Chapter 2

FINANCIAL APPRAISAL:
CONCEPT AND TECHNIQUES
INTRODUCTION

Financial appraisal is a technique to evaluate past, present and projected performance of a concern. Generally, financial appraisal is concerned with the analysis of financial statements. This analysis can be applied to any kind of detailed information of financial data. The main purpose of this analysis is to evaluate the past financial performance, the current financial position, future prospects for earnings, ability to pay interest and debt on maturity and profitability of a concern. Therefore, financial appraisal simply is the process of scientific evaluation of a concern's financial performance.

FINANCIAL ANALYSIS VS FINANCIAL APPRAISAL

Financial analysis is the process of making an analytical study of the financial and operational data contained in the profit and loss account and the balance sheet of a given concern and, thereby, satisfying the informational needs of the internal and external users of such data. An analysis of both these statements gives a comprehensive understanding of
business operations and their impact on the financial health. The analysis of financial statements spotlights the significant facts and relationship concerning managerial performance, corporate efficiency, financial strength and weakness and creditworthiness that would have otherwise been buried in a maze of details.

On the other hand, financial appraisal is the process of scientifically making a proper and comparative evaluation of profitability and financial health of a given concern on the basis of summarized and analyzed data, i.e., the output of financial analysis. Financial analysis is the preliminary step towards the financial evaluation of the results drawn by the analysts. It is, therefore, evident that the financial appraisal begins where the financial analysis ends and financial analysis starts where the summarization of financial data in the form of profit and loss account and the balance sheet ends.

FINANCIAL STATEMENTS – CONCEPTS

One of the most important functions of the accounting process is to accumulate and report historical accounting information. The most prominent examples of such reports are the general purpose financial statements showing an organization's financial purpose and results of its operation. These financial statements are the end result of the process of financial accounting. In the words of Hampton, "a financial statement is an organized collection of data organized according to logical and consistent accounting procedures." To quote Anthony, "financial statements are the interim reports, presented annually and reflect a division of the life of an
enterprise into more or less arbitrary accounting periods more frequently a year.5

Although any formal statements expressed in money values 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.'6 The same opinion was expressed by Myer who stated that the term financial statements, as used in modern business, refers to the two statements which the accountant prepares at the end of a period of time for a business enterprise. They are the balance sheet or statement of financial position, and the income statement, or profit and loss statement.7

Lawrence and Charles add two more besides the balance sheet and income statements, one dealing with the retained earnings and the other with sources and uses of enterprise funds.6 McMullen also advocates that the principle financial statements published for the information of outsiders are the balance sheet, the income statement, the statement of retained earnings or owners' equity and the statement of changes in financial position (formerly usually known as the statement of sources and application of funds).9

It is, therefore, apparent that the principle financial statements are the balance sheet, the income statement, the statement of retained earnings and the statement of changes in financial position. But the major and independent form of financial statements, which are vital to financial analysts and financial management are the income statement and the balance sheet. Both these statements contain the basic information often
needed by various persons interested in the enterprise. These primary statements are often supplemented by schedules showing details of particular items. They consist of such schedules as the schedule of property, plant and equipment, the schedule of investments, the schedule of reserves and so forth.

The Balance Sheet

The balance sheet shows the financial condition of a business enterprise at a certain date normally at the time when the books of accounts are closed and balanced, usually at the end of accounting year. A balance sheet is a 'status report' and as such it shows 'what we have' and from 'where' on the last date of the accounting year. According to Anthony, "a balance sheet shows the financial position of an accounting entity as on a specified moment of time". To quote Kennedy and McMullen, "the balance sheet reveals the financial condition or status of a business, as reflected in the accounting records, at one particular moment in time, usually the close of business on the day indicated by the date of the statement". In the views of Pyle, White and Larson, "a balance sheet is so called because its two sides must always balance, the sum of the assets shown on the balance sheet must equal liabilities plus owners' equity". Hastings opines, "balance sheet reveals the property owned by the business – the assets and the debts owed by the company – the liabilities. The same view was also expressed by Black and Hirt. The balance sheet is also known as statement of financial condition. In other words, it is designed to show the condition of the business in a form easily readable and more quickly comprehended than would be possible from a
survey of the figures shown in ledgers and records. Further, it can also be described as the statement of financial position, statement of assets and liabilities, statement of resources and liabilities, statement of assets, liabilities and capital and statement of worth. To conclude, it is always presented at a definite date highlighting the bird’s eye-view of the financial condition of an enterprise.

The Income Statement

The income statement is an accountant’s major report of activity. It is a performance report recording the changes in income, expenses, profits or losses as a result of business operations during a specified period of time. It is usually known as profit and loss account, which depicts the net income or net loss resulting from the business operations during the period of time covered by the statement. The income statement measures the progress of a business in carrying out the function of delivering services and products to its customers for which the enterprise was launched.

Foulke defines the income statement as, “the mathematical interpretation of the policies, experience, knowledge, foresight and aggressiveness of the management of a business enterprise from the point of view of income, expenses, gross profit, operating profit and net profit or loss.” The final net profit or loss is the ultimate measure of the skill of active management. According to Gutmann, “income statement signals out and summarises those transactions in which there is a loss or gain for the owners of the business”. He further adds that the balance sheet might be described as financial cross sections taken at certain
intervals and the earnings statements as condensed history of the growth or decay between the cross sections.\textsuperscript{19} In the words of Walgenbach, Dittrich and Hanson, "it is a statement showing the results of operations for a period which lists the revenues and expenses and presents the resulting net income amount."\textsuperscript{20} To quote Kennedy and McMullen, "it is a statement of activity and the results of that activity."\textsuperscript{21} Similarly, Paton and Paton advocate that the income statement is accountant's major report of activity.\textsuperscript{22} As an interim report, it suggests a long range view of a business enterprise by depicting the direction in which the business is moving and the reason underlying it.

The Statement of Retained Earnings

The statement of retained earnings is an analysis of the retained earnings, accounts for the accounting period and is usually presented with the other corporate financial statements.\textsuperscript{23} The statement of retained earnings indicates the magnitude and causes of changes in retained earnings of the enterprise due to the year's activities. The statement serves as the link between the income statement and the balance sheet. The changes in the equity account, between balance sheet dates are reported in the statement of retained earnings.

The Statement of Changes in Financial Position

The statement of changes in financial position is a logical adjunct to the balance sheet and income statement.\textsuperscript{24} It has only recently become a required component of published corporate reports, equal in status to the balance sheet and the income statement. According to Franof, "the statement of changes in financial position is most commonly used to
indicate changes during the year in the companies' working capital position". The statement of changes in financial position indicates both the sources and application of working capital. Thus, it reveals the sources from which funds have been received during the year and how these funds were used within the enterprise.

OBJECTIVES OF ANALYSIS OF FINANCIAL STATEMENTS

The financial statements are intended to provide an accurate picture of a firm's financial condition and operating results in a condensed form. To quote Hingorani and Ramanathan, "the objective of financial statement analysis is a detailed cause and effect study of the profitability and financial position". Thus, the analysis helps to understand the profitability performance including financial position of the enterprise. According to Korn, and Thomas, "an analyst of financial statements attempts to interpret or draw conclusions from the statements". In the words of Garrison, "without financial statement analysis, the story that key relationships and trends have to tell may remain buried in a sea of statements detail". He also states that the purpose of financial statement analysis is to assist statement users in predicting the future by means of comparison, evaluation and trend analysis.

An appropriate analysis of these statements provides a valuable insight into the financial condition and operations of a business. It is, therefore, imperative that financial statements such as balance sheet, profit and loss account, statement of retained earnings and sources and application of funds are prepared to disclose useful overall summaries of the financial data accumulated by a concern. Myer says that the analysis
and interpretation of financial statements of a business enterprise usually has as its objective the formation of an opinion with respect to the financial condition of that enterprise. According to Salmonson, Hermanson and Edwards, "financial statements are issued to communicate useful financial information to interested parties." The financial statements should be comprehensible to investors and creditors who have a reasonable understanding of business and economic activities and financial accounting and who are willing to spend the time and effort needed to study the financial statements.

USES OF FINANCIAL STATEMENTS

The financial statements play a pivotal role in providing the information concerning the financial position of an enterprise and the results of its operation. The information so obtained is useful for decision making. In this context it is appropriate to quote Biernan and Drebin, "financial statements are prepared primarily for decision making. The statements are not an end in themselves, but must be useful in decision statement context". To be precise, financial statements are the blueprints of the financial affairs. In the words of Shuckett and Mock, "financial statements may reveal shortcomings in control or indicate major areas for changes in corporate policy". The financial statements are constructed with a view to presenting a periodical review or report on progress by the management and deal with the position of investment in the business and the results achieved during the period under review.

Furthermore, the published financial statements of a business concern basically serve two purposes: for the public, they are a window on
the management of companies inasmuch as they reveal many facts about the financial development of companies; to the management, they are its eyes inasmuch as they reveal the strength and weakness and also trends in the finances of the company in the light of which the management can take appropriate steps to settle matters right. The financial statements are more useful to varied interest groups such as business executives, shareholders, debentureholders, creditors, bankers, government authorities, financial analysts, researchers and employees. To the business executive, they are useful to measure the effectiveness of his own policies and decisions, determine the advisability of adopting new polices and procedures, and document to owners the results of his managerial efforts; to the stockholders and debenture holders, financial statement analysis is their means of reinforcing judgments or of forming new judgments regarding the capital investment they have undertaken; to the creditors and bankers, these statements act as a magic eye highlighting the credit worthiness i.e., assurance whether the enterprise will meet the obligations as and when they mature; to the government authorities, to assess the revenue through various taxes; to the financial analysts and researchers, to guide management and to establish certain principles.

To put in a nutshell, financial statements are of varying importance to cater to the different needs of groups with varied interests.

LIMITATIONS OF FINANCIAL STATEMENTS

The published financial statements of business enterprises are the end products of accounting and have the appearance of completeness,
exactness and finality prepared with the object of presenting a periodical review or report of the progress of the business by the management. But, these statements are not final because the ultimate profit or loss can be ascertained only when the business is completely sold or liquidated. Financial statements are essentially interim reports prepared for an accounting period usually comprising twelve months. In fact, these statements are neither, complete nor accurate as the flow of income and expenses are artificially cut off at the balance sheet date.

Financial statements should reveal all necessary information. In other words, these accounting reports should make a full disclosure of all material information. But too much disclosure may be as misleading as too little. Further, there is no responsibility cast on management to report on the results of operation, by-products, divisions and segments of activity and in case is such information is disclosed.

While these are no doubt serious deficiencies, company reports suffer from many other inadequacies. Partly on account of its preoccupation with the profit and loss complex, and partly and more importantly due to the restricted framework of presentation expected in law, management is least inclined to report anything on the qualitative aspects of corporate performance. Reporting is almost exclusively in terms of financial statements and monetary indices of achievement. This is patently incomplete. Financial statements are the result of recording and summarizing financial transactions. Therefore, some significant events that influence the entity cannot be determined from financial statement
analysis. For instance, if a major customer is lost, this will not initially influence the financial statement but will result later in reduced sales.

Financial statements are constructed on the basis of certain accounting concepts and conventions. On account of this, the financial position, as disclosed by these statements, may not be realistic. Both the profit and loss account and the balance sheet reflect rupee value of transactions of different dates. The rupee value is changing very fast and as such the conclusions based on these figures may be quite misleading. Financial statements do not reflect many factors which affect materially the financial condition and the operating results because they cannot be stated in terms of money. These factors include sources and commitments for materials, merchandise and supplies, the reputation and prestige of the company with the public, the credit rating of the company, and the efficiency, loyalty and integrity of the management and employees.

Financial statements are accounting for the past rather than accounting for the future and as such are of little value for the management in its task of decision making. It seems, therefore, unrealistic to expect that the financial statements can record the full scope of business operations. The limitations show the tentative character of financial statements which is to be considered while arriving at the correct conclusion from the techniques of financial analysis.

ANALYSIS AND INTERPRETATION OF FINANCIAL DATA

According to Kennedy and McMullen, "analysis and interpretation of the financial statements is presentation of information that will aid in
decision making by business managers, investors, and creditors as well as other groups who are interested in the financial status and operating results of a business.  He further observes that the process of analyzing financial statements involves the compilation, comparison and study of financial and operating data and the preparation, study and interpretation of measuring devices such as ratios, trends and percentages.

In the words of Myer, "financial statement analysis is largely 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 trends of these factors, as shown in a series of statements."

Analysis and interpretation may be classified into two parts, viz., 'internal analysis', and 'external analysis'. In internal analysis, groups like managerial authorities, employees and others who are closely related with the books of accounts of a concern, are mainly interested parties. In external analysis, outsiders viz., shareholders, debenture holders, creditors, etc., are interested. As Myer observes, "in internal analysis the analyst is within the enterprise he is analyzing; he has access to the books of account, and complete information about the business at his disposal. In external analysis he is not connected with the enterprise, and the only data available to him are the statements and such information as the business is willing to submit."

TECHNIQUES OF FINANCIAL APPRAISAL

Several kinds of tools and techniques are used for the evaluation and appraisal of the financial statements of a concern. The main objective of these techniques is to minimize or reduce the financial data collected
and used in more appropriate and understandable terms. The undermentioned are the tools and techniques which are commonly applied in analyzing the financial statements of a business enterprise.

- Ratio Analysis
- Trend Analysis
- Common Size Analysis
- Comparative Statement Analysis
- Statistical Techniques of Analysis
- Diagrammatic and Graphic Presentation of Financial Data

Ratio Analysis

Ratio analysis is the process of determining and interpreting numerical relationship based on financial statements. According to Anthony, "a ratio is simply one number expressed in terms of another. It is found by dividing one number, the base into the other. A percentage is one kind of ratio in which the base is taken as equaling hundred and quotient is expressed as 'per hundred' of the base". In the words of Kennedy and McMullen, "the relationship of one item to another expressed in simple mathematical form is known as ratio". 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". Meigs, Johnson and Meigs define it as mathematical expression of relationship of one item to another. As advocated by Hunt, Williams and Donaldson, "ratios are simply a means of highlighting in arithmetical terms, the relationships between figures drawn from financial statements". In the words of Batty, "the term 'accounting
ratios' is used to describe significant relationships 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.  

The main purpose of ratio analysis is to measure past performance and to project future trends. It is also used for inter-firm and intra-firm comparison as a measure of comparative productivity. The significance of the various components of financial statements can be judged only by ratio analysis. As Foulke rightly remarks, "ratio will point out weaknesses and indicate whether a financial condition is wholly or partly good, questionable or poor." Emphasizing the importance of ratio, he further adds that the ratio is the symptom like the blood pressure, the pulse, or the temperature of an individual. In the words 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."

Financial ratios may be categorized into certain groups on the basis of the items which are used for the ratios. Herbert has divided financial ratios into the following four categories: (i) liquidity ratios; (ii) profitability ratios; (iii) activity ratios; and (iv) leverage ratios. To quote Clemens and Dyer, "the ratios used must be appropriate for the particular user." Thus, ratio analysis enables the user for the clear understanding of financial statements than by looking at the absolute quantities alone.
Trend Analysis

Trend analysis is a guide to follow the changes that occur in a business enterprise from period to period. In other words, this is a horizontal analysis of financial statements often called as 'Pyramid' method of ratio analysis – a guide to yearly changes. According to Chowdary, "trend analysis reveals the direction of changes or is a guide to the movement of facts and figures revealed while comparing the financial statements of different periods". This analysis ensures easy understanding of the changes in an item or a group of items over a given period of time and useful to draw conclusions concerning the changes in data. Myer states that the trend ratios indicate the trends of the various statement items across the years. They provide a horizontal analysis of comparative statements and a dynamic study of the behaviour of the items with the passage of time. He also opines that trend ratios are index numbers of the movements of various financial variables of a business.

As observed by Garrison, "the results of financial statement analysis are of value, only when viewed in comparison with the results of the other periods and in some cases, with the results of other firms. It is only through comparison one can gain insight into trends, and make intelligent judgment as to their significance." Trend analysis is, therefore, the interpretation of the items of the comparative financial statements of varied period.

According to Salmonson, Hermanson and Edwards, "trend percentages are a useful means for comparing financial statements for
several years. They emphasize changes or trends that have occurred over a period of time. They are calculated by:

(i) selecting a base year;

(ii) assigning a weight of cent per cent to the amounts appearing on the base year financial statements; and.

(iii) expressing the amounts shown on the other year’s financial statements as a percentage of their corresponding base year financial statement amounts.56

> Common Size Analysis

Under common size analysis technique individual items of profit and loss account and balance sheet are reduced to a common base which is treated as equivalent to hundred. A statement prepared under this technique is known as cent per cent or component percentage statement. In the case of profit and loss account, sales are taken as hundred and all items are expressed with reference to them. In the balance sheet the total is treated as equivalent to hundred and all individual assets and liabilities are reduced to this base. This technique indicates the structure of the balance sheet and profit and loss account. The trend depicted by the common size is more authentic as it shows ‘qualitative assessment’ as opposed to ‘quantitative assessment’ shown by absolute figures.

Further, this technique of analysis is useful when we wish to compare one company with another for presentation of data in percentage form as it eliminates problems relating to differences in organization size.57 Preparation of common size statements give a clear view of the structure of assets and liabilities on the one hand and income and
are indices, averages, ranges, standard deviation, coefficient of correlation, analysis of variance ('F' test), regression analysis and students 't' test.

Diagramatic and Graphic Presentation of Financial Data

In the words of Mills, "when the results of observation or statistical investigations have been secured in quantitative form one of the first steps towards analysis and interpretation of data is that of presenting these results graphically". Diagrams and graphs are visual aids which give a bird's eye-view of a given set of numerical data. They present the data in simple, readily comprehensible and intelligible form. Graphic representation of statistical data gives a pictorial aspect to what would otherwise be a mass of figures. Diagrams and graphs depict more information than the data shown in the table.

CONCLUSION

Figures are dumb. However, they may tell a vivid story of the financial adventures of an enterprise, if systematically analysed and appraised. Financial appraisal, pinpoints the strengths and weaknesses of a business undertaking. Financial appraisal, therefore, is simply the process of evaluation of a firm's financial performance.
REFERENCES


29. Ibid., p. 594.


38. Ibid.


40. Ibid.


48. Ibid.


54. Ibid.


