CHAPTER – IV
FINANCIAL ANALYSIS

The two basic financial statements the income statement and the balance sheet show the result of business operations and the position of the organization at a particular point of time. But these statements do not show the information like whether the gross profit and net profit figures are reasonably good or not, whether the operating expenses have been incurred efficiently or not, whether the organization is able to meet the cost of the borrowed funds or not, how is the short term solvency position, how is the long run stability and so on. Thus, these statements do not throw light on the performance of the company.

In order to know the performance of an organization, the financial statements are analysed. Analysis should be distinguished from interpretation. “The term ‘analysis’ refers to methodical classification of data given in the financial statements while the term ‘interpretation’ refers to explaining the meaning of data so simplified”\(^1\). In the words of Arulanandam and Raman, “Analysis refers to breaking down a
complex set of facts or figures into simple elements while interpretation is explaining the real significance of these simplified statements. Analysis is thus prerequisite for interpretation.” Though there are various techniques of analysing the financial statements, the ratio analysis is the most widely used technique.

Ratio analysis technique was first used by bankers to determine credit worthiness of enterprises applying for loans, sometime in 1906 in the U.S.A. and it was again used by Alexander Well in 1919. Since 1919, the use and number of ratios have increased with the growing interest of investors (shareholders)³.

An accounting ratio is the relationship between two figures or amounts. For instance, the relationship between net profit and sales can be expressed as:

\[
\frac{Net\ Profit}{Sales} = \frac{Rs.\ 20,000}{Rs.\ 1,40,000} = 0.14
\]

It means a net profit of 0.14 paisa has been earned on every rupee of sales. In the words of Hunt, Williams and Donaldson, “Ratios are simply a means of highlighting in
arithmetical terms the relationships between figures drawn from financial statements"⁴.

Such relationships or ratios are very useful to the creditors, investors, various interested parties and of course to the internal management as well for various reasons. With the help of these ratios, the creditors may know the solvency position, the investors may know the various profitability aspects and internal management may appraise the efficiencies and inefficiencies of various departments, thereafter, corrective actions may be taken.

But, as a matter of fact, the ratio analysis technique becomes effective only when ratios are compared. The comparison is of two types:

- Comparing the ratios of a particular firm of a particular year with the past year / years.

- Comparing the ratios of a particular firm with the other firms in the same industry or with the industry average.

The Accounting Ratios can be expressed in three ways:

- **Pure Ratio**: The relationship in the form of pure ratio is expressed as:
Current Assets \( \frac{\text{Rs. 5000}}{\text{Rs. 2500}} = \frac{5}{2} = 2:1 \)

- **Times**: In times the ratio is expressed as:

\[
\frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\text{Rs. 5000}}{\text{Rs. 2500}} = 2 \text{ times}
\]

- **Percentage**: A ratio may also be expressed in percentage form, that is:

\[
\frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\text{Rs. 5000}}{\text{Rs. 2500}} \times 100 = 200 \text{ percent}
\]
REFERENCES


