Chapter III

THEORETICAL FRAMEWORK

CHAPTER 3

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3.1 Financial Statement

3.1.1 Introduction

One of the most important functions of the accounting process is to accumulate and report historical accounting information. The most prominent example of such reports has the general purpose financial statement showing an organizations financial position and result of its operations. These financial statements are the end result of the process of financial accounting. In the word of Hampton, "A financial statement is an organized collection of data, organized accounting to logical and consistent accounting procedure." Therefore all the statement and accounting reports which the accounts prepared at the end of the period for the business enterprise may be taken as financial statement but the principle financial statement are the 'Balance sheet and the Profit and loss account.'

3.1.2 Meaning and Concept of Financial Statements

Concept

The American institute of Certified Public Accountants states the nature of financial statements as "financial statements are prepared for the purpose of presenting the periodical review or report on progress by the management and deal with the status of investment in the business and the result achieved during the period under review. They reflect a combination of recorded facts, accounting principles and personal judgments."

According to 'John N. Myer – "The financial statements are compared of data which are the result of a combination of

1) Recorded fact concerning the business transactions
2) Conventions adopted to facilitate the accounting techniques.
3) Postulates or assumptions made to and

4) Personal judgments used in the application of convention and postulates."

Analyzing financial statement is a process of evaluating relationship between component part of financial statements obtain a better understanding of firms position and performance.

Financial statements at least refer to the two statements, which prepared by business concern at the end of the year. There are

1) Income statement or Trading and Profit & Loss accounts, which are prepares by business concern in order to know the profit, earned and loss sustained during a specified period.

2) Position statement or Balance Sheet, which are prepares by a business concern on a particular date in order to know its financial position.

To the statement of corporation there added a third statement, the retained earnings statement, which reconciles the period with that at the beginning.

These statements are prepared for external reporting to owners, investors and creditors, employees, customers and tax authorities. So these statements are called external reports which communicate financial information to the outsiders. Financial statement may also be use for internal reports used by management as an important tool for decision-making. Financial statements are the products of the accounting of business transactions expressed in money value.

3.1.3 Objectives of Financial Statement

Some important objectives of financial statements are given below

1) To provide financial information that assist in estimating the earning potential of the enterprises.
2) To provide reliable financial information about the economic resources, and obligations of the business enterprises and the change in these items
3) To provide reliable information about changes in the resources of an enterprise that result from its profit directed activities.

4) To disclose the extent possible other information related to the financial statements such as enterprises accounting policies that is relevant to the statements of users needs.

3.1.4 Importance of Financial Statement

The information given in the financial statements is very useful to number of parties. These are the following.

1) Owners

The owners provide funds for the operations for the operations of a business and they want to know whether their funds are being properly utilizes or not, the financial statements prepared from time to time satisfy their curiosity.

2) Creditors

Creditors (i.e. suppliers of goods and services on credit bankers and other lender of money) want to know the financial position of a concern before giving loans or granting credit. The financial statement helps them in judging such position.

3) Investors

Prospective investors, who want to invest money in a firm, would like to make an analysis of the financial statement of that firm to know how safe the proposed investment will be.

4) Employees

Employees are interested in the financial poison of a concern they serves, particularly when payment of bonus depends upon the size of the profits earned. They world like to know that the bonus being paid to them is correct, so they become interested in the preparation of correct Profit and Loss account.

5) Government

Central and state governments are interested in the financial statements because they reflect the earnings for a particular period for purpose of taxation moreover; these financial statements are use for comparing statistics concerning business, which, in turn, help in compiling notional accounts.

6) Research Scholars

The financial statements being a mirror of the financial position of a firm are of immense value to the research scholar who wants to make a study into financial operations of particular firm.

7) Consumers

Consumers are interested in the establishment of good accounting concern so that cost of production may be reduces with the resultant reduction of price of good they buy.

8) Manager

Management is a art of getting thing done through others. This requires that the subordinates are doing work properly financial statement serves the manager in appraising the performance of the subordinate.

3.1.5 Limitations Of Financial Statements

Followings are the main limitations of financial statements,

1) Interim and not final report

Financial statements do not depict the exact position and the essentially interim reports. The exact position can be only knows, if the business is closed.

2) Lack of precision and definiteness

Financial statements may not be realistic because, these are prepared by following certain basic concept and conventions. For example, going concern concept gives us an idea that business will continue and assets are to be recorded at cost but the book value at which the assets is shown may not be actually realizable similarly, by following the principle of conservatism the financial statements will not reflect the true position of the business.

3) Lack of objective judgments

Financial statements are influence by the personal judgment of the accountant. He may select any method for depreciation, valuation of stock, such judgment if based on integrity and competency of the accountant whiff definitely affect the preparation of financial statements.

4) Records only monetary facts

Financial statements disclosed only monetary facts i.e. those transactions recorded in the books of accounts, which can be measures in monetary terms such as, conflicts between production manager and marketing manager may be very important for a business concern but not recorded in the business books.

5) Historical in nature

These statements have drawn after the actual happening of the events. They attempt to present a view of the past performance and have nothing to do with the accounting for the future. Modern management is forward looking but these statements do not directly help them in making future estimated and taking decision for the future.

6) Artificial view

These statements do not gives a real and correct report about the worth of the assets and their loss of value these are shoes on historical cost basis. Thus, these statements provide artificial view as market or replacement value and the effect of changes in the levels are completely ignored.

7) Scope of manipulation

These statement are sometime prepared according to the needs of the situation or the whims of the management. A high efficient concern may conceal its real profitability by disclosed loss or minimum profit whereas an inefficient concern may declare dividend by wrongly showing profit in profit and loss account.

8) Inadequate information

There are many parties, who are interested in the information given in the financial statements but these objectives and required are differ. The financial statements as prepared under the provision of the company Act. 1956 fail to meet the needs of all.

3.2 Financial Analysis

3.2.1 Introduction

The basis for financial analysis is financial information. A business firm preparation it's final accounts viz. balance sheet and profit and loss a/c, which provides useful financial information for decision-making. The financial managers have certain analytical tools, which helps in financial analysis and planning. There are various tools of financial analysis and planning viz. financial statement analysis, fund flow statement analysis, cash budgeting.

Financial analysis is a scientific evaluation of the profitability and financial strength of any banking business financial performance, is judged on the basis of financial data as contained in the profit and loss a/c were as financial position statement or balance sheet of the concerned unit.

The aim of financial analysis is to find out what financial statement mean. Analysis means breaking the statements into processes.

3.2.2 Concept

According to John Myer, "Financial statement analysis is 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 trend of these factors as shown in a series of statements."

According to Metcaff R. W. and Titard R. L.

"Analysis of financial statements is a process of evaluating relationship between component parts of financial statement obtains a better understanding of firm's position and performance."

3.2.3 Significance and Purpose of Financial Analysis

Purpose of analysis and interpretation depends upon as to who is interested and what is his object? Different user of financial information have different object still the following may be state as common or general purpose of analysis.

a) To assess entity's capacity to meet short-term liabilities

b) To assess entity financial soundness in the long run

c) To assess operational efficiency and profitability

d) To assess relative performance of one unit with other units of the same industry

e) To review the progress of the unit over a period of time

f) To forecast the future prospects of the units

3.2.4 Limitations of Analysis

Financial statements are the output of accounting tools and techniques of analysis have developed by management accounting. Analysis has conducted by the analyst. The accounting, management accounting and the analyst, all the three suffer from limitations or inadequacies. Therefore, it is but natural that financial analysis should also suffer from certain limitations or inadequacies. Therefore, it is but natural that financial analysis should also suffer from certain limitations.

1) Financial statements are historical in nature. They provide information relating to past only. Past can never be a perfect guide to future.

2) Reliability of analysis shall depend upon as to how much reliable the financial statements are?

3) Static analysis is not much valuable. Analysis can be careful and effective only when comparison has made possible either over.

4) Non availability/ non-comparability of figure

5) Analysis cannot substitutes sound judgment one should not take the result of the analysis as judgment or conditions.

6) Perceptions of the users are different. Even if the results are same, the interpretation of the different users shall not be the same.

7) Pit-fall of inter firm comparisons are far more difficult when the performance, efficiency, profitability etc. of different firms are being studied.

The above limitations of financial analysis should make the analyst cautions in his approach. He should be careful while commenting. Analysis can be useful if used by competent analyst working with a keen sense of observation, expertise and neutrality i.e. free from bias.

3.2.5 Objectives of Financial Analysis

Financial analysis is helpful in assessing the financial position and profitability of a concern. This has done through comparison by ratios for the same concern over a period of year, or for one concern against another etc.

Main objectives of analysis of financial statements are to assess,

a) The present the future earning capacity or profitability of the concern.

b) The operational efficiency of the concern as a whole and of its various parts of departments

c) The short term and long term solvency of the concern for the benefits of the debenture holders and trade creditors

d) The comparative study in regard, to one firm with another firm with another firm or one department with another

e) To assess the possibility of developments in the future, by making forecast and preparing budgets.

f) The financial stability of a business concern

g) The real meaning and significance of financial data

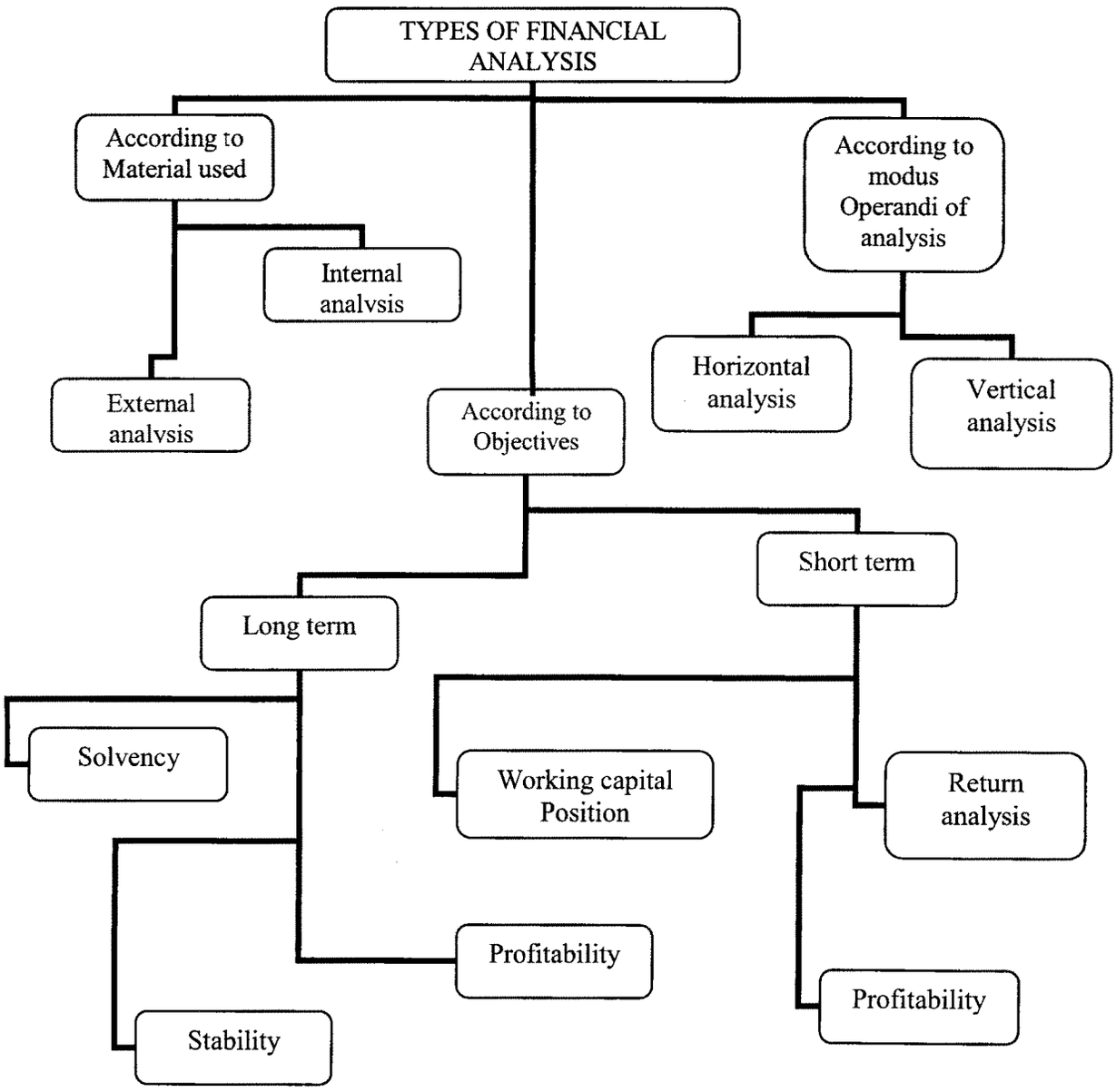
h) The long term liquidity of its funds

3.2.6 Types of Financial Analysis

Financial analysis can be classify in to different categories depending upon,

- The material used,
- The objectives of analysis
- The modus operandi of analysis,

Chart no 2 Types Of Financial Analysis



3.2.6.1 On The Basis Of Material Used

According to this basis, financial analysis can be of two types.

a) **External analysis**

External analysis has made by those who do not have access to the detailed records of the company such analysis depend entirely upon published financial statements. The user in this category include investors, creditors etc.

b) **Internal analysis**

Internal analysis is conducted by those who have assess to the books of accounts and other related information from the records of the company such analysis is conducted by government, and court agencies who assume special power by virtues of same enactment.

3.2.6.2 According To Objectives Of Analysis

a) **Long term**

In long term, the business enterprises must earn a minimum amount, to maintain a suitable rate of returns on the investment to provide for the necessary growth and development of the enterprise and to meet the cost of capital. Proper planning requires sufficient knowledge of the enterprises current position, which may be determined from the short-term financial analysis only.

b) **Short term**

It is primarily concerned with the working capital analysis, so that a forecast for may be made of the prospects for future earning, ability to pay interest, debt maturities both current and long term profitability of a sound dividend policy. In short rum analysis the current liabilities and current assets are properly analyze.

3.2.6.3 On The Basis Of Modus Operandi

According to this basis, financial analysis can also be of two types.

a) Horizontal analysis

In case of this type of analysis financial statements for a number of years, reviewed and analyzed. The current year's figures are comparing with the standard or base year. It is also known as Dynamic Analysis.

b) Vertical analysis

Vertical analysis is that types of analysis where financial statement reviewed of one period (year) only. It is also known as "static analysis."

It is to be noted that both analysis – Vertical and Horizontal – can be done simultaneously also. For example the income statement of a company for several years may be given. Horizontal elements of cost and sales over a number of years on the other hand, vertical it may show the percentage of each elements of cost to sales.

3.3 Comparative Financial Statement

3.3.1 Introduction

The element of financial position is shows in a comparative form so, as to give an idea of financial position at two or more period. Any statement prepared in comparative form will covered in comparative statements.

3.3.2 Meaning Of Comparative Statements

A simple method of touching the period changes in the financial performance of a company is to prepare comparative statements. Comparative financial statements will contain items. At least for two periods Changes increase and decreases in terms of income statement and balance sheet can be show in two ways:

1) Aggregate changes
2) Relative or proportional changes

From practical point of view, generally, two financial statements (Balance sheet and income statement) are prepared in a comparative form for financial analysis purposes. Not only has the comparison of the figures of two periods but also the relationship between balance sheet and income statement enabled an in-depth study of financial position and operative results. The comparative statements may show.

1. Absolute figures (rupee/ amount)
2. Increase or decrease in absolute amount.
3. Absolute data in terms of percentage
4. Increase or decrease in terms of percentages.

The analyst is able to draw useful conclusions when figures are gives in a comparative position. The figures of sales for a quarter, half-year or one year may tell only the present position of sales efforts. When sales amount of pervious periods are gives along with the amount of current periods then the analyst will be able to study the figures of current periods then the analyst will be able to study the trends of sales over different periods of time. Similarly, comparative figures will indicate the trend and direction of financial position and operating results.

i) Comparative Income Statements

This statement discloses the net profit or net loss resulting from the operation of business. Such statement shows the operating result for a number of accounting periods so that changes in absolute data from one period to another period may be states in the term of absolute changes or in terms of percentage. This statement helps in deriving meaningful conclusions, as it is very easy to ascertain the changes in sales volume. Administrative expenses, selling and distribution expenses cost of sales etc.

ii) Comparative Balance Sheet

This statement prepared on two or more different dates can be use for comparing assets and liabilities and to find out any increase or decrease in these items. This facilitates the comparisons of figures of two or more period

and provides necessary information, which may be useful in forming an opinion regarding the financial condition as well as progressive outlook of the concern.

3.4 Common-Size Statement Analysis

3.4.1 Introduction

The common-size statements balance sheet and income statement, are shows in analytical percentages of total assets, total liabilities and total sales. The total assets are taking as 100 and different assets are express as a percentage of the total liabilities. These statements are also known as component percentage or 100 percent statements because every individual item is stated as a percentage every individual item is stated as a percentage of the total 100.The shortcomings where changes in items could not be compared with the totals have been covered up.

The common size statement may be prepared in the following way-

1. The totals of assets or liabilities have taken as 100.
2. The individual assets are express as a percentage of totals of asset ie.100 and different liabilities have calculated in relation to total liabilities.

The common size balance sheet is a horizontal analysis. The comparison of figures in different periods is not useful because total figures may be affects by a number of factors. It is not possible to establish standard norms for various assets. The trends of figures from year to year-to-year may not be studied and even they may not give proper result.

3.4.2 Advantages Of Common-Size Statement

1. This method of analysis is simple and easy to understand.
2. This analysis makes possible "Comparison between two or more years, or two or mores companies or a single company and the aggregate statement for the entire industry."
3. Common size statement particularly the vertical format provides a direct picture of the significant aspects of the health of an enterprise.

4. The common size statements afford a qualitative analysis of the health of an enterprise unlike the comparative financial statements, which restrict the analysis to a more quantitative comparison.
5. The quantitative analysis brings out the important tendencies of the enterprises, which can be use as a guide in the formulation of future financial policies.
6. The common size statement can be used to make comparison is however, subject to the limitations, imposed by different characteristics of the firms and also the diversity in accounting policies pursued by the firm in question.

3.4.2 Disadvantages of Common Size Statement:

1. Common size statements, as presented above, do not provide any reference level to indicate whether the proportion of an item is 'normal', 'abnormal' or supernormal.
2. Again, sales have been chose, as a base the implied assumption is that sales are a stable and tenable norm. Further, it implies that the movement of all other item bears a close relationship with sales. If sales happens to be a Volatile and erratic parameter, the percent to sales loses credibility to that extent,

Thus, the change in the rupee value of sales is a function of sales price and sales volume.

3.5 Trend Analysis

3.5.1 Introduction

For the purpose of comparative study of financial statements over a number of years for end percentage or ratio are very useful. This analysis is an important tool of horizontal financial analysis. This method is immensely helpful in making comparative study of financial statement of several years. Under this method trend, percentages have calculated for each item of the financial statement taking the figure of base year as 100. The starting year has usually taken as the base year. The trend percentage shows the relationship of

each item with its preceding year's percentages. These percentages can also be present in the form of Index Numbers showing relative change in the financial data of certain period.

3.5.2 Precautions

While reading the trend percentage, the analyst must take care to ascertain that.

1) The concept consistency is adhered. It the accounting principles and practices have not been follows consistently the comparison is meaningless.
2) The base year selected is the normal year and is representative of the items shown in the statement.
3) Trend percentage has calculated only for some important items, which can logically connect with each other.
4) Absolute figures are taken in to consideration. In the absence of absolute figures, the conclusions drawn only from percentages can be misleading.
5) The figures for the current year have adjusted in the light of price level changes as compared to the base year before calculating trend percentages. If this has not done, the comparison will be meaningless.

In this method of analysis one of the periods under study, any one year has taken as base year and each item in this year has taken as 100, percentage of the some item in each of remaining year is calculated. As the large amounts are, reduce to percentages. The management finds it easy to compare and know the trends and their directions. However, the trend percentages have calculated only for major items and not for each item. Management is interested in knowing changes in important items only.

3.5.3 Procedure for Calculating Trends

To calculate trends the following procedure is apply.

1) One year is takes as a base year. Generally, the first or the last year is takes as base year.
2) The figures of base year are takes as 100.

3) Trend percentage is calculates in relation to base year. If a figure in other year is less than the figures in base year the trend percentage will be less than 100 and it will be more than 100 if figure is more than the base year figure. Each year figure is divides by the base years.

3.5.4 Interpretation of Trend Analysis

The interpretation of trend analysis involves a cautious study. The mere increase or decrease in trend percentages may give misleading results if studied in isolation. An increase of 20% in current assets may be treats favorable. If this increase in current assets have accompanied by an equivalent increase in current liabilities, them this increase will be unsatisfactory. The increase in sales may not increase profit if the cost of production has also gone up.

3.5.5 Method of Trend Analysis

The trend analysis can be done in following 3 ways.

1) Trend Percentage

In this method a statement is taken as the base with reference to which all other statement are to be analyzed, for the figure of next year, the figure of next year, the figure of the last year works as base as in the case of chain base index numbers. This method suffers from the lack of continuity. Hence to remove this defect, the fixed base method is applied such fixed base trend percentages shows the increase or decrease of annual figures.

2) Trend Ratio

The second method of trend analysis is the calculation of trend analysis. In this method the base year figures is takes as 100 and then figures of the subsequent year are shown in the term percentage. Thus, this method is like fixed base index numbers, It can show the trend in operating results but financial position of a concern cannot be explained.

3) Graphic & Diagrammatic Representation

The trend value can be shows on graph paper also such presentation of the figures relives a layman from the data.

3.5.6 Utility of Trend Analysis

1) This is a simple technique it does not involve tedious calculations and does not required trained experts.
2) It is a method to indicate the future for ends.
3) It reduces the changes of errors at it provides the opportunity to compare the percentage with absolute figures.

3.6 Ratio Analysis

3.6.1 Introduction

One of the methods of analyzing financial statement is 'Ratio Analysis'. An absolute figure does not convey much meaning it therefore becomes necessary to study a certain figure in relation to some other relevant figure, to arrive at certain conclusion e.g. if we given the figure of only gross profit earned by a certain firm, we can not say whether the gross profit is heavy, reasonable or insufficient. For this purpose, we must take into consideration the figure of sales. Thus, the gross profit is requires to be studied in relation to the sales to decide the percentage of gross profit to sales. On the basis of this percentage, we can conclude whether the gross profit earned is reasonable or other wise. Thus, the relationship between the two figure expressed mathematically is called a ratio.

To examine the financial condition and performance of a company the financial executive needs certain yardsticks. The yardstick frequently used is ratio analysis. The construction of ratio is a major analytical statement expressed in absolute rupee figures. The use of ratios aids the financial manager and other analysts in pointing out the relative importance of the various items appearing in the financial statements. Every important item in the balance sheet and the income statement has a relationship with one or more items in either or both statements, which can be express in ratio. By using ratio, comparisons with financial statements or other companies have facilitated and comparison of company's financial performance can made over a period of time.

In finance, a financial ratio is a ratio of selected values on a enterprise's financial statements. There are many standard ratio used to evaluate the overall financial condition of corporation or other organization. Financial ratios are use by managers within a firm, by current and potential shareholders of a firm and by firm's creditors. Security analysis used financial ratio to compare the strengths and weakness in various companies.

3.6.2 Meaning of Ratios

Ratios are simply a method of highlighting in arithmetical terms the relationship between figures drawn from various financial statements.

Robert Anthony defines a ratio as "Simply one number expressed in terms of another; a great number of ratio can be computed from the basis financial statements – balance sheet and profit and loss account.

Ratio, as a tool of financial management, can be express as a) percentage b) fraction and c) a stated comparison between numbers.

In the words of Livingstone and Kerrigan; "A ratio is the relation of one amount 'X' to the another amount 'Y' expressed as the ratio of 'X' to 'Y' or X : Y or as a fraction or number or a percentage".

As observed by Hunt, Williams and Donaldson. "Ratio is simply a means of highlighting in arithmetical terms the relationship between figures drawn from financial statement".

According to Butty. "The term 'Accounting Ratio' is used to describe significant relationship which exist between figures shown on a balance sheet, in a profit and loss account in a budgetary control system or in any other part of the accounting organization".

Analysis of an enterprise by financial ratio enables the financial manager as well as interested external parties to evaluate the firm's financial performance and condition rapidly by making comparisons of ratio obtained from other comparable firms.

In the wards of Helfert, "Ratio analysis provides guides and clues especially in spotting trends towards better or poor performance and in finding

out significant deviation from any average or relatively applicable standard. Thus ratio analysis enables the user to better understand financial statement than by looking at the absolute quantities alone.

Ratio analysis has three steps first; the financial manager selects from the statement those sets of data, which is relevant to this objective of analysis and calculates appropriate ratios for the company. The second step calls for a comparison either with the industry standards or with the ratio of the same company relating to past. After such comparison, the conclusions may be drawn and presented in the shape of reports.

The ratio has calculated by dividing one figure by the other figure. It may be express in any of the three ways – "Times", "Proportion" or "Percentage" according to the convenience or suitability. When one value is divided by the other, the quotient obtained indicates "Times". If the quotient is multiplied by 100, we get the percentage. If we take proportion between the two figures, we get the proportion or ratio. Suppose the current assets are off Rs. 50,000/- and current liabilities are of Rs. 12,500/-. The relation between these two items can be express as under

i) $\frac{50,000/-}{12,500} = 4$ times

i.e. current assets 4 times the current liabilities

ii) $\frac{50,000/-}{12,500} \times 100 = 4$ times

i.e. current assets are 400% of the current liabilities

iii) $\frac{4}{1} = 4 : 1$

Proportion or Ratio of current assets to current liabilities

An accounting ratio is an arithmetical relationship between two figures in statements of accounts stated either as proportion (i.e. ratio), rate (i.e. time) or percentage e.g percentage of net profit to capital, ratio of current assets and current liabilities stock turnover ratio indicating number of times the stock is replaced during the year.

3.6.3 Necessity And Advantages Of Ratio Analysis

Ratio analysis is an important and useful tool to check upon the efficiency with which working capital is being use in the enterprise. Some ratio indicate the trend our progress or down fall of the company. It helps the financial manager in evaluating the financial position and performance of the company. The use of ratio analysis is not confine to the financial manager only. The credit supplier, bank, lending institutions and experienced investor all use ratio analysis as their initial tools in evaluating the company as a desirable borrower or as potential investment outlet with the help of ratio analysis financial executive can measure whether the company is at resent financial whether the company is at present financially healthy or not.

The following are the important material uses of ratio analysis.

1. Aid In Financial Forecasting

Ratio analysis is very helpful in financial forecasting. Ratio relating to past sales, profit and financial position is base for further trends.

2. Aid In Comparison

With the helps of ratio analysis, ideal ratios can composed and they can be use for comparison of a particular company's progress and performance.

3. Aid In Cost Control

Ratio are very useful for measuring the performance and very useful in cost control.

4. Communication Value

Different financial ratios communicate the strength and financial standing the company to the internal external parties.

5. Other Uses

Financial ratios are very helpful in the diagnosis and financial health of company. They highlight the liquidity, solvency, profitability and capital gearing etc. of the company. They are a useful tool of analysis of financial performance.

3.6.4 Limitations of Ratio Analysis

1. A Single Ratio Has No Significance

A ratio taken by itself would be meaningless unless it is studies along with other ratios, ratios of one company should compared with ratio of other such similar companies and any deviations should be investigated.

2. It Ignores Qualitative Factors

They are the factors, which cannot be express in terms of money. Ratio analysis is a tool of quantitative analysis and does not taken accounts of qualitative factors like sincerity, ability to pay back loans etc, which may sometimes be of more importance in taking financial decisions.

3. False Results Of Based An Incorrect Accounting Data

Accounting ratios can be correct only if the data. (On which they are based) are correct. Sometimes, the information given in the financial statements is affect by window dressing i.e. showing position better than what actually is. For example, if inventory values are inflated or depreciation is not charged on fixed assets, not only will one have an optimistic view of profitability of the concern but also of its financial position so the analyst must always b on the look out for signs of window dressing, if any.

4. No Idea Of Probable Happening In Future

Ratios are an attempt to make an analysis of the past financial statements. So they are historical documents. Now a days keeping in view the complexities of the business it is important to have an idea of the probable happenings in future.

5. Variation In Accounting Methods

The two firm's results are comparable with the help of accounting ratio only if they follow the same accounting methods or bases.

6. Price Level Change

Changes in price levels make comparisons for various years difficult. For example, the ratio of sales to total assets in 1984 would be much higher

than in 1970 rising price, fixed assets been shown at cost and not at market price.

7. Only One Method Of Analysis

Ratio analyses have only a beginning and give just a fraction of information needed for decision-making. So to have a comprehensive analysis of financial statement, ratio should be use along with other method of analysis.

8. No Common Standards

It is very difficult to lay down a common standard for comparison because circumstances differ from concern to concern and the nature of each industry is different. For example a business with current ratio of more than 2:1 might not be in a position to pay current liabilities in time because of an unfavorable distribution of current assets in relation to liquidity. On the other hand, another business with a current ratio of even less than 2:1 might not be experience any difficulty in making the payment of current liabilities in time because of its favorable distribution of current assets in relation to liquiding.

9. Different Meaning Assigned To Different Times

Different firms, in order to calculate ratio may assign different meanings. For example, profit for the purpose, of calculating a ratio may taken as profit before charging interest and tax or profit before tax but after interest or profit after tax and interest.

This may affect the calculation ratio in different firms and such ratio when used for comparison may lead to wrong conclusions.

3.6.5 Types Of Ratio

1. From view point of liquidity Ratio
2. From view point of leverage Ratio
3. From view point of Activity Ratio
4. From view point of Profitability Ratio

1 From View Point Of Liquidity Ratio

Liquidity Ratios are extremely essential for a firm to be able to meet its obligations as they become due. These ratios measure the ability of the firm to meet its current obligations. In fact, analysis of liquidity needs the preparation of cash budgets and cash flow statement but liquidity ratios, by establishing a relation between cash and other current assets to current obligations, provides a quick measures of liquidity. A firm should ensure that it does not suffer from lack of liquidity and also that it is not too much highly liquid. It means the concern should invest a part of its funds in such a way that the investment can be easily converted in to cash immediately at the required time.

The reputation as regard credit worthiness of the firm depends on such ability of the business unit to meet its obligations in time. The failure of a company to meet its obligation, due to lack of sufficient liquidity will result in bad credit ratings, loss of creditor's confidence, or even in law suits resulting in the closure of the company. A very high degree of liquidity is also bad, idle assets earn nothing. The firm's funds will unnecessarily tied up in current assets.

Therefore, it is necessary to strike a proper balance between liquidity and lack of liquidity. The ratios which indicates the extent of liquidity on lack of it are

A Current Ratio

B Quick Ratio

C Cash Position Ratio

A. Current Ratio on Working Capital Ratio or 2:1 Ratio

Current ratio may be defines as the relationship between current asset and current liabilities. This ratio also known as working capital ratio is a measure of general liquidity and is most widely used to make the analysis of the short-term financial position or liquidity of a firm. It is calculate by dividing the total of current assets by total of the current liabilities.

Thus

$$\text{Current Ratio} = \frac{\text{Current Asset}}{\text{Current Liabilities}}$$

Two basic components of this ratio are current assets and current liabilities. Current assets include cash and those assets, which can easily converted in to cash with in a short period of time generally, one year, such as marketable securities, bills receivable, sundry debtors, inventories, work- in-progress etc. Prepaid expenses should also be included in current assets because they represent payments made in advance, which will not have to be paid in near future. Current liabilities are those obligations which are payable within a short period of generally one year and included expenses, short term advances, income-tax payable, dividend payable etc, Bank overdraft should also generally be included in current liabilities because if represents short-term arrangement with the bank and is payable with in a short period. But where Bank overdraft is permanent or long-term arrangement with the bank, it should be excluded.

Significance and Limitation Of Current Ratio

Current Ratio is a general and quick measure of liquidity of firm. It represents the 'Margin of Safety' or cushion available to the creditors and other current liabilities. It is most widely used for making short-term analysis of the financial position on short-term solvency of a firm. But one has to be careful while using current ratio as a measure of liquidity because it suffers from the following limitation.

1. It is crude ratio because it measures only the quantity and not the quality of current assets.
2. Valuation of current assets and 'Window dressing' is another problem of current ratio.

Current ratio can be very easily manipulate by over valuing the current assets or excluding certain short-term liabilities from current liabilities management are generally tempted to do so in order to present a more

favorable current ratio to the outsiders such as bankers, creditors, etc. Hence, one has very careful in calculating current ratio as measure liquidity.

Satisfactory Current Ratio

The analyst interested in the liquidity and solvency of a business enterprise would be naturally interested in the considerable excess of current assets over current liabilities. The reason is simple to understand and based on conservatism that while the liabilities are generally reduce by payments; the assets available to pay them may be subject to shrinkage.

For example, there may be unexpectedly large amount of bad debts on same of the stock on hand may become absolute or unexpected losses may occur in the investments in marketable securities. The ultimate result of all such factors is that the financial analysis usually accepts that an organization should have its current liabilities covered at least twice by current assets. Thus a minimum 2 to 1 current ratio is often referred to as a 'rule of thumb'

It is not however, a completely reliable rule since many business enterprises may operate successfully with a less than 2 to 1 current ratio and it varies from one business to another and in seasonal business from one season to another. It should be noted that a very high ratio although strong from liquidity points of view, may not be so desirable from profitability point of view since there may be surplus current assets e.g. surplus cash on hand earning a nil or an inadequate rate of return. Low current ratio is not necessarily an indication of reduced liquidity but instead it in reflects a better management of current assets.

For calculating, the current ratio of M/S Laxmi Vishnu and Co. Ltd. Current Assets and Current Liabilities are includes following items from their Income statement and Balance sheet.

A) Current Assets	B) Current Liabilities
Cash in hand	Sundry Creditors
Cash at bank	Outstanding Expenses
Sundry Debtors	Outstanding Expenses
Closing Stock	

B. Quick Ratio

The quick or acid test ratio is a more refined measure of the firm's liquidity. This ratio establishes a relationship between quick or liquid assets and current liabilities. An asset is liquid if it can convert in to cash immediately or reasonably soon without a loss of value. Cash is the most-liquid assets. The other assets, which are considered to be, relatively liquid and included in the quick assets are book debts (debtors and bills receivables), and marketable securities (temporary investment) stock (inventories) and prepaid expenses are considered to be less liquid. Inventories normally require some time for realizing in to cash, the value of stock also has a tendency to fluctuate. The quick or liquid assets are separate for calculating the quick or acid test ratio.

The quick ratio has found out by dividing the total of the quick assets by total current liabilities. The quick or acid test, ratio is sometime called "Liquidity Ratio".

$$\text{Quick Ratio} = \frac{\text{Quick Asset}}{\text{Current Liabilities}}$$

Quick assets include cash and book debts (debtors and bills receivables) only. Inventories are excludes because it takes time to sell finished goods and convert raw material and work-in-progress in to finished goods. There is also uncertainty as to whether or not the inventories can sold. Prepaid expenses should also be excludes because they cannot be converted in to cash.

C. Cash Position Ratio

Through receivables are generally more liquid than inventories, there may be debts having doubt regarding their real stability in time. So to get an idea about the absolute liquidity do a concern, both receivable and inventories are excludes from current assets and only absolute liquid assets such as cash in hand, cash at bank and readily reliable securities are taken in to consideration.

This ratio is obtained by subtracting both the debtors (+ Bills Receivable) and inventory from the current assets, thus, it is obtained by

dividing cash and marketable security by current liability. If marketable securities are not there then only cash in hand and cash at bank is take.

$$\text{Cash Position Ratio} = \frac{\text{Cash + Marketable Securities}}{\text{Current Liabilities}}$$

OR

$$\text{Cash Position Ratio} = \frac{\text{Cash}}{\text{Current Liabilities}}$$

A ratio of 0.75 : 1 is considered to be a good ratio. Such a ratio should imply that firm has enough cash on hand to meet all current liabilities.

2. Long – term Solvency Ratio / Leverage Ratio

Bankers and other short – term creditors are more interested in current debts paying ability of a business i.e. short –term solvency of the business concern. While shareholders and other financial institutions, which provide long – term finance are mainly concerned with the long-term financial prospects of the business. Hence, analysis and interpretation of long – term solvency of the business is significant from viewpoint of shareholders and financial institutions.

Long – term solvency means the ability of a business concern to meet its long –term obligations. It implies that business concern must an ability to discharge its liabilities through the realization of its assets to achieve this long-term solvency proper balance between assets and liability should maintain.

Ratio Applied To Judge Long-Term Solvency Of The Company

There are various ratios to judge long-term solvency. To analysis the long-term solvency of this company following ratios are been selected.

A. Proprietary Ratio / Owners Funds Ratio:

This ratio is also known as tangible net worth to total assets ratio or capital to total assets are equity ratio. A variant to the debt equity ratio is the

15342

proprietary ratio. which has also known as equity ratio or shareholders to total equities ratio or net worth to total assets ratio. This ratio establishes the relationship between shareholder's funds and total assets of the firm. The ratio of proprietors' funds to total funds (proprietors + outsiders funds or total funds or total assets) is an impotents of this ratio are shareholder's funds or proprietors funds and total assets. The shareholder's funds are equity share capital, preference share capital, undistributed profit, reserves and surpluses. Out of this amount, accumulated loss should deduct. The total assets on the other hand denote total resources of the concern. The ratio can calculate as under.

$$\text{Proprietary Ratio} = \frac{\text{Owns funds}}{\text{Total Assets}}$$

The proprietary ratio also known as, Owner's fund ratio, Shareholders equity ratio, Equity, or Net worth ratio. It expenses the relationship between the contributions of owns and the contribution of owners plus outsiders.

B. Fixed Asset Ratio

This ratio includes the relationship between capital and fixed assets. When the amount of capital exceed the value of fixed asset a part of the net working capital is supplied by the proprietor provided that there are no other non current assets and when proprietor's funds are less than the fixed assets, creditor's obligations have been used to finance a part of the fixed assets.

This ratio is work out as under

$$\frac{\text{Depreciated value of fixed assets}}{\text{Owner's fund (Capital)}} \times 100$$

C. Debts To Equity Ratio

This ratio has calculated to measure the relative proportions of outsider's funds and shareholder funds invested in the company. This ratio expresses the relationship between total liabilities (external equities) and the

owner's equity (internal equity). This ratio is also known as external internal equity ratio.

Formulation

$$\text{Debt equity ratio} = \frac{\text{Liabilities}}{\text{Owners equities}}$$

Or

$$\text{Debt equity ratio} = \frac{\text{Outsider's funds}}{\text{Shareholder's Funds}}$$

Components

The liabilities or outsiders equity consist of all out side liabilities, that is long term and short-term e.g. Debenture, mortgage loan, creditors bill payable, out standing expenses etc.

On the other hand, the owners equity includes paid up equity share capital. The terms of reserve and surplus like capital reserve, revenue reserve, retained earning and so on.

Significance

This ratio provides meaningful information for evaluating relative position of creditors and owners. The purpose of this ratio is to drive an idea of the amount of capital supplied to the firm by the owners and of assets 'Cushion', available to creditors on liquidation.

Normally the acceptable standard for this ratio is 1: 1. This ratio signifies the excess of the proprietor's funds over outsider's funds and there by indicates the soundness of the financial structure of the business.

D. Ratio Of Current Assets To Proprietor Fund

This ratio shows percentage of owner's capital invested in current assets. This ratio should be use in conjunction with a ratio of fixed assets to proprietor's funds / owner's funds.

If the ratio of current asset to proprietor funds is higher than that of fixed assets to proprietor fund, it is an indication of the financial strength of the business.

This ratio is calculated by the following formula

$$\text{Current Assets to Proprietary fund} = \frac{\text{Current Assets}}{\text{Proprietor's funds}}$$

5. From View Point Of Activity Ratio

These ratios are very important for a concern and are being use to measure the effectiveness with which a concern uses its resources at its disposal. These ratios are usually calculates on the basis of sales or cost of sales and are expressed in integers rather than as a percentage such ratios should be calculated separately for each type of asset. Higher the turnover ratio, the better the profitability and use of capital or resources will be.

The following are the important turnover or performance ratio of M/S Laxmi Vishnu and Company. Some important ratios are applied to judge turnover adequacy.

A. Debtors Turnover Ratio

A firm sells goods on credit and cash basis. When firm extends credits to its customers, book debts (debtors or accounts receivables) are creates in the firm's accounts. Debtors are expect to be converting in to cash over a short period and therefore, are included in current assets. The liquidity position of the firm depends on the quantity of debtors to great extent. Financial analysts employ two ratios to judge the quality or liquidity of debtors. The first ratio is debtor turnover and is find out by dividing credit sales by average debtors.

Sundry debtors constitute an important item of current assets, the amount of the accounts receivable at any particular time should not exceed a reasonable proportion of net sales. This proportion is express as a ratio, which is compute as follows.

$$\frac{\text{Sundry Debtor}}{\text{Average daily sales}}$$

OR

$$\frac{\text{Account Receivable}}{\text{Net Sales}} \times 365$$

= No of Days

(Reserve for Doubtful debts has not deducted from the debtors)

Significance

Debtors' turnover ratio is an enabling device to find out as to how many days average sales are tied up in the value of amounts owing by debtors according to the balance sheet. It is also an excellent supplementary check to be used for judging the adequacy of current ratio.

Rule Of Thumb

A rule of thumb is that the collection period should not exceed 1 1/3 times the regular payment period e.g. if regular payment period is 30 days, then average collection period should not exceeds 40 days.

Change in the ratio indicates changes in the company's credit policy or changes in its ability to collect its receivables.

The objective of comparison implied in the debtor's turnover ratio is to learn how old the accounts are and partly to learn how fast cash will flow from their collections. If the credit period is 30 days and the ratio shows 60 days, it shows that at least half the accounts are overdue as 60 days sales are lock up in trade debtors. This situation has thought of as over investment in receivable and may be the result of over-extension of credit, lack of effective collection policies of the collection department etc. Thus, this ratio is an index of the

number of days for which the period of credit is allows or in other words, it indicates the number of days for which accounts remain uncollected.

B. Total Assets Turnover Ratio

Although fixed assets are directly concerned with the generation of sales, but other assets also contributes to the production and sales activities of the firm. The firm must manage its total assets efficiently and should generate maximum sales through their proper utilization. The total assets turnover ratio is calculated by the following formula.

$$\text{Total Assets Turnover} = \frac{\text{Sales}}{\text{Total Assets}} = \text{No of times}$$

The ratio indicates the sales generated per rupee of investment in total assets. Thus, it aims to point out the efficiency or inefficiency in the use of total assets or capital employed. Increase in ratio indicates that more revenue is generates per rupee of total investment in assets normally a standard ratio is taken 2 times.

C. Fixed Assets Turnover Ratio

This ratio expresses the number of times fixed assets are being turned over in a stated period. Fixed assets being of a tangible nature generally it includes land, building, plant and machinery, furniture and fixtures, vehicles etc. We can generalize that fixed assets are usually those assets which are required for relatively long periods for carrying on the business of the enterprises, which are not intended for resale.

The business has required these assets, ordinarily in order to use them in production of other goods and services. Investment in fixed assets is required to be made continuously.

As the investment in fixed assets has made for the ultimate purpose of producing sales, the ratio of sells to fixed assets is measure of the achievement

of that purpose. If the ratio is too high it indicates that firm is overtrading on its assets, but in case the ratio is low it signifies that the firm has excessive investment in fixed assets. However as the sales has depend on factors other than fixed assets the ability, efficiency, quality and style of goods favorable markets demand creation etc. no direct relationship, which can be significantly measure but the ratio, can be established between sales and fixed assets.

The ratio is calculate by the following formula

$$\frac{\text{Sale}}{\text{fixed asset}}$$

D. Creditors Turn Over Ratio

In the course of business operations, a firm has to make credit purchases and incur short-term liabilities. A supplier of goods i.e. creditor is naturally interested in finding out how much time the firm is likely to take in repaying its trade creditors. The analysis for creditor turnover is basically the same as that of debtors turnover ratio except that in place of trade debtors, the trade creditors are taken as one of the components of the ratio and n place of average daily sales, average daily purchases are taken as the other component of the ratio.

Creditor's turnover ratio is calculates in two forms.

(a) Creditors / Payable Turnover Ratio

$$= \frac{\text{Net Credit Annual Purchase}}{\text{Average Trade Creditors}}$$

If information about credit purchase is not available, the figure of total purchases may taken as the numerator and the trade creditors includes sundry creditors has not known the balance of creditors given may taken to find out the ratio. The ratio indicates the velocity with which the creditors are turn over in relation to purchases. Generally higher the creditors velocity better it is or other wise lower the creditors velocity, less favorable are the results.

(b) Average Payment Period Ratio = $\frac{\text{Total Creditors (Creditors + Bills Payable)}}{\text{Average Daily purchase}}$

Average Payment Period = $\frac{\text{Trade Creditors x No. of working days}}{\text{Net Annual Purchase}}$

E. Stock Turnover or Inventory Ratio

The inventory, or stock, turnover indicates the efficiency of the firm's inventory management. It is calculates by dividing the cost of goods sold by the average inventory.

Inventory turnover = $\frac{\text{Cost of goods sols}}{\text{Average inventory}}$

The cost of goods sold figure is computed by subtracting closing inventory (stock) from the total of opening inventory and the manufacturing cost (including costs of purchase). Average inventory figure, used in the denominator, is the average of the opening and closing inventories.

Some time the cost of goods sold may not be available in the published financial statements, therefore, the analysts compute the inventory turnover us sales divided by inventory as of the year-end.

Inventory Turnover = $\frac{\text{Sales}}{\text{Inventory}}$

It should be noticed that the first formula is more logical than the second. In case of the first formula, both the numerator the cost of goods sold and the denominator the average inventory, are valued at cost and are comparable. While in case of second formula, the numerator Sale is valued at market price and the denominator is valued at cost and are non comparable.

4 From view point of Profitability Ratio

The primary objective of a business undertaking is to earn profits. Profit earning has considered essential for the survival of the business. A business

enterprise can discharge its obligations to the various segments of the society only through earning of profit. Profits are thus a useful measure of overall efficiency of the business. The efficiency of a business therefore should be measures by the amount of profits earned by the business. Every business involves an investment of funds. The business enterprise must be capable of utilizing these funds in such a direction that it should be earns fair return on its investments. The profit earned in a business has definite bearing on its investment. If the minimum profit has not earned, the management will have to find out ways and means for alternative investment.

Profitability ratios are calculating to measure the overall efficiency of the business. The measurement of profitability requires the calculation of several inter connected ratios varying according to aims of analysis. It can be measured and analyzed from there angles of vision.

1. from view point of management
2. from view point of shareholders
3. from view point of creditors

Following profitability ratios are calculates for measure profitability of M/S Laxmi Vishnu and Co.

A. Gross profit to Net sales
B. Gross profit to Total net assets
C. Net profit to Net sales
D. Net profit to Net worth

The above ratios provide a sound diagnosis of the financial health of enterprise in terms of profitability. Here the net profit or gross profit is compares with sales, total assets a capital employed. These ratios may also be compares with other units in similar industries and any wide variations will have to be gone in to depth. Sometimes profitability might go up by temporary factors and like wise might fall due to extra ordinary factors on the of the above profitability ratios the analyst must analyze the reasons either for a rise or a fall in the ratios.

To have a complete picture of earning capacity, both gross profit and net profit has taken. A concern's gross earning capacity may be more, but due to high taxes, higher interest rate and other raising over head, the net earning capacity may be less.

The term 'Profit' may represent the following.

1. PBDIT – Profit before depreciation interest and tax
2. PBIT – Profit before interest and tax
3. PBT – Profit before tax
4. PAT – Profit after tax

In each case, the figure of profit can be compares with net sales to arrive at the operating ration.

A. Gross Profit to Net Sales Ratio

Gross Profit ratio measures the relationship of gross profit to net sales and is usually represents as percentage. This ratio is also call 'Turnover Ratio'. The ratio is express in percentage of gross profit to sales. The two basic components of the gross profit ratio are sales and cost of goods sold since gross profit is simply the excess of net sales over cost of goods sold. Net sales have fond by deducting sales return or returns inwards if any out of the sales.

Formula is

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100$$

The determinations of this ratio are the gross profit and sales, which mean net sales, obtained after deduction the value of goods returned by the customers from total sales.

Gross profit results from the difference between net sales at cost of goods sold without taking into account expenses generally charged to profit and loss account.

In order to analyst the gross profit margin effectively, in formation should be available with respect to purchasing, mark ups and mark down a

credit collection as well as general merchandising policies, however, these dates are not usually available to the external analyst.

The gross profit should be adequate to cover the operating expenses and provide for fixed charges, dividends and building up of reserves. A low gross profit ratio may indicate unfavorable purchasing and mark-up policies, the inability of management to develop sales volume.

An increase in the gross profit ratio may reflect an increase in the sales price of the goods sold without any corresponding increase in costs. This ratio help to measure the operating effectiveness, in setting up profit targets, to measure the profit achievement.

B. Gross Profit To Total Net Assets

The ratio of gross profit to total assets has ascertained to know the earning capacity of the total assets. If the ratio is high, it is an indication that the total assets has efficiently employed in earning the profit. A low ratio indicates over investment in assets and this would mean improper or under utilization of assets or investments.

Formula is

$$= \frac{\text{Gross Profit}}{\text{Total Net Assets}} \times 100$$

C. Net Profit To Net Sales Ratio

Net profit ratio expresses net profit as a percentage of sales. This ratio indicates what portion of sales has left to the proprietors after all costs, charges and expenses have deducted. It has calculated as follows.

$$\text{Net profit Ratio} = \frac{\text{Net Profit}}{\text{Net Sales}} \times 100$$

The major problem in the calculation of this ratio is the determination of net profit figure. Some authors have suggested the exclusion of any unusual

and or nonrecurring items, which have been included in the determination of net profit. Such items as again the loss on sales of fixed assets or investments etc. Should either be omitted or appointed to a number of year's calculations, while others maintain that the proper distinction is only between operating income and net income and therefore the extra ordinary items through excluded from the operating income may be included in the computation of net income figure.

Another controversy is in respect of income tax. No uniform procedure exists in practice some accountants treat net profit figure as one arrived at after deducting income tax. While other do not according to Moare and Jacdicke, the management at the operating level has no control over the computation of income faxes or tax planning activities, consequently income before tax the deduction would be more appropriates measure of its efficiency. It has left that the current approach is to divide the net profit into two parts.

a) Net profit before tax

b) Net profit after tax

Whichever figure is use for calculation of the ratio, the some has clearly stated as.

$$= \frac{\text{Net Profit after taxes}}{\text{Net Sales}} \times 100$$

OR

$$= \frac{\text{Net Profit before taxes}}{\text{Net Sales}} \times 100$$

Helps to judge the profitability of the concern

D. Operating Ratio

The operating ratio is an important ratio that explains changes in the net profit margin ratio. This ratio is computes by dividing all operating expenses cost of goods sold, operating expense by sales.

A higher operating ratio is unfavorable since it will leave a small amount of operating income to meet interest, dividends etc. Operating ratio is a yard stick of operating efficiency. The operating ratio indicates the average aggregative variations in expenses.

$$\text{Operating Ratio} = \frac{\text{Cost of Goods Sold} + \text{Operating Exp.}}{\text{Sales}}$$