CHAPTER I
INTRODUCTION

'Finance' studies the principles and the methods of obtaining control of money from those who have saved it, and of administrating it by those in to whose control it passes. Finance is, therefore, an aspect of the economic theory of the firm. Finance may be said to be the circulatory system of the economic body, making possible the needed cooperation between the many units of activity. Finance is the process of conversion of accumulated funds to productive use.

"Finance may be defined as that administrative area or set of administrative functions in an organisation which relate with the arrangement of cash and credit so that the organisation may have the means to carry out its objective as satisfactorily as possible".

Finance is usually divided into categories according to the type of entry or organisation served. The major classification of this nature is two-fold: Public finance and business finance.

Meaning of Financial Statements:

Although any formal statements expressed in money value might be thought of as Financial Statements, the term
has come to be limited by most accounting and business writers to mean the 'balance sheet' and the profit and loss statement.¹

The balance sheet also known as "Statement of Condition",² statement of financial position, statement of assets and liabilities, statement of resources and liabilities, statement of assets, liabilities and capital and statement of worth.³ It reveals the property owned by the business, the assets and the debts owned by the company, the liabilities.⁴

The profit and loss account "is the condensed and classified record of the gains and losses causing changes in the owner's interest in the business for a period of time".⁵

Financial Statements are not defined in the Companies Act, 1956. However, the term Financial Statements, as used in Modern Management, refer to the balance sheet, the profit and loss account and the statement of retained earnings.

Financial Statements contain the Balance Sheet and the Profit and Loss account. "Balance sheet and profit and loss account are the important reports of a corporate entity. The financial objective of these statements is to communicate information on the discharge of accountability of an entity to various parties to whom the entity is accountable."  

Significant changes have taken place over the years in the process of financial planning and control. "Rule of thumb" methods and practices are being replaced with a detailed analysis with the help of better techniques. There appears to be a serious gap between the available theory and the practices followed by the Indian industry. The theory of financial management advocates the objective of maximisation of shareholders' 

wealth, but the Indian industry does not seem to have accepted it. Despite the voluminous literature which has been built upon financial ratio analysis, the principles of such analysis have lacked scientific character. They have been based more on subjective feeling, convention and belief than on clear empirical evidence. Very little progress has been made in empirical testing of financial ratios with a view to showing which of them really reflects a firm's state of health, its chances of survival or failure.

Mere examination of the financial status of the firm without a study of relationships among the various financial factors in a business and a study of the techniques of financial statement analysis.

The following are the more commonly used techniques of analysis.

a) Ratio Analysis
b) Trend Analysis
c) Funds Flow Analysis
d) Common-size Statement Analysis

Out of the above mentioned techniques of financial analysis the universally used and accepted one in modern times is the "Ratio Analysis" with trends. It is the
principal technique used in judging the condition portrayed by the financial statements.

**Ratio Analysis:**

It is used to judge the financial growth and development and the present condition of a business enterprise. Alexander Wall was one of the foremost proponents of ratio analysis in 1919. He elaborated his methods in several volumes.

"A ratio is simply one number expressed in terms of another. It is found by dividing one number, the base in to the other. A percentage is one kind of ratio in which the base is taken as 100 and the quotient is expressed as "Per Hundred" of the base."

The ratios are conveniently classified as follows:

- a) Balance Sheet Ratios
- b) Revenue Statement Ratios
- c) Balance Sheet and Revenue Statement Ratios.

"The above classification, however, is rather crude, since it leads one to think that analysis of the income statement or the balance sheet can be attempted in isolation."

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To get a correct idea about the profitability and financial strength of a firm, it is necessary that an opinion should be framed after a detailed study of the various statements in relation to one another.

The other way of classifying the ratios is as under:

a) Liquidity ratios
b) Leverage ratios
c) Activity ratios
d) Profitability ratios

**Trend Analysis**

Trend analysis makes it easy to understand the changes in an item or a group of items over a period of time and to draw conclusions regarding the changes in data. It is a dynamic method of analysis showing the changes over a period of time.

The limitations of this technique are:

a) The base year chosen may not be a normal year
b) It does not provide proper weight to the important items.

Gilman proposed trend percentages as a substitute for the ratio techniques. The analyst divided the magnitude of significant items or groups of items in each of a
series of statements by their magnitudes in one year selected as the base in the series, thus obtaining a series of trend percentages or relatives to the base year. By studying the variations from the base year, a comprehensive view of the progress of the business can be obtained.

Concept of Financial Analysis

Financial Analysis is a process of synthesis and summarisation of financial and operative data with a view to getting an insight into the operative activities of a business enterprise. It is a technique of x-raying the financial position as well as the progress of a company. By establishing strategic relationships between the components of Balance Sheet and Profit and Loss account and other operative data, it unveils the meaning and significance of the various items embodied in the financial statements.

The major financial statements are profit and loss account and the balance sheet. The profit and loss account is a dynamic statement that records income and expenses between two balance sheet dates. The balance sheet is a static

statement that shows the financial position on a certain
date. It is an instantaneous photograph of the assets,
liabilities and net worth of an enterprise at a particu-
lar unit of time.12

Both these statements are inter-related. An ana-
lysis of both these statements gives a comprehensive un-
derstanding of business operations and their impact on the
financial health.13

Process of Financial Analysis

The initial step in the financial analysis technique
is the reorganisation and rearrangement of the entire finan-
cial data as embodied in the financial statements. This
calls for the breaking-down of individual components of fi-
nancial statements and reducing them into a few groups of
principal elements according to their resemblances and affi-
nities. These elements are specifically defined so that
their computation can be readily ascertained for checking
the accuracy. By such rec classification, the Balance Sheet
and Profit and Loss account are completely recast and pre-
sented in the condensed form, entirely different from their
original shape.

Aid Publishers, 1970
13. Western/Brigham, Managerial Finance, Holt, Rinehart,
The next step is the establishment of significant relationships between the individual components of profit and loss account and balance sheet. This is done through the application of tools of financial analysis like, Ratio, common size, trend and fund flow etc. Finally, the significance of comparative data obtained by applying tools of financial analysis is evaluated. This initially requires establishing of the standards with which the comparative data can be measured and evaluated. These standards may be based either on some authoritative literature on the subject or on personal experience regarding the situation in which a business enterprise operates or the average ratio of the firm under consideration, or of the industry of that particular group.

Some authors have contended that there are three most common standards used in ratio analysis. They are:

a) Absolute Standards
b) Historical Standards
c) Budgeted Standards

The following table depicts the standards norms for various ratios used in the techniques of financial analysis.

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Table 1.1
REFERENCE LEVEL FOR FINANCIAL STRUCTURE PERCENTAGE OF TOTAL ASSETS / TIMES

<table>
<thead>
<tr>
<th>Large Established Firms</th>
<th>Current Liabilities</th>
<th>Long Term Debt</th>
<th>Preferred Stock</th>
<th>Net Worth</th>
<th>Current Ratio</th>
<th>Coverage of Fixed Charges</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td>20.25</td>
<td>6-10</td>
<td>0-4</td>
<td>65.70</td>
<td>2</td>
<td>7</td>
</tr>
<tr>
<td>Utilities</td>
<td>5-10</td>
<td>45-50</td>
<td>10-15</td>
<td>30-35</td>
<td>1</td>
<td>4</td>
</tr>
<tr>
<td>Trade</td>
<td>3-35</td>
<td>6-8</td>
<td>0-2</td>
<td>60-65</td>
<td>2.5</td>
<td>7</td>
</tr>
</tbody>
</table>

Table 1.2
SUMMARY OF FINANCIAL RATIOS—REFERENCE GUIDES FOR LARGE MANUFACTURING FIRMS

<table>
<thead>
<tr>
<th>Name of the Ratio</th>
<th>Reference Guide</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Liquidity</td>
<td></td>
</tr>
<tr>
<td>a) Current Ratio</td>
<td>2/1</td>
</tr>
<tr>
<td>b) Quick Ratio</td>
<td>1/1</td>
</tr>
<tr>
<td>c) Inventory to Working Capital</td>
<td>Varies</td>
</tr>
<tr>
<td>2. Leverage</td>
<td></td>
</tr>
<tr>
<td>a) Debt to Total Assets</td>
<td>50%</td>
</tr>
<tr>
<td>b) Time Interest Earned</td>
<td>8%</td>
</tr>
<tr>
<td>c) Fixed Charges Coverage</td>
<td>4 times</td>
</tr>
<tr>
<td>d) Current Liabilities to Net Worth</td>
<td>35%</td>
</tr>
<tr>
<td>e) Fixed Assets to Net Worth</td>
<td>65%</td>
</tr>
<tr>
<td>3. Activity</td>
<td></td>
</tr>
<tr>
<td>a) Cash Velocity</td>
<td>Varies</td>
</tr>
<tr>
<td>b) Inventory Turnover</td>
<td>8 times</td>
</tr>
<tr>
<td>c) Fixed Assets Turnover</td>
<td>Varies</td>
</tr>
<tr>
<td>d) Average Collection Period</td>
<td>30 days</td>
</tr>
<tr>
<td>e) Total Assets Turnover</td>
<td>2 times</td>
</tr>
<tr>
<td>4. Profitability</td>
<td></td>
</tr>
<tr>
<td>a) Gross Operating Margin</td>
<td>Varies</td>
</tr>
<tr>
<td>b) Net Operating Margin</td>
<td>Varies</td>
</tr>
<tr>
<td>c) Sales Margin</td>
<td>4 to 6%</td>
</tr>
<tr>
<td>d) Productivity of Assets</td>
<td>10-12%</td>
</tr>
<tr>
<td>e) Return to Net Worth</td>
<td>13-15%</td>
</tr>
</tbody>
</table>

Suggested Standard Ratios

<table>
<thead>
<tr>
<th></th>
<th>Individual</th>
<th>Public Utility</th>
<th>Rail &amp; Roads</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed obligations</td>
<td>25</td>
<td>60</td>
<td>50</td>
</tr>
<tr>
<td>not exceed this</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>percentage of capital</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>structure</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Fixed charges (including bond interest but in many cases also rent) should be earned at least this number of times

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The standards guide in understanding the sound as well as unsound relationships reflected by comparative data obtained from the financial statements. The specific conclusions arrived at as a result of financial analysis are presented in the form of a report. The entire process of financial analysis may be stated, as the fact process involves compilation, comparison and study of the financial and operative data and the preparation, study and interpretation of measuring devices.

Statement of the Problem

In any dynamic business, investing and financing of funds are a continuing process; they are like, the two sides of the same coin. While investing, the dominant consideration is to optimise profitability, while financing it
is one of minimizing risk. In fact, the art and science of balancing the two apparently conflicting considerations, risk and profitability, is the essence of financial management. The future plans of the business enterprise should be framed only on knowing the firm's financial strength and weakness. So, this problem necessitates the study of the financial performance of a business enterprise known as the Panyam Cements & Mineral Industries Limited, Cementnagar, Kurnool.

Objectives of the study

The main objectives of the present study are to seek answers to the following questions.

1. Is the firm in a position to meet its current obligations?

2. What sources of long-term finance are employed by the firm and what is the relationship between them? Is there any danger to the solvency of the firm due to the employment of excessive debt?

3. How efficiently does the firm use its assets?

4. Are the earnings of the firm adequate?

5. Do investors consider the firm profitable and safe for the purpose of investment in the shares of the firm?

Period of Study

The period covered by the study extends over 10 years from 1978-79 to 1987-88. The consideration for restricting the study to this period is that the latest data for manageable
investigation are available for this period. During this period significant changes have also taken place in the credit policies and monetary system of the government.

**Collection of data**

The data relating to the financial statements of the Panyam Cements & Mineral Industries Limited, Cementnagar, Kurnool, has been collected from the published Annual Reports for ten years, from 1978-79 to 1987-88, which were obtained directly from the registered office of the concern.

For the purpose of analysing the financial statements of the Panyam Cements and Mineral Industries Limited, the Profit and Loss Accounts and Balance Sheets have been recast and presented in a condensed form. The figures taken from Annual Reports have been rounded off to two decimal places in lakhs of rupees.

**Tools and Techniques:**

For the purpose of Financial Analysis the profit and loss account and balance sheets are completely recast and presented in a condensed form. The condensed form presents 'Profit and Loss Account and Balance Sheet' in a standard form as given in Appendices I and II.

The Ratio Technique has been adopted for purposes of analysis in the present study and the common size analysis of balance sheet has also been done. Moreover, trend
analysis for studying the behaviour of ratios over a period of 10 years i.e., from 1978-79 to 1987-88, has been applied and fund flow analysis has also been used. However, the conclusions arrived at suffer from the inherent weakness of the technique of financial analysis.

Constraints of the Study

The following limitations in the present study may however, be noted.

1. Owing to financial and time constraint the researcher has covered only one unit.

2. It was felt very difficult to get the financial information from the unit, as the complete dealings of finance were performed from Central Office situated at Hyderabad.

Concepts used in the Study

Sales: Value of finished goods, increase/decrease in stock of finished goods and other income.

Cost of goods sold: Sales minus gross profit.

Gross Profit: Excess of sales over cost of goods sold.

Provisions: Goodwill payment for previous year, bonus for previous year, provision for bonus and provision for gratuity.

Net profit before depreciation: Gross profit minus provisions.

Net profit after depreciation: Net profit before depreciation minus depreciation.
Appropriations:- Excess provision for taxes in previous years, excess provision for taxation no longer required and interest and consideration for hire capitalised.

Net profit before tax:- Net profit after depreciation minus appropriation less donations.

Net profit after tax:- Net profit after tax minus provision for taxation.

Proposed dividends:- Equity dividends.

Reserves and Surplus: Earnings retained for the current year adjusted by transfer to debenture redemption, reserve, investment allowance reserve and general reserve.

ASSETS

1. Gross Block:

   Land and buildings: Freehold land, factory building, residential building, labour colonies, roads and bridges, buildings under construction.

   Plant & machinery and electrical machinery:

   Others: Furniture & equipments, motor vehicles tools, carts and trollys livestock and library.

   Gross block: Total value of land and buildings, plant & machinery and electrical installations and others before depreciation.

   Net block: Gross block minus depreciation.

2. Current Assets:

   Inventory: Stores and spare parts, loose tools, raw material at cost, process stocks at cost finished goods at cost.
| **Investments:** | Investments in government securities and in shares of Housing Development Finance Corporation, Bombay. |
| **Cash:** | Cash on hand, balance with scheduled banks in current account and in deposit account. |
| **Receivables:** | Sundry debtors unsecured considered good. |
| **Loans and advances:** | Advance to staff and workmen, advance to supply of raw materials and spares, prepaid expenses, deposit with electricity Board, Excise, Railways and others and loans and others. |

**LIABILITIES:**

| **Long-term funds:** | Net worth plus long term borrowings consisting of secured, unsecured loans fixed deposits and deferred credits. |
| **Reserves and surplus:** | includes Capital Reserve, Capital Redemption Reserve, Reserve for Development Rebate, Reserve for Investment allowance, Dividend Equalisation Reserve and General Reserve. |
| **Net worth:** | Share Capital plus Reserves and surplus. |
| **Short-term funds:** | Current liabilities, Provisions and Miscellaneous Expenditure. |
| **Current liabilities:** | Sundry creditors, customers credit balances, trade deposits, unclaimed dividends and interest accrued but not due on loans. |
| **Provisions:** | Provision for Income-tax less advance tax and proposed dividends. |
Chapterisation:

The following chapters are contemplated in bringing out this study.

1. Introduction
2. Profile of the Panyam Cements and Mineral Industries Limited
3. The Financial Structure
4. Analysis of Fixed Assets
5. Analysis of Working Capital
6. Conclusions.