CHAPTER :- 4

CONCEPTUAL FRAMEWORK OF FINANCIAL PERFORMANCE.

4.1 INTRODUCTION.
4.2 FINANCIAL PERFORMANCE.
4.3 FINANCIAL STATEMENT.
4.4 FINANCIAL STATEMENT ANALYSIS.
4.5 METHODS OF ANALYSIS OF FINANCIAL STATEMENTS.

4.5.1 COMPARATIVE STATEMENTS.
4.5.2 COMMON-SIZE STATEMENTS.
4.5.3 TREND PERCENTAGES.
4.5.4 STATEMENT OF CHANGES IN WORKING CAPITAL.
4.5.5 CASH FLOW STATEMENT.
4.5.6 RATIO ANALYSIS.

4.5.6.1 MEANING OF RATIO.
4.5.6.2 DEFINITION OF RATIO.
4.5.6.3 DEFINATION OF RATIO ANALYSIS.
4.5.6.4 IMPORTANCE OF RATIO ANALYSIS.
4.5.6.5 OBJECTIVE OF RATIO ANALYSIS.
4.5.6.6 USES OF RATIO ANALYSIS.
4.5.6.7 LIMITATIONS OF RATIO ANALYSIS
4.5.6.8 CLASSIFICATION OF RATIOS.

4.5.7 WORKING CAPITAL RATIO

REFERENCES.
CHAPTER :- 4

CONCEPTUAL FRAMEWORK OF FINANCIAL PERFORMANCE.

4.1 INTRODUCTION:-

In this chapter researcher has take to know the financial performance and he has also taken method of analysis of financial statement and with that he has to maser the performance with ratio analysis.

4.2 FINANCIAL PERFORMANCE:-

The performance of the firm can be measured by its financial results, i.e., by its size of earnings Riskiness and profitability are two major factors which jointly determine the value of the concern.¹ Financial decisions which increase risks will decrease the value of the firm and on the other hand, financial decisions which increase the profitability will increase value of the firm. Risk and profitability are two essential ingredients of a business concern.

There has been a considerable debate about the ultimate objective of firm performance, whether it is profit maximization or wealth maximization. It is observed that while considering the firm performance, the profit and wealth maximization are linked and are effected by one-another.

A company’s financial performance therefore is normally judged by a series of ratios or figures, however there are following three ratio
parameters which can be used to evaluate financial performance, they are:

a) Return on Equity
b) Earnings per Share and
c) Price Earnings Ratio.

All three parameters are discussed in detailed along with various other ratios. However, it is to be noted that fundamentally, the balance sheet indicates the financial position of the company as on that point of time. However, profit and loss account is a statement, which is prepared for a particular financial year. In Indian context, where an analyst has to rely upon the audited financial statement for a particular company, the performance is to be judged from the financial statement only. This chapter, however indicates some of the techniques, which can be used for such analysis of financial performance.²

4.3 FINANCIAL STATEMENT:-

Company is required to present its financial statements every year as required by the provisions of the companies Act. Generally, these financial statements comprise of Balance sheet and Profit and Loss Account is also known as Income Statement. Balance sheet shows the financial position of the company as on the data of balance sheet. The financial position comprises of what company/entity owns and what it owes. In other words, financial position shows what are the assets and liabilities of the enterprise

Company records day to day transactions in its books of accounts from this information, financial statements are prepared at the end of the year.³ These financial statements comprise mainly of the following two
Financial statements:
- Balance sheet showing financial position of business.
- Profit and loss accounts showing the performance or result of business during the year.

Financial statements are prepared in terms of provisions of law. They are prepared in accordance with generally accepted accounting principles and accounting standards. For example, stock is valued at cost or market price whichever is lower.

The financial statements are used for various objectives. For example, determining profit for the purpose of managerial remuneration, for making provision for income tax, for determining taxable profit, etc.

4.4 FINANCIAL STATEMENT ANALYSIS:-

Financial Analysis is the process of identifying the financial strengths and weaknesses of the company by properly establishing relationships between the items of the balance sheet and the profit and loss account. Financial analysis can be undertaken by management of the firm, or by parties outside the firm, viz. owners, Creditors’, investors and others. The nature of analysis will differ depending on the purpose of analyst. Financial ratios are tools for interpreting financial statements to provide a basis for valuing securities and appraising financial and management performance.

Information published in financial statements may not be sufficient form the viewpoint of different parties. Different parties or stockholders are interested in arriving at conclusions for their own objectives based on information contained in financial statements. For such conclusions, the information may not be readily available from financial statements. For
example, position of the company from the viewpoint of 1) liquidity, 2) profitability or 3) solvency may not be known directly from the face of financial statements. For this purpose, information contained in financial statements is not be analyzed based on the figures of financial statements and other related supplementary information. Such conclusions cannot be drawn straight from the number shown in financial statements.

   For the purpose of analysis different information and figures have to be compared and such information can be obtained in the form of percentage or rate of turnover. Thus, conclusions drawn based on different financial numbers given in the financial statements is known as analysis and the opinions framed based on such conclusion is known as interpretation.5

4.5 METHODS OF ANALYSIS OF FINANCIAL STATEMENTS:-

   One gets information based on financial statements. Analysis of such information by comparison or with the help of percentages or formula and arriving at conclusions based on such analysis is known as financial statement analysis of financial statements:

   4.5.1 COMPARATIVE STATEMENTS:-
   4.5.2 COMMON-SIZE STATEMENTS:-
   4.5.3 TREND PERCENTAGES:-
   4.5.4 STATEMENT OF CHANGES IN WORKING CAPITAL:-
   4.5.5 CASH FLOW STATEMENT:-
   4.5.6 RATIO ANALYSIS:-
4.5.1 COMPARATIVE STATEMENTS :-

One cannot get an idea about profitability and financial position by analyzing only one year’s financial statements. Under this method of analysis, one needs at least two years’ figures. By putting figures of different years together, one can know about the change of trend in business. This method is useful to know about the business trend of various matters. To understand the presentation for analysis of financial statements are prepared in this method:

- Profit and loss statement.
- Balance sheet.

4.5.2 COMMON – SIZE STATEMENTS :-

These statements are prepared to know percentage of each of assets to total assets and percentage of each element of expense as percentage of total sales. Such statements are also known as hundred percentage statement.

Common- size statements are also useful in comparing financial position of two companies. While analyzing balance sheet, each asset as a percentage of total assets and each liability as a percentage of total liabilities is calculated. Similarly, in analyzing profit and loss account, each item expense and income is calculated as percentage of total sales.

4.5.3 TREND PERCENTAGES :-

The Time Series Analysis or Trend Analysis indicates of ratio indicates the direction of changes. The trend analysis is advocated to be studied in light of the following two factors.
i) The rate of fixed expansion or secular trend in the growth of the business and

ii) The general price level.

Any increase sales statement may be because of two reasons, one may be the increase in volume of business and another is the variation in prices of the goods / services.

For trend analysis, the use of index number is generally advocated. The procedure followed is to assign the number 100 to the items of each base year and to calculate percentage changes in each item of the other years in relation to the base year. This is known as ‘Trend-Percentage Method’.

### 4.5.4 STATEMENT OF CHANGES IN WORKING CAPITAL :-

In financial management, two important decisions are very vital and crucial. They are decision regarding fixed assets/fixed capital and decision regarding working capital/current assets. Both are important and a firm always analyzes their effect to final impact upon profitability and risk.

Fixed capital refers to the funds invested in such fixed or permanent assets as land, building, and machinery etc. Whereas working capital refers to the funds locked up in materials, work in progress, finished goods, receivables, and cash etc.

Thus, in very simple words, working capital may be defined as “capital invested in current assets.” Here current assets are those assets, which can be converted into cash within a short period of time and the cash received is gain invested into these assets. Thus, it is constantly
receiving or circulating. Hence, working capital is also known as circulating capital or floating capital.

There are two concepts of working capital. These are:

1. **Gross working capital: (Total Current Assets)**

   The gross working capital, simply called as working capital refers to the firm’s investment in current assets. Current assets are the assets, which can be converted into cash within an accounting year or operating cycle. Thus, Gross working capital, is the total of all current assets.

2. **Net Working Capital: (Total Current Assets – Total Current Liabilities)**

   Net working capital refers to the difference between current assets and Current liabilities. Current liabilities are those claims of outsiders, which are expected to mature for payment within an accounting year. Net working capital may be positive or negative. A positive net working capital will arise when current assets exceed current liabilities and a negative net working capital will arise when current liabilities exceed current assets i.e. there is no working capital, but there is a working capital deficit.

   “Working Capital represents the amount of current assets that have not been supplied by current, short term Creditors’.”

   “Gross working capital refers to the amount of funds invested in current assets that are employed in the business process while, Net Working Capital refers to the difference between current assets and current liabilities.”
“Working Capital is the excess of current assets that has been supplied by the long-term Creditors’ and the stockholders.”

The two concepts of working capital, gross working capital and net working capital are exclusive. Both are equally important for the efficient management of working capital. The gross working capital focuses attention on two aspects: How to optimize investment in current assets? And how should current assets be financed? While, net working capital concept is qualitative. It indicates the liquidity position of the firm and suggests the extent to which working capital needs may be financed by permanent sources of funds.

4.5.5 CASH FLOW STATEMENT :-

Cash flow analysis is primarily used as a tool to evaluate the sources and uses of funds. Cash flow analysis provides insights into how a company is obtaining its financing and deploying its resources. It also is used in cash flow forecasting and as part of liquidity analysis. The cash flow statement was previously known as the flow of Cash statement. The cash flow statement reflects a firm's liquidity. The balance sheet is a snapshot of a firm's financial resources and obligations at a single point in time, and the income statement summarizes a firm's financial transactions over an interval of time. These two financial statements reflect the accrual basis accounting used by firms to match revenues with the expenses associated with generating those revenues. The cash flow statement includes only inflows and outflows of cash and cash equivalents; it excludes transactions that do not directly affect cash receipts and payments. These non-cash transactions include depreciation or write-offs on bad debts or credit losses to name a few. The cash flow
statement is a cash basis report on three types of financial activities: operating activities, investing activities, and financing activities. Non-cash activities are usually reported in footnotes. The cash flow statement is intended to

1. provide information on a firm's liquidity and solvency and its ability to change cash flows in future circumstances
2. provide additional information for evaluating changes in assets, liabilities and equity
3. improve the comparability of different firms' operating performance by eliminating the effects of different accounting methods
4. indicate the amount, timing and probability of future cash flows

The cash flow statement has been adopted as a standard financial statement because it eliminates allocations, which might be derived from different accounting methods, such as various timeframes for depreciating fixed assets.¹⁴

4.5.6 RATIO ANALYSIS :-

Ratio analysis is a powerful tool of financial analysis. A ratio is defined as “the indicated quotient of two mathematical expressions" and as “the relationship between two or more things.”¹⁵ In financial analysis, a ratio is used as a benchmark for evaluating the financial position and performance of a firm. An accounting figure conveys meaning when it is related to some other relevant information. A ratio gets utility by comparison to other data and standards.
The relationship between two accounting figures, expressed mathematically, is known as a “Financial Ratio.” Ratios help to summaries large quantities of financial data and to make qualitative judgment about the firm’s financial performance. The point to note that a ratio reflecting a quantitative relationship helps to form a qualitative judgment. Financial analysis can be undertaken by management of the firm, or by parties outside the firm, viz. owners, Creditors’, investors and others. Generally, ratios are divided in four areas of classification that are providing different kind of information liquidity, profitability, activity and leverage ratios.

Ratio analysis is a very powerful analytical tool useful for measuring performance of an organization. The ratio analysis helps the assets to current liabilities will work out to be $\frac{750000}{500000} = 1.5$ management to analyze the past performance of the firm and to make further projection.

The ratio analysis of working capital can be used by management as a means of checking upon the efficiency with working capital.

Ratio analysis is essentially concerned with the calculation of relationships, which after proper identification and interpretation may provide information about the operations and state of affairs of a business enterprise.

Ratio analysis is such a significant technique for financial analysis. It indicates relation of two mathematical expressions and the relationship between two or more things. A financial ratio is a relationship between two financial variables.

Ratio analysis is a process of comparison of one figure against another, which make a ratio, and the appraisal of the ratios to make
proper analysis about the strengths and weaknesses of the firm’s operations. The calculation of ratios is a relatively easy and simple task but the proper analysis and interpretation of the ratios can be made only by the skilled analyst.

While interpreting the financial information, the analyst has to be careful in limitations imposed by the accounting concepts and methods of valuation. Ratio analysis is extremely helpful in providing valuable insight into a company’s financial picture.

4.5.6.1 MEANING OF RATIO:

4.5.6.2 DEFINITION OF RATIO:

4.5.6.3 DEFINITION OF RATIO ANALYSIS:

4.5.6.4 IMPORTANCE OF RATIO ANALYSIS:

4.5.6.5 OBJECTIVES FOR RATIO ANALYSIS:

4.5.6.6 USES OF RATIO ANALYSIS:

4.5.6.7 LIMITATION OF RATIO ANALYSIS:

4.5.6.8 CLASSIFICATION OF RATIOS:

4.5.6.1 MEANING OF RATIO:

A ratio is nothing but a simple arithmetical expression of the relationship of one number to another. It may be defined as the indicated quotient of two mathematical expressions. In simple language ratio is one number expressed in terms of another and can be worked out by dividing one number into the other.

For example, if the current assets of a firm on a given date are Rs. 750000 and the current liabilities are Rs. 500000 then the ratio of current
assets to current liabilities will work out to be 750000 / 500000 = 1.5

A ratio is the mathematical relationship between two quantities in the form of a fraction or percentage.

### 4.5.6.2 DEFINITION OF RATIO :-

“The relationship between the two figures expressed mathematically is called a ratio.”

- Hingorani, Ramanathans & Crewal

### 4.5.6.3 DEFINITION OF RATIO ANALYSIS :-

“A number expressed in terms of another.”

“Ratio is a yardstick used to evaluate the financial condition and performance of a firm relating two pieces of financial data to each other.”

- James C. Van Harne

“The relation of one amount, ‘a’ to another ‘b’, expressed as the ratio of ‘a’ to ‘b’.”

- Kohler

“Ratio is a fraction whose numerator is the antecedent and denominator the consequent.”

“Ratio is the relationship or proportion that one amount bears to another the first number being the numerator and the later denominator.”

- H. G. Guthmann

“Ratio analysis is one of the important tools of financial analysis. They assist the management in its basic function of forecasting, Planning, control and communication.”

- Dr. S.N.Maheshwari & Sunil Maheshwari
4.5.6.4 IMPORTANCE OF RATIO ANALYSIS :-

The major benefits arising from ratio analysis are as follows:

- Ratio analysis is a very powerful analytical tool useful for measuring performance of an organization.\textsuperscript{21}
- Ratio analysis concentrates on the inter-relationship among the figures appearing in the financial statements.
- Ratio analysis helps the management to analyze the part performance of the firm and to make further projections.
- Ratio analysis allow interested parties to make evaluations of certain aspects of the firms performance as give below :
  - Shareholders and prospective investors will analysis ratios for taking investment and disinvestment decisions.
  - Bankers who provide working capital will analysis ratio for appraising the credit worthiness of the firm.
  - The financial institutions that provide long-term debt will analysis ratios for project appraisal and debt servicing capacity of the firm.
  - The financial analysis will analyze ratio for making comparison and recommending to the investing public.
  - The credit rating agencies will analyze ratios of a firm to give the credit rating to the firm.
  - The government agencies will analyze ratio of a firm for review of its performance.
  - The company’s management will analyze ratios for determining the financial health and its profitability. The ratios will also be used for inter- firm and intra-firm comparison and will also be used in financial planning and decision making.
4.5.6.5 OBJECTIVES OF RATIO ANALYSIS :-

With the help of ratio analysis financial executives can measure whether the firm is at present financially health or not. The following are some of the important objectives of ratio analysis.

4.5.6.5.1 TO SERVE AS AN AID IN FINANCIAL FORCASTING :-

4.5.6.5.2 TO SERVE AS AN AID IN COMPARISON :-

4.5.6.5.3 TO SERVE AN AID IN COST CONTROL :-

4.5.6.5.4 TO COMMUNICATE :-

4.5.6.5.5 OTHER OBJECTIVES :-

4.5.6.5.1 TO SERVE AS AN AID IN FINANCIAL FORCASTING :-

Ratio analysis is very helpful in financial forecasting. Ratio relating to the fast sales, profits and financial position are the vase for the future trends.

4.5.6.5.2 TO SERVE AS AN AID IN COMPARISON :-

With the help of ratio analysis ideal ratios can be composed and they can be used for comparison of a particular firms and performance.

4.5.6.5.3 TO SERVE AN AID IN COST CONTROL :-

Ratios are very useful for measuring the performance of any organization and it is very useful in cost control.
4.5.6.5.4 TO COMMUNICATE :-

Different financial ratios communicate the strengths and financial standing of the firm to both internal and external parties.

4.5.6.5 OTHER OBJECTIVES :-

Financial ratios are very helpful in the diagnosis of the financial health of a firm. They highlight the liquidity, solvency, profitability and capital gearing etc. of the firm. Thus, ratio analysis serves as a useful tool for analyzing the financial performance of any firm.

4.5.6.6 USES OF RATIO ANALYSIS :-

The ratio analysis is one of the most powerful tools available in the hands of the management to take sound financial decisions. It is used as a device to analyze and interpret the financial health of an enterprise. The managerial uses of ratio analysis are the following:

4.5.6.6.1 HELPS IN DECISION MAKING:-
4.5.6.6.2 HELPS IN FINANCIAL FORCASTING AND PLANNING:-
4.5.6.6.3 HELPS IN COMMUNICATING:-
4.5.6.6.4 HELPS IN COORDINATION:-
4.5.6.6.5 HELPS IN CONTROL:-
4.5.6.6.6 FACILITATES INTRA-FIRM COMPARISON:-
4.5.6.6.7 FACILITATES INTER-FIRM COMPARISON:-
4.5.6.6.1 HELPS IN DECISION MAKING:-

Ratio analysis helps in making decisions from the information provided in the financial statements.

4.5.6.6.2 HELPS IN FINANCIAL FORCASTING AND PLANNING :-

Planning is looking ahead and ratios calculated for a number of years work as a guide for the future. Meaningful conclusions can be drawn for future from these ratios. Thus, ratio analysis helps in forecasting and planning.

4.5.6.6.3 HELPS IN COMMUNICATING :-

The financial strength and weakness of a firm are communicated in a more easy and understandable manner by the use of ratios.

4.5.6.6.4 HELPS IN COORDINATION :-

Better communication of efficiency and weakness of an enterprise results in better coordination in the enterprise.

4.5.6.6.5 HELPS IN CONTROL :-

Ratio analysis even helps in making effective control of the business. Standard ratios can be based upon Performa financial statement
and variances or deviations, if any, can be found by comparing the actual with the standards so as to take a corrective action at the right time.

**4.5.6.6 FACILITATES INTRA-FIRM COMPARISON** :-

Comparison of ratios of the same firm over a period of years can be made. It helps to know the improvements in financial performance over a period of years.

**4.5.6.7 FACILITATES INTER-FIRM COMPARISON** :-

Ratios of a firm can be compared with the ratios of similar nature of rims. This comparison will indicate how well the concern is operating relatively to its competitors.

**4.5.6.7 LIMITATIONS OF RATIO ANALYSIS** :-

Ratio analysis has a number of pitfalls. Some of these are as follow:

**4.5.6.7.1 LIMITED USE OF A SINGLE RATIO** :-

A single ratio does not convey much of a sense. To make a better interpretation, a number of ratios have to be calculated which is likely to confuse analyst.
4.5.6.7.2 LAKE OF ADEQUATE STANDARDS :-

There are no well-accepted standard or rules of thumb for all ratio which can be accepted as norms, it renders interpretation of the ratios difficult.

4.5.6.7.3 INHERENT LIMITATION OF RATIOS :-

Ratios of the past are not necessarily true indicators of the future.

4.5.6.7.4 CHANGE OF ACCOUNTING PROCEDURE :-

Change in accounting procedure by a firm often makes ratio analysis misleading.

4.5.6.7.5 WINDOW DRESSING :-

Financial statement can easily be window dressed to present a better picture of its financial and profitability position to outsiders. But, it may be very difficult for an outsider to know about the window dressing made by a firm.22

4.5.6.7.6 PERSONAL BIAS :-

Ratios have to be interpreted and different people may interpret the same ratio in different ways.
4.5.6.7.7 **INCOMPARABLE :-**

Not only industries differ in their nature but also the firms of the similar business widely differ in their size and accounting procedures. It makes comparison of ratios difficult and misleading.

4.5.6.7.8 **PRICE LEVEL CHANGES :-**

While making ratio analysis, no consideration is made to the price level and it makes the interpretation of ratio invalid.

4.5.6.7.9 **RATIO ON SUBSTITUTES :-**

Ratios become useless if separated from the statement from which they are computed.

4.5.6.7.10 **UNSUITABLE FOR FORECASTING :-**

Ratios indicate what has happened in the past. Since past is quite different from what is likely to happen in future, it is difficult to use ratio for forecasting purposes.

4.5.6.8 **CLASSIFICATION OF RATIOS :-**

Ratio can be classified either on the basis of tradition (statement) or on the basis of their functions.

- Traditional Classification.
- Functional Classification.
Figure No. 4.1: Traditional classification of ratios.

**Traditional classification**

- **Balance sheet ratio**
  1. Current ratio.
  2. Liquid ratio \ Acid test \ Quick ratio.
  3. Absolute liquidity ratio.
  4. Proprietary ratio.
  5. Debt quit ratio.
  6. Capital gain ratio.

- **Profit and loss a/c ratio**
  1. Gross profit ratio.
  2. Net profit ratio.
  3. Operating ratio.
  4. Operating profit ratio.
  5. Expenses ratio.
  6. Interest coverage ratio.

- **Composite / mixed ratio**
  1. Stock turnover ratio.
  2. Debtor turnover ratio.
  3. Creditor turnover ratio.
  4. Fixed asset turnover ratio.
  5. Return on share holders fund.
  6. Return on capital employed.
  7. Capital turnover ratio.
  8. Working capital turnover ratio.
  9. Return on total resources.
  10. Total asset turnover ratio.
Figure No. 4.2: Functional classification of ratios.

**Functional classification**

**Liquidity ratio**
1. Current ratio.
2. Liquid ratio \ Acid test \ Quick ratio.
3. Absolute liquidity ratio.

**Activity ratio**
1. Stock turnover ratio.
2. Debtors turnover ratio.
3. Fixed asset turnover ratio.
4. Total asset turnover ratio.

**Profitability ratio**
1. Gross profit ratio.
2. Net profit ratio.
3. Operating ratio.
4. Operating profit ratio.
5. Expenses ratio.
6. Return on investment.
7. Return on Capital.
8. Return on equity.
9. Earning per shares (EPS).

**Long term solvency & Leverage ratio**
1. Debt equity ratio.
2. Debt to total capital ratio.
3. Interest coverage ratio.
4.5.7 WORKING CAPITAL RATIO :-

- Current ratio.
- Quick ratio.
- Liquidity ratio.
- Cash ratio.
- Interval measure.
- Net working capital ratio.
- Inventory turnover.
- Inventory to working capital ratio.
- Debtors’ turnover ratio.
- Creditors’ turnover ratio.
- Current assets turnover.
- Average collection period.
- Working capital turnover ratio.
- Gross profit margin.
- Net profit margin.
- Operating expense ratio.
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15. Webster’s New Collegiate Dictionary, 8th Ed., Springfield,


17. Foster, op. cit.


