CHAPTER - 3

FINANCIAL STATEMENT

The profit and loss account or income-statement or earning statement and the balance-sheet or statement of assets and liabilities and owner's equity are two very important financial statements and their presentation is statutory under companies Act 1956. They help to evaluate the financial performance of the company during the period under review. However an inexperienced or ignorant person-or-investor may be confused by the quantitative financial information contained in the financial statements. The financial position can be better understood by presenting the same data in a simpler and more understandable way which can tell some more facts behind the figures. For this purpose the following tools are used to analyse and interpret the data contained in the financial statement.

1. Comparative profit and loss accounts and balance sheet.
2. Common size statements.
3. Trend analysis.
5. Fund-flow statement.
6. Ratio analysis.

INTERPRETATIONS :

The interpretation of financial statements discloses some important facts behind the figures by establishing meaningful relationship among certain related items. The basic input in all types of analyses are figures contained in financial statements, so the output is naturally affected by the reliability
of basic input. Thus it becomes necessary to know the limitations of financial statements which are given below.

(1) Financial statements are interim reports of a ongoing concern. The continued existence of business and its far reaching transactions are arbitrarily broken into accounting periods usually one year. So the yearly presentation of figures cannot be claimed as perfect and thus reliable.

(2) Financial statement provides illusory exactness. Treatment of certain items is decided on personal judgement which opens the avenues of subjectivity in the presentation of figures, e.g., division of revenue and capital expenditure, selection of depreciation method, spreading of deferred revenue expenditure and valuation of inventory. So the accuracy of the presentation will largely depend on the persons making such judgements.

(3) Certain accounting concepts are followed in presenting certain items, the fixed assets are shown under the going concern concept. They are shown at historical cost less accumulated depreciation. This value has no relation with the realizable value or replacement value or market-value. So the value of fixed assets under liquidation is bound to be different from the book figures. Thus the value of fixed assets are different under going concern concept than the liquidation concern concept. In the balance-sheet they are shown under going concern concept. So they do not reflect the competitive earning ability of the assets.

(4) Certain accounting conventions are rigidly followed in presentation of the data in financial statements. Business
conservation distorts the true presentation of facts, e.g. in valuing the closing-stock the principal viz., "market price or cost price whichever is less" is followed. Similarly in the balance sheet. "Contingent liabilities" are disclosed but "contingent assets" are ignored thus business conservation accounts for probable losses but ignores the contingent gains. Business conservation is a sound convention, but it does affect the presentation of true financial position.

(5) Financial statements do not disclose those facts which cannot be expressed in monetary terms e.g. efficient labour force, team spirit, high morale of staff, and quality of management, economic climate of the country as a whole, all of which do affect the earning ability of the firm.

(6) The effects of Changing price level are not considered in certain items, the fixed assets are shown at historical cost, (book-value) less depreciation under rising price level the replacement cost of fixed assets is bound to be higher. Similarly rise in market price of inventories is ignored under the conservation convention, the equity share are shown at their paid-up value in the balance-sheet, the paid-up value loses it's value the moment the shares are quoted in the stock-market at a price different from paid-up value. Thus the true presentation of financial position is distorted.

(7) In a dynamic business environment, the chances of contingent liabilities and contingent assets are more. However, they cannot be estimated precisely and with certainty; such a situation makes the data a bit unreliable; moreover contingent liabilities are...
disclosed as information but under the business conservation, contingent assets are ignored.

(8) Financial statements record only the historical data which provides the platform only for the post-mortem examination. As such, this element reduces their importance as a source of information.

(9) The balance-sheet is presented on a specific day, so it is a static presentation. The snapshot of balance-sheet is coloured with such figures that it looks attractive to the outsiders. The technique of dummy transactions, postponement of payment etc. can be resorted to manipulate the figures to safeguard the interest of one party at the cost of the other party, a balance-sheet is but a collection of unamortized costs at a specific point of time.

(10) Profit and loss account sometimes includes certain non-recurring items like profit on sale of fixed assets, amortization of miscellaneous expenses etc. Inclusion of such items reduces its comparability.

Now, the analysis as an important and valid technique of interpretation and criticism of financial statement is discussed in detail as under:

(B) **RATIO ANALYSIS**

A ratio is simply one number expressed in terms of another. A ratio really puts figures into perspective, it is difficult to see how a company is doing by looking at a large
number of figures. Ratio summarizes the figures in a form that is
easily understood, interpreted and used.

Ratio express a relationship between one figure and
another. It is important that the relationship between the
figures is real. Otherwise, the result would be meaningless and
serve no purpose. A ratio expressing the cost of sales as a
percentage of investment is of no consequence as there is no
commonality between the figures, whereas the ratio that expresses
gross profit as a percentage of sales indicates the mark up made
on the cost of purchases or the margin earned by the company.

To interpret ratios properly, one must ensure that the
ratios being measured are consistent and valid. At a time of
rising prices, a current ratio wherein investors are valued under
the "last-in-first-out" method is meaningless. Similarly, in
comparing results if the length of the periods being compared or
if there is a large non-recurring income or expenses the ratio
calculated would be misleading. In truth, the usefulness of ratio
is entirely dependent on their intelligent and skillful
interpretation.

The ratio analysis is a technique which establishes the
numerical relationship between two relevant variables, such
numerical relationship can be established in the following ways.

(a) **The Quotient**: Where the relevant variables are presented in
the form of quotient, i.e. in numerator and denominator form.

\[ \text{e.g. current ratio} = \frac{\text{current assets}}{\text{current liabilities}} \]
(b) **In Percent**: Where the relationship between the variables is established in the form of percentage.

\[ \text{e.g. Gross profit} = \frac{\text{Gross profit}}{\text{Sales}} \times 100 \]

(c) **In rate-or-time**: Where one variable is presented as a rate or times higher or lower than the other relevant item.

\[ \text{e.g. inventory turnover is 6 times a year.} \]
\[ \text{e.g. sales to fixed assets are 4 times.} \]

It should be concluded that the relationship of two variables can be presented in any of the above mentioned three methods or in all the three methods.

However, traditionally the ratios are presented as under:

**In Quotient**: Liquidity, leverage and some of the valuation ratios.

**In Percent**: Profitability and some of the valuation ratios.

**In Times**: Activity or turnover ratios.

So we can state that the ratio analysis is a technique of ascertaining and interpreting the numerical relationships of the two relevant items presented in the financial statements.

(C) **IMPORTANCE OF RATIO ANALYSIS**:

It is in the analysis of financial statements that ratios prove to be invaluable:

(a) To analyse the performance of a company and compare it with that of the other similar companies.
(b) To determine the relative weaknesses and strengths of a company - whether it is profitable, financially sound and whether its condition is improving or deteriorating.

(c) To fulfill the need of an interested person in knowing a company's financial position.

(2) **Evaluation of the Changes**:

When the ratios are compared with other ratios as stated earlier it will indicate any of the following three situations:

(a) Increase, (b) decrease, (c) No change, the evaluation of the change can be made in the following contents.

(i) Whether the change is favourable or unfavourable e.g. increase in profitability will indicate a favourable situation. While increase in cost ratio will indicate an adverse situation.

(ii) Whether the change is marginal or substantial.

(iii) Whether the change is at an increasing, decreasing or constant rate.

(iv) Whether the change caused by controllable or uncontrollable factors etc.

(D) **CLASSIFICATION OF RATIOS**:

In general the ratios are classified on the following basis:
(1) Functional classification.
(2) Classification as per financial statements.
(3) Classification according to importance.
(4) Classification as per-stock-exchange director, Bombay.

Hence we will consider the functional classifications only as they are used in this research study for the purpose of analysis, interpretation and comparison and description of selected firms in the fertilizer industry.

(E) FUNCTIONAL CLASSIFICATION:

This type of classification considers the basic aspect and performance of business activities of a concern. They are classified as under:

1. Liquidity:

These ratios measure ability to meet current obligations (liquidity ratios).

2. Profitability:

These ratios measure earning success of the firm (Profitability ratios).

3. Leverage or Solvency:

Measure degree of debt employment.

4. Activity or Turnover:

These ratios measure efficiency of assets management.
(A) **Liquidity Ratios**:  

These ratios measure the liquidity position of the company. They represent the ability of the firm to discharge debt on maturity. They are measured in quotient.  

The following two ratios are very popular and major liquidity ratio which has been selected for our analysis:

(a) **Current Ratio**:  

The current ratio measures the inter-relationship between current assets and current liabilities, it is also called as working capital ratio, as working capital is current assets minus current liabilities and it is ascertained as follows:

\[
\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}
\]

Now what are current assets?  

**Current assets are**: (i) cash, (ii) bank balance, (iii) marketable securities, (iv) debtors, (v) bill receivables, (vi) stock of raw materials, work-in-progress, finished goods, stores, spares and supplies, (vii) pre-paid expenses, (viii) advance payment of income tax, (ix) accrued income etc.

Now what are current liabilities?  

(i) creditors, (ii) bills payable, (iii) short-term borrowings, (iv) bank overdrafts, (v) cash credits etc. (vi) provision for taxes, (vii) proposed dividend, (viii) unclaimed dividend, (ix) accrued expenses.
NOTE:

(i) A higher current ratio indicates a better financial position and liquidity. It saves the company from technical insolvency. It is good for the creditors as it eliminates the possibilities of defaults in the payment of interest and redemption of the principal amount.

(ii) A very high ratio is not good for the company because it shows that lots of funds are blocked in inventory or debtor or cash in hand or bank which is a loss on part of opportunity cost or income. Normally figure two is recommended but in an inflationary position the lower figure (quotient) is also acceptable.

(a) Acid Test Ratio:

The stock or inventory which comprises current assets, cannot be converted into cash promptly, thus debtors, marketable securities etc. are near cash current assets, while inventories are remote cash current assets, similarly bank-overdraft is excluded from current liabilities to ascertain liquid liabilities, so the acid test of liquidity will not consider the inventories as an item of liquid current assets, and bank overdraft as an item of current liabilities. Hence Acid-test ratio is ascertained as follows:

\[
\text{Acid-test Ratio} = \frac{\text{Liquid assets (i.e. current assets - inventory)}}{\text{Liquid liabilities (i.e. current liabilities less bank-over draft)}}
\]
NOTE:

(i) Normally 1:1 is considered as the standard acid-test ratio. Such a position indicates sound liquid position as every one rupee assets is available for one rupee debt (short-term debt).

(ii) If it is higher than above said measure it is very good for creditors of the company but if liquid assets such as cash in hand are more, it indicates idle investment which is harmful and sacrifices profitability of the concern.

(b) **Profitability Ratios**:

Probability ratios are important because they touch the basic objectives of business activity. Practically all parties are highly interested in these ratios. These ratios are ascertained as follows:

(i) **Net-Profit Ratio**:

This ratio shows relationship between cost and sale and profit as profit = sale - cost. It is to ascertain how the costs are controlled and how the sale has been achieved and what is the percentage of profit to sale.

\[
\text{Net-profit ratio} = \frac{\text{Net-profit} \times 100}{\text{sale}}
\]

Cost is nothing but operating expenses such as cost of goods sold or it is called as cost of sale plus other operating expenses like administration changes, sales and distribution expenses and interest and sale means total sales less sales return, it is called net-sale, in this ratio the higher the percentage of profit on sale the better it is as it shows good business operation of the firm.
(ii) **Return-on-capital Employed Ratio or (ROI) Ratio:**

This ratio evaluates the earning of the assets employed in the business. It is also known as rate of return on investment (ROI) normally the funds are employed in the business as fixed assets and current assets. A higher ratio indicates efficient utilization of assets. It is ascertained as follows:

\[
\text{Return on capital employed} = \frac{\text{Net-profit}}{\text{Total assets}} \times 100
\]

OR

\[
= \frac{\text{Net-profit}}{\text{Capital employed}} \times 100
\]

Capital employed = Net fixed assets + working capital.

(iii) **Return on Owner's Equity:**

This ratio is also called as return on proprietor's fund. This ratio measures the profitability on the funds, supplied by proprietors; it is owners the proprietor's fund includes the following:

(a) equity capital
(b) preference capital
(c) reserve and surpluses.

It is also like share capital + share holders reserves.

The ratio is ascertained as under:

\[
\text{Return on-owners equity} = \frac{\text{Net-profit} \times 100}{\text{Owner's equity (net-worth)}}
\]

So as it is profitability measure, the higher the ratio the better it is, and favourable will be the situation of shareholders and business concerns as a whole. It should be
higher than the above mentioned ratio, that is return-on-
capital employed because the fund provided by share-holders
is more risky as compared to other types of funds.

(iv) **Gross Profit Ratio:**

This ratio takes into consideration direct manufacturing
cost and generally it is higher than net-profit ratio which
considers all operating costs. A higher ratio indicates
control over direct-cost and good efficiency in deployment
of scarce resources. It is ascertained as under:

\[
\text{G. P. ratio} = \frac{\text{Gross profit}}{\text{sale}} \times 100
\]

Gross profit = sales-cost of goods sold.

(c) **Leverage or Solvency Ratios:**

Leverage ratio measures the use of fixed-interest-bearing
securities in magnifying the return on equity capital. It is also
known as financial leverage or trading on equity or debt-equity
ratio or capital-gearing ratio. If the firm is using higher
proportion of debt fund in relation to own fund (i.e. equity and
reserve and surplus), then it is treated a high-levered or
high-geared firm. Following are the important ratios falling
under this category.

(i) **Debt-equity ratio or capital gearing ratio:**

Debt equity ratio popularly known as D/E ratio measures the
proportion of borrowing and owned funds in the total
investments. Borrowing includes debentures and long-term
loans which carry fixed rate of interest, as well as
short-term liabilities. In sense, total liabilities are
considered. Equity includes equity capital and preferred capital plus reserve and surplus. Owned funds are also known as net-worth.

Net worth or equity = Equity capital + Preference Capital 
+ Reserve and surplus

Net worth = Share-capital + Shareholder's Reserve and surplus.

It is ascertained as follow

Debt-equity ratio = \( \frac{\text{Long term debt+short-term liabilities}}{\text{Equity or (Net-worth)}} \)

This ratio is considered on quotient basis. Normally 2:1 or 1.5:1 is considered as the standard debt-equity ratio. However, the standard are not follows rigidly.

(ii) Debt-Ratio:

Debt/assets ratio is another important leverage ratio. It is ascertained as under:

\[
\text{Total debt to total assets} = \frac{\text{total debt}}{\text{total assets}}
\]

It is used to measure. The proportion of assets that are financed by debt. The ratio of less than fifty-percent normally is accepted because the creditor can be sure that if the company goes into liquidation they will receive their money back and debt servicing will not be a problem for the company. A higher ratio will be adverse situation for creditors as well as company if anything goes wrong with the economy.
(iii) Interest-Coverage Ratio:

This ratio is a ratio of profit before taxes and interest expenses and also depreciation, as it is a non-cash item against profit to interest expenses. It is ascertained as under.

\[
\text{Interest coverage ratio} = \frac{\text{Profit before interest-tax-dep.}}{\text{Interest}}
\]

The higher ratio the better it is, as it is like profit ability ratio and so also it shows that company can easily perform its debt services as well as keep some balance for equity share holders.

(d) **Activity or Turnover Ratios**:

The core of business activity is to employ funds in different fixed and current assets for business operation so as to yield returns out of efficient utilization of fixed and current assets. Activity ratios measure the efficient utilization of each component of assets in relation to sales. Activity ratios are the productivity ratios which measure the relationship of out-put (i.e. sale) and input (i.e. individual asset) thus in the numerator sales are considered while in the denominator different components of assets are considered. They are measured in "time" on "rate" basis. The higher the ratio, the greater is the turnover which indicates an efficient utilization of assets.

The following are important turnover ratios:
(i) Assets-turnover ratio:

This ratio indicates the efficient utilization of all assets, i.e. fixed assets and current assets, it is also known as "capital-turnover" it is ascertained as under:

\[
\text{Asset turnover} = \frac{\text{Sales}}{\text{Total assets}}
\]

Total assets = fixed assets + current assets.
The higher the turnover, better will be the utilization of the assets.

(ii) Account receivable turnover:

It is also called as debtor turnover ratio.

This ratio shows investment in debtors in relation to sales. As debtors arise due to credit sales, in the numerator net-sale is taken and in the denominator, debtors, as it shows in the balance-sheet and profit and loss account of company. The higher the ratio the better it is because it shows the efficient business activity and economic condition of the country as a whole, it is ascertained as:

\[
\frac{\text{Sale}}{\text{Debtors}}
\]

(iii) Inventory turnover ratio:

This ratio is also called as stock-turnover ratio it measures the investment in inventory in relation to sales. The higher the ratio the better it is because it shows turning over inventory in relation to sale and high and speedy business activity and in the final sense growth and profit for business concern. It is ascertained as under:

\[
\text{Inventory turnover ratio} = \frac{\text{Net-sale}}{\text{Closing-inventory}}
\]
(iv) **Working capital turnover:**

The ratio shows the contribution of working capital in total sales through the proportion of current assets in total assets and sales. It is ascertained as under:

\[
\text{Working capital turnover} = \frac{\text{Net-sales}}{\text{Net-working-capital}}
\]

The higher the ratio the more efficient will be the utilization of resources.

(v) **Fixed Assets Turnover:**

The capital employed in business is in the form of current assets and fixed assets. This ratio measures the contribution of fixed assets in sales and consequently in profitability. It is ascertained as under:

\[
\text{Fixed assets turnover} = \frac{\text{Sales}}{\text{Total fixed assets}}
\]

(e) **Uses of Ratios to Different Groups:**

Ratio analysis is an important tool of interpreting financial statements. Many financial experts are of the opinion that "the analysis and interpretation of financial statements are an attempt to determine the significance and meaning of financial data so that a forecast may be made for the prospect for further earning ability to pay interest and debt maturities, both current and long-term and profit ability of a sound dividend policy. Ratio analysis is very important for different groups like owners, creditors, management, prospective investors and research-scholars. As their interests differ from each other, all are more concerned with those few ratios which directly affect their respective interests."
(1) Owners:
They are persons who have contributed risky capital in the business as they assume a greater risk in equity investments. Their objective is to get maximum return on their investment as dividends and capital appreciation of equity shares.

(2) Creditors:
They are persons who lend their fund to the business on a fixed rate of interest, their basic objective is to get regular interest along with a guarantened repayment of the principal amount. They are primarily concerned with the profitability, liquidity and leverage ratios.

(3) Management:
Management is interested in practically all categories of ratios as it has to fulfill the basic objective of maximizing profits. Thus it is primarily concerned with the core ratio viz., the rate of return on capital employed. For the maintenance of liquidity, it is interested in liquidity ratios; for the efficient utilization of assets it takes deep interest in turnover or activity ratios. For the maintenance of financial stability and solvency, it gives more importance to leverage ratio. To sustain the existing equity share-holders and to attract prospective investors in equity shares, it is also interested in valuation ratios.

(4) Potential Investors:
Potential investors fall into two categories: (a) those who invest in equity capital and (b) those who provide debt fund. The investment decision of both groups is largely guided by the
interpretation of financial statement through ratio analysis. Equity investors are keenly interested in valuation ratios, while suppliers of debt fund are interested in liquidity and leverage ratios.

(5) Research Scholar:

This group like management of the firm is interested in all affairs of the concern-liquidity, profitability, leverage and solvency, activity and turnover, and they want to examine and conduct thorough research on financial management and financial affairs of the company.

(6) Limitations of Ratio Analysis:

Ratio analysis is an important tool and technique of analysing financial position. The basic input in the analysis are figures appeared in the financial statements, but a ratio tells something more than the figures presented in the financial statements. However, ratio analysis is not free from certain limitation.

1. Ratio analysis uses the information presented in financial statements viz., profit and loss account and balance sheet, so all limitation of financial statements are transplanted into ratio analysis. The correctness largely depends on the reliability of financial statements whose limitations are already discussed.

2. Ratios by themselves are of little use, so the interpretation of ratio involves either implicit comparison with the past performance of the same company or with the performance
of some other company. But the comparison does not always
consider the similar situation.

3. Ratio analysis analyses the post-data. In dynamic business
conditions, the past trends do not show perfect tendency to
continue in future, thus ratios tell very little about future.

4. Price changes largely affect the interpretation of ratios.

5. The interpretation of financial statements should be made on
a composite basis rather than on the basis of a few ratios which
may give misleading results.

6. The inter-firm comparison of ratios should not be made on
absolute data of ratios, they should be considered in the light
of prevailing economic conditions, peculiarities of the industry,
management policies, government policies, local factors affecting
business etc.

7. As the business environment changes substantially it is
difficult to prescribe any standard ratios and to follow them
rigidly.

Thus ratio analysis is a supplement to and not a
substitute for business judgement, it provides guidance rather
than readymade answers. Ratios are clues rather than conclusions.