business as to outside shareholders or other interested parties.

1. Ratios may be used as measure of efficiency on financial stability.
2. Past ratios indicate trends in costs, sales, profits, etc, or relevant facts and so they can be used for forecasting likely events in the future.
3. Control may be materially assisted by the use of ratios. This includes in control of performance as well as control of costs.

7. Statement of Changes in Financial Position (SCFP)

The income statement (P & L A/c) does not show the effect of all the events, which affect liquidity. The correct appraisal of performance, requires the knowledge about movement of funds during a year and their impact on the financial position. Such statement is known as statement of changes in financial position or Funds statement.

One of the key purposes of statement of changes in financial position is to explain fully the increase/decrease in working capital during a period.

The above theoretical frameworks regarding Financial Statements provide a base and guideline for further chapters.