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CHAPTER-III

TECHNIQUES OF FINANCIAL ANALYSIS

A. THE FINANCIAL STATEMENTS

3.1 INTRODUCTION

The object of this chapter is to design the theory of financial statements analysis, which will be useful for the purpose of emperical study.

3.2 CONCEPT OF FINANCIAL STATEMENTS

The financial statements are account balances arranged in effective and meaningful order. Therefore, that the facts and concepts they portray may be readily interpreted and used as basis for decisionsby all people, who are interested in the affairs of business. On the basis of information in the financial statements, management may review the Company's progress to date and decide upon the course of action tobe taken in future, creditors may choose to extend, maintain or restrict credit and shareholders may judge prospects for their investments, and elect to sell or to continue ownership. The employee groups may form judgement as to the ability of the Company to pay higher wages, and the general public may appraise the effectiveness of the economic unit from which it buys goods or services.

The term 'financial statement', as used in modern business, refers to two statements-the balance sheet and income statement, or profit and loss statement, showing the results achived during a certain period. They are prepared at the end of accounting year for a business enterprise. It has now become a practice, particularly in the case of big companies, to add a third statement which is the statement of retained earnings. Moreover, the 'package of financial statements' as it is sometimes referred to, also includes such schedules, as those relating to land, building, equipment, investories, long-term investments, accrued liabilities, long term debt, cost of goods manufactured, selling expenses and administrative and general expenses, intended to supplement the data contained in financial statements. These schedules are considered as part of the statements for the purpose of analysis and, in fact, they constitute the first step towards the analysis of certain data in the balance sheet and income statement. Over and above these the statement of changes in not working capital, which is an important statement from the point of view of analysis is being included in the 'package' by some corporate enterprises, though it is not currently in general use.

When the adequate disclosure of important information cannot be given merely by the listing of the financial statement items, explanatory footnotes have to be given as an integral part of financial statements. These explanatory notes are important in as much as they tend to enhance the value of the statements to the readers.

3.3. FUNCTIONS OR IMPORTANCE OF FINANCIAL STATEMENTS

George O. May points out the following major uses of financial statements.

1. As a report of stewardship.
2. As a basis for fiscal policies.

3. As a guide to the value of investments already made.
4. As a basis of granting credit.
5. To determine the legality of dividends.
6. As a guide to wise dividend action.
7. As an information to prospective investors.
8. As a basis for price or rate regulation.
9. As an aid to Government.
10. As a basis of taxation.

3.4 STRUCTURE OF FINANCIAL STATEMENTS

—Income Statement

— Balance Sheet

The term 'financial statement' is, however, used here to mean Income statement & Balance Sheet.

INCOME STATEMENT OR PROFIT & LOSS ACCOUNT :

This statement or account records balances of all the nominal accounts i.e. income and expenses. It explains what has happened to a business as a result of operations between two balance sheet dates. In the words of Prof. S.B. Chowdhary, "The profit & loss account summarises those transactions in which there is a loss or gain for the owners of the business.

This statement or account shows the income earned and the expenses incurred to earn that income during the accounting period on the basis of 'matching concept'. It means the expenses, whether paid or not, incurred to earn certain revenue must be matched against that revenue. To determine net profit or net loss these expenses are deducted from the revenues earned. According to the Companies Act the profit & loss a/c must give a true and fair view of the profit earned or loss sustained during the accounting year.

BALANCE SHEET :

It is a sheet or a statement of all the balances of the accounts remained after all the nominal accounts have been closed by transferring their balances to the profit & loss account. All debit balances are taken to the right hand side i.e. liabilities side of the statement. As such balance sheet is defined as a statement of assets and liabilities of the business.

The Balance Sheet reveals the financial position of the business at a certain point of time—the last day of the accounting year. It indicates what the business owes and what it owns on a particular day. What it owes are its liabilities, including capital and reserves, whereas what it owns are its assets.

B. ANALYSIS OF FINANCIAL STATEMENTS

3.5. INTRODUCTION

After the detailed discussion of financial statements. It becomes necessary to study the concept of analysis of financial statements. The main aspects of financial statements analysis are discussed below one by one :

3.6 MEANING OF ANALYSIS AND INTERPRETATION

Analysis of financial statements or "financial analysis" or "financial appraisal" have the same meaning and are generally used as synonymous. The techniques of financial statements analysis are used for the purpose of financial appraisal. Financial appraisal is a scientific evaluation of the profitability and financial strength of any banking business. In other words, financial appraisal is an evaluation of the financial performance as also of the financial position of the concerned unit. Financial performance is 'judged on the basis of financial data as contained in the profit and loss account whereas financial position is evaluated on the basis of figures in the position statement or balance sheet of the concerned unit.

The aim of financial analysis is to find out what financial statements mean.

Analysis means breaking the statements intoprocesses of re-arrangement, re-grouping, calculating ratio etc. Analysis of financial statements helps in diagnosing the financial health and weakness of a business unit.

In the words of myers, "financial statement analysis is largely a study of relationship among the various financial factors in a business as disclosed by a single set of statements and a study of the trends of these factors as shown in a series of statements".

Interpretation means a mental process of forming opinions or drawing inferences about the health, profits etc. based upon the analysis.

3.7. NEED OF FINANCIAL ANALYSIS

Interpretation and analysis are closely connected because interpretation is impossible without analysis, and short of interpretation, analysis is useless. Therefore, interpretation requires analysis. A financial statement figures consist not only of account balances, which usually are the result of a number of debit and credit entries for a variety of transactions, but also combinations of account balances, these figures do not represent homogeneous data and, therefore, it is difficult to interpret them. This necessitates an analysis of the totals in statements into their components so as to restore some sort of homogeneity to the statement data.

3.8 IMPORTANCE OF FINANCIAL ANALYSIS

The analysis and interpretation of financial statements is an important accounting activity. The users of business financial statements are interested in these statements primarily as an aid to determine the financial position and the results of the operations.

There are different parties interested in the financial analysis of these statements and their aim and objectives of analysis also differ significantly.

3.9 OBJECT OF FINANCIAL ANALYSIS

The following are the main objctives of the analysis of financial statements :

1. To estimate the earning capacity of the firm.
2. To guage the financial position and financial performance of the firm.
3. To determine the long term liquidity of the funds as well as solvency.
4. To determine the debt capacity of the firm.
5. To decide about the future prospects of the firm.

As a matter of fact, the objectives of analysis of these statements, depend to a large extent on the point of the view of the analyst, the degree of Interest in company and the need for depth of enquiry and finally on the amount and quality of the data available. The object of the analysis determines the extent, the depth and the nature of analysis. If a thorough analysis is desired and the full data needed are not available or if the suspicion exists that the firm is trying to hide or confuse its real position, the financial analyst must be virtually defective in order to find out the truth.

3.10 PROCESS OF FINANCIAL ANALYSIS

A common procedure of analysis of financial statements, whether done by any interested party, will be as follows :

1. Deciding upon the extent of analysis : First of all the depth object and extent of analysis has to be

determined by the analyst. The determination of thes basic facts determinesthe scopeof analysis, tools of analysis and the amount and quality of financial data to be required.

2. Going through the financial statements : Before analysing and preparing any statements or composing financial ratios, it is necessary for the analyst to go through the various financial statements of the firm.

3. Collection of necessary Information : The analyst should collect other useful information from the management, useful for analysis but not being revealed from the published financial statements.

4. Rearrangement of financial data : Before making actual analysis and interpretation the analyst must rearrange the data provided by these statements in useful manner. The approximation of figures, re-classification of consolidation of items, etc. is done in this step.

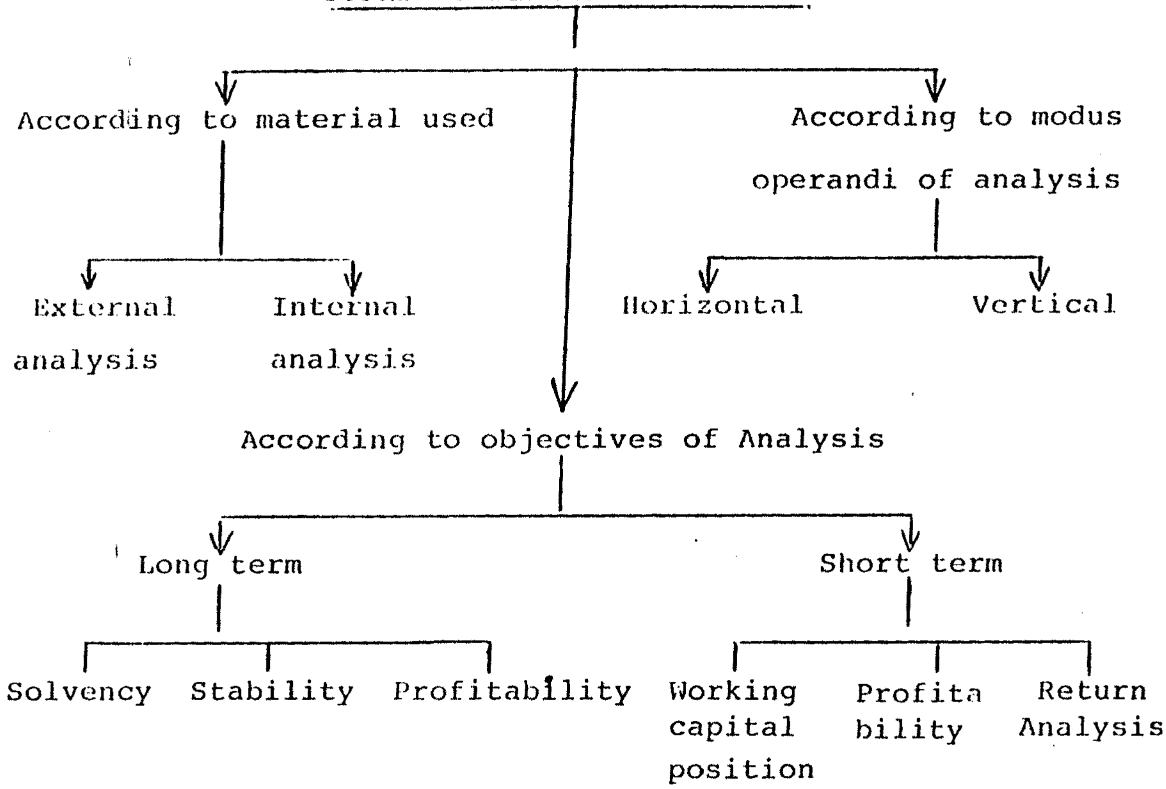
5. Analysis : Now the actual analysis is made. For analysis any of the above technique may be used.

6. Interpretation & Presentation : After analysing the statements the interpretation is made and the inferences drawn from this analysis are 'presented in the shape of reports to the management, etc.

3.11 TYPES OF FINANCIAL ANALYSIS :

A distinction may be drawn between various types of financial analysis eitheron the basis of material used for the same or according to the modus operandi of the analysis or the object of the analysis. The following chart will give a snap-shot view of it.

TYPES OF FINANCIAL ANALYSIS



3.11.1 ACCORDING TO MATERIAL USED :

3.11.1.1 EXTERNAL ANALYSIS :

External analysis of financial statement is made by those who do not have access to the detailed accounting records of company, ie. banks, creditors and general public. Those people depend almost entirely on published financial statements. The main objective of such analysis varies from party to party.

3.11.1.2 INTERNAL ANALYSIS :

The internal analysis is accomplished by those who have access to the books of accounts and all other information related to business. While conducting this analysis, the analyst is a part of the enterprise he is analysing. An analysis for managerial purposes is the internal type of analysis and is conducted by executives and employe of the enterprise as well as governmental and court agencies which may have major regulatory and other jurisdiction over the business.

3.11.2 ACCORDING TO MODUS OPERANDI OF ANALYSIS

3.11.2.1 HORIZONTAL ANALYSIS :

When financial statements for a number of years are reviewed and analysed. The analysis is called horizontal analysis. As it is based on data from year to year. Rather than on one date or period of time as a whole, this is also known as Dynamic Analysis.

3.11.2.2 VERTICAL ANALYSIS :

It is frequently used for referring to ratios developed for one date or for one accounting period. Vertical analysis is also called 'Stafic Analysis.' This is not very correct analysis of the firm's financial position and its interpretation, as it does not enableto study data in perspective.This can only be provided by a study conductd over a number of years, So that comparison can be effected. Therefore vertical analysis is not very useful.

3.11.3 ACCORDING TO OBJECTIVES OF ANALYSIS :

3.11.3.1 SHORT TERM ANALYSIS :

The shortterm analysis of financial statement is mainly concernedwith theworking capital analysis. In the short run a company musthave ample funds readily available to meet its current needs and should have sufficient borrowing capacity to meet the contingencies. Hence in short term analysis, the current assets, the current liabilities are analysed and cash position (liquidity) of the concern is determined for short term analysis, the ratio analysis is very useful.

3.11.3.2 LONG TERM ANALYSIS :

In the long term the company must get reasonable rate of return on the investment to provide for the necessary growth and development of the company and to meet the cost of capital. Financial planning is also necessary for the continued success of a company. Thus, in the long run analysis the stress is on the stability and earning potentiality of the concern. In long-term analysis, the fixed assets, the long-term debt structure and the ownership interest are analysed.

3.12 LIMITATIONS OF FINANCIAL STATEMENT ANALYSIS :

The analysis of financial statements has certain limitations. Hence while using this technique, we must keep in mind these limitations. Main limitations are as follows:

1. The analysis of financial statements is only a means to reach conclusions and not conclusion in itself.

2. The figures drawn from one year's statement have limited use and value. So, it will be dangerous to depend upon them only.

3. The results of the analysis of financial statements should not be taken as an indication of good or bad management.

4. The basic nature of financial statement is historic. A past can never be hundred percent representative of the future.

5. Any change in the method or procedure of accounting mars the utility of such analysis.

6. The figures of one firm are seldom fully comparative with those of the other because there is difference in the nature of products, procedure in accounting, cost of plant and machinery, nature and pattern of financing, etc.

7. The repaid changes in the value of money also reduce the validity of such analysis and no useful conclusions can be drawn from a comparative study of the financial statements of different years.

8. Balance sheet draws the position of the business as at the end of a particular date. It does not intend to show the actual realisable value of the business. Fixed assets are not being shown as realisable value.

9. Depreciation of the assets does not represent the actual reduced life of the assets. Moreover, basis or rate of depreciation.

1. Financial statements do not record many facts which have a direct bearing on the financial soundness of the company, because such facts cannot be expressed in monetary value or in terms of money.

3.13. **TECHNIQUES OF FINANCIAL ANALYSIS :**

An analysis of financial statements consists of a study of a relationship and trends to determine whether or not the financial position and results of operations as well as the financial progress of the company are satisfactory. The analytical methods listed below, are used to measure the relationships among the financial statement items of a single set of statement and changes that have taken place in these items as reflected in successive financial statements. The fundamental objective of any analytical method is to simplify or reduce the data under review to more understandable terms. There are three groups virtually concerned with a firms financial condition .

1. The firm's creditors

2. The firm's investors and

3. The financial management

The following are more commonly used techniques of the financial statement analysis :

1. Ratio Analysis
2. Funds Flow Analysis
3. Common-size statements Analysis
4. Comparative statements Analysis
5. Trend Analysis.
6. Other techniques of Analysis

— Cash flow Analysis

— Break even Analysis

— Moving averages

— Index numbers

— Range

— Standard deviation

— Correlation

— Regression

— Analysis of time series