Chapter-II

Financial Statement Analysis
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FINANCIAL STATEMENT ANALYSIS

Introduction

Finance is one of the major elements, which activates the overall growth of economy. Finance is the life blood of economic activity. A well-knit financial system directly contributes to the growth of the economy. An efficient financial system calls for the effective performance of financial institutions financial instruments and financial markets.

In our present day economy, finance is the provision of money at the time when it is required. Every enterprise, whether big, medium or small, needs finance to carry on its operations and to achieve its targets. It fact, finance is so indispensable today that it is rightly said to be the life blood of an enterprise. Without adequate finance, no enterprise can possibly accomplish its objectives.

Meaning

Finance is the provision of money at the time when it is required. Finance refers to the management of flows of money through an organization. It concerns with the application of skills in the manipulation, use and control of money.
Definition

According to Guthmann and Dougall "Finance can be broadly defined as the activity concerned with the planning, raising, controlling and administering the funds used in the business".

Importance of finance

Finance is the life blood and nerve center of a business, just as circulation of blood is essential in the human body for maintaining life, finance is a very essential to smooth running of the business. It has been rightly termed as universal lubricant which keeps the enterprise dynamic. No business, whether big, medium or small can be started without an adequate amount of finance. Right from the very beginning, i.e., conceiving an idea to business, finance is needed to promote or establish the business, acquire fixed assets, make investigations such as market surveys, etc., develop product, keep men and machine at work, encourage management to make progress and create values.

Even an existing concern may require further finance for making improvements or expanding the business. Thus, the importance of finance cannot be over-emphasised and then subject of business finance has become utmost important both to the academicians and practicing managers. The academicians find interest in the subject because the subject is still in its developing stage and the practicing managers are interested in the subject because among the most crucial decisions of a firm are those related to finance.
Finance Function

Finance function is the most important of all business functions. It remains a focus of all activities. It is not possible to substitute or eliminate this function because the business will close down in the absence of finance. The need for money is continuous. It starts with the setting up of an enterprise and remains at all times. The development and expansion of business rather needs more commitment for funds. The funds will have to be raised from various sources. The sources will be selected in relation to the implications attached with them. The receiving of money is not enough, its utilisation is more important. The money once received will have to be returned also. If its use is proper then its return will be easy otherwise it will create difficulties for repayment. The management should have an idea of using the money profitably. It may be easy to raise funds but it may be difficult to repay them. The inflows and outflows of funds should be properly matched.

Financial statement analysis

Financial statements are prepared primarily for decision-making. They play a dominant role in setting the frame work of managerial decisions. But the information provided in the financial statements is not an end in itself as no meaningful conclusions can be drawn from these statements above. However, the information provided in the financial statements is of immense use in making decisions through analysis and interpretation of financial statements.
Financial analysis is the process of identifying the financial strengths and weaknesses of the firm by properly establishing relationship between the items of the balance sheet and the profit and loss account. There are various methods or techniques used in analysing financial statements. Such as comparative statements, trend analysis, common-size statements, schedule of changes in working capital, fund flow and cash flow analysis and ratio analysis.

**Meaning of financial statement**

A financial statement is an organized collection of data according to logical and consistent accounting procedures. It's purpose is to convey an understanding of some financial aspects of a business firm. It may show a position at a moment of time as in the case of a balance sheet or may reveal a series of activities over a given period of time, as in the case of an income statement.

**Types of financial statement**

There are four types of financial statements

1) **Income statement**

The income statement is generally considered to be the most useful of all financial statements. It explains what has happened to a business as a result of operations between two balance sheet dates. For this purpose it matches the revenues and costs incurred in the process of earning revenues and shows the net profits earned or loss suffered during a particular period.
2) Balance Sheet

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

3) Statement of retained earning

The term retained earning means the accumulated excess of earning over losses and dividends. The balance shown by the income statement is transferred to the balance sheet through this statement, after making necessary appropriations.

4) Statement of Changes in Financial Position

The statement may emphasize any of the following aspects relating to changes in financial position of the business:

i) Changes in working capital position. In such a case the statement is termed as Statement of Changes in Financial Position or popularly fund flow statement.

ii) Changes in cash position. In such a case the statement is termed as Statement of Changes in Financial Position or popularly cash flow statement.
Financial statements are indicators of the two significant factors

i) Profitability, and

ii) Financial soundness

Analysis and interpretation of financial statements, therefore, refers to such a treatment of the information contained in the income statement and the balance sheet so as to afford full diagnosis of the profitability and financial soundness of the business.

Most of the authors have used the term ‘Analysis’ only to cover the meanings of both analysis and interpretation, since analysis involves interpretation. According to Myres, “Financial statement analysis is largely is a study of the relationship among the various financial factors in a business as disclosed by a single set of statement and a study of the trend of these factors as shown in series of statements”.

TYPES OF FINANCIAL ANALYSIS

Financial analysis can be classified into different categories depending upon,

i) The material used and

ii) The modus operandi of analysis.
* On the basis of material used

Those who are outsiders for business do external analysis. The term outsiders include investors, credit agencies, government agencies and other creditors who have no access to the internal records of the company.

Internal analysis is done by persons who have access to the books of accounts and other information related to the business.

* On the basis of Modus Operandi

Horizontal analysis, financial statements for a number of years are reviewed and analysed. The current years figures are compared with standard or base year. Since this type of analysis is based on the data from year to year rather than on one date, it is also termed as 'Dynamic Analysis'.

Vertical analysis a study is made of the quantitative relationship of the various items in the financial statements on a particular date. It is also called as ‘Static Analysis’ as it is frequently used for referring to ratios developed on one date or for one accounting period.

Limitations of Financial Analysis

➢ It is only a study of interim reports

➢ Financial analysis is based upon only monetary information and non-monetary factors are ignored.
➢ It does not consider changes in price levels.

➢ As the financial statements are prepared on the basis of a going concern, it does not give exact position.

➢ Changes in accounting procedure by a firm may often make financial analysis misleading.

➢ Analysis is only a means and not an in itself. The analyst has to make interpretation and drawn his own conclusions.

TOOLS OF FINANCIAL STATEMENT ANALYSIS

Comparative Balance Sheet

Balance sheet is the most significant financial statement. It indicates the financial condition or the state of affairs of a business at a particular moment of time. The single balance sheet shows assets and liabilities as on a particular date. The comparative balance sheet shows the value of assets and liabilities on different two dates. It helps in comparison. A comparative balance sheet has two columns to record the previous year. A third column is used to show the increase or decrease in figures. A forth column may be added for giving percentage of increase on decrease.

Thus, while in the balance sheet the emphasis is on status, in the comparative balance sheet it is on change. Comparative balance sheet indicates whether the business is moving in a favourable or unfavourable direction. It is very useful for studying the trends in an enterprise.
Comparative Profit And Loss Account

The profit and loss account gives the results of the operations of a business. The comparative profit and loss account statement gives an idea of the progress of a business over a period of time. The change in absolute data in money values and percentage can be determined to analyse the profitability of the business. Like comparative balance sheet, profit and loss account also has four columns. First two columns give figures of various items for two years. Third and fourth columns are used to show increase or decrease in figures in absolute amounts and percentage respectively.

Fund Flow Statement

The fund flow statement is a statement which shows the movement of funds and is a report of the financial operations of the business undertaking. It indicates various means by which funds were obtained during a particular period and the ways in which these funds were employed. In simple words, it is a statement of sources and application of funds.

Meaning of Fund Flow Statement

Fund flow statement is a statement which indicates various means by which the funds have been obtained during a certain period and the ways to which these funds have been used during that period. The term ‘funds’ used here means working capital, i.e., the excess of current assets over current liabilities.
Meaning of funds

The term fund has been defined in a number of ways.

• In a narrow sense, it means cash only and a fund flow statement prepared on this basis is called a cash flow statement

• In a broader sense, the term ‘funds’ refers to money values in whatever form it may exist

• In a popular sense, the ‘funds’ means working capital, i.e., the excess of current over current liabilities. The working capital concept of funds has emerged due to the fact that total resources of a business are invested partly in fixed assets in the form of fixed capital and partly kept inform of liquid or near liquid form as working capital.

Meaning of Flow of Funds

The term ‘flow’ means movement and includes both ‘inflow and outflow’. The term flow of funds means transfer of economic values from one asset of equity to another. Flow of funds is said to have taken place when any transaction makes change in the amount of funds available before happening of the transaction.

Uses of fund flow statement

1) It explains the financial consequences of business operations

Fund flow statement provides a ready answer to so many Conflicting situations such as:
a. Why the liquid position of the business is becoming more and more unbalanced inspite of business making more and more profits?

b. How was it possible to distribute dividends in excess of current earnings or in the presence of a net loss for the period?

c. Where have the profits gone?

2) **If answers intricate queries**

The financial analyst can find out answers to a number of intricate questions

a. What is the overall credit-worthiness of the enterprise?

b. What are the sources of repayments of the loan taken?

c. How much funds are generated through normal business operations?

3) **Its acts as an instrument for allocation of resources**

A projected fund flow statement will help the analyst in finding out how the management is going to allocate the source and resources for meeting the productive requirements of the business.
Cash flow Statement

Cash flow statement is based on a narrower concept of funds, i.e., cash. Cash flow statement is based on cash basis of accounting. No such schedule of Changes in working capital is prepared. It is prepared by taking the opening balance of cash, adding to this all the inflows of cash and deducting the outflows of cash from the total, the difference represents the closing balance of cash.

Meaning of cash flow statement

A cash flow statement is a statement depicting change in cash position from one period to another. A projected cash flow statement or a cash budget will help the management in ascertaining how much cash will be available to meet obligations to trade creditors, to pay bank loans and to pay dividend to the shareholders. A proper planning of the cash resources will enable the management to have cash available whenever needed and put it to some profitable or productive use in case there is surplus cash available.

Preparation of cash flow statement

A cash flow statement can be prepared on the same pattern on which a fund flow statement is prepared. The change in the cash position from one period to another is computed by taking into account sources and applications of cash.
Sources of cash

It can be both internal as well as external

Internal sources

Cash from operation is the main internal sources. The net profit shown by the profit and loss account will have to be adjusted for non-cash items for finding out cash from operations. Some of these items are as depreciation. Amortization of intangible assets, loss on sale of fixed assets, gain from sale of fixed assets, and creation of resources.

External Sources

Issues of new shares have been issued for cash, the net cash received will be taken as a source of cash. Long-term loans such as issues of debentures, loan from industrial finance corporation, state finance corporation etc., are sources of cash, short-term borrowings, etc., from banks increase cash available and they have to be shown separately under this head.

Application of cash

Purchase of fixed assets

Cash may be utilised for additional fixed assets or renewals or replacement of existing fixed assets.
Payment of long-term loans

The payment of long-term loans such as loans from financial institutions or debentures results in decrease in cash.

Decrease in deferred payment liabilities

Payments for plant and machinery purchased on deferred payment basis have to be made as per the agreement.

Loss on account operations

Loss suffered on account of business operations will result in outflow of cash.

Payment of tax

Payment of tax will result in decrease of cash and hence is an application of cash.

RATIO ANALYSIS

The ratio analysis is one of the most powerful tools of financial analysis. It is the process of establishing and interpreting various ratios. (Quantitative relationship between figures and group of figures).

A ratio is a simple arithmetical expression of the relationship of one number to another. Some analysis also express ratio as a ‘rate’ or ‘time’.
Types of Ratio analysis

A. Liquidity Ratio

B. Operating Ratio / Financial Ratio

C. Profitability Ratio

A. Liquidity Ratio

These ratios measure the concern’s ability to meet short-term obligations as and when they become due. These ratios show the short-term financial solvency of the concern. Usually the following two ratios are calculated for this purpose:

i. Current ratio

This ratio establishes a relationship between current assets and current liabilities. The objective of computing this ratio is to measure the ability of the firm to meet its short-term obligations and to reflect the short-term financial strength / solvency of a firm. In other words, the objective is to measure the safety margin available for short-term creditors.

ii. Quick ratio

This ratio establishes a relationship between quick assets and quick liabilities. The objective of computing this ratio is to measure the ability of the firm to meet its short-term obligations as and when due without relying upon the realization of stock.
B. Operating Ratio

This ratio measures the relationship between operating cost and net sales. The main objective of computing this ratio is to determine the operational efficiency with which production and/or purchase and selling operations are carried on.

C. Profitability Ratios

These ratios measure management’s overall effectiveness as shown by the returns generated on sales and investment usually three types of profitability ratios are calculated.

1). Profitability Ratios in relation to sales

i. Gross profit ratio

This ratio measures the relationship between gross profit and net sales. The main objective of computing this ratio is to determine the efficiency with which production and/or purchase operations are carried on.

ii. Operating profit ratio

This ratio measures the relationship between operating profit and net sales. The main objective of computing this ratio is to determine the operational efficiency of the management.
iii. Net profit ratio

This ratio measures the relationship between net profit and net sales. The main objective of computing this ratio is to determine the overall profitability due to various factors such as operational efficiency trading on equity etc.

iv. Operating ratio

This ratio measures the relationship between operating cost and net sales. The main objective of computing this ratio is to determine the operational efficiency with which production and / or purchases and selling operations are carried on.

v. Expenses ratio

To identify the causes of variations in the operating ratio, the following expenses ratios may be calculated

- Material consumed ratio

  This ratio indicates the efficiency or otherwise in purchasing / utilizing the raw materials.

- Conversion cost ratio

  This ratio indicates the efficiency or otherwise of the manufacturing process.

- Administrative expenses ratio
This ratio indicates the efficiency or otherwise in the incurrence of administrative expenses.

- **Selling and distribution expenses ratio**

  This ratio indicates the efficiency or otherwise in the incurrence of selling and distribution expenses.

2) **Profitability ratio in relation to investment**

   i. **Return on total assets**

      This ratio measures a relationship between net profit before interest and tax, and total assets.

   ii. **Return on capital employed**

      This ratio measures a relationship between net profit before interest and tax and capital employed.

**Return on shareholder’s funds (or return on equity)**

This ratio measures a relationship between net profit after interest, and tax, and shareholder’s funds.

3) **In relation to equity shareholder’s funds**

   i. **Return on equity shareholder’s funds**
This ratio measures a relationship between net profit after interest, tax and preference dividend and equity share holder’s funds.

ii. **Earning per Share (EPS)**

This ratio measures the earnings available to an equity share holders on a per share basis.

iii. **Proprietary ratio**

This ratio measures a relationship between proprietor’s funds the total asset.

**Conclusion**

Financial statement analysis consists of major part of any kind of business activities which are directly related to the business performance. Each business concern has to evaluate them and provide such as share holder, customers, suppliers, banks and public to prove their business performance. But many of the financial statement analysis represent only data, which are based on historical information of the business concern. It will not help to improve the efficiency and performance of the business. But, as per the legal aspect and information basis it is very essential for all the business concern. Financial statement analysis of this aspects covers Ratio analysis, cash flow statement and fund flow statement etc.