

## **Chapter 1**

### **CONCEPTUAL FRAMEWORK OF FINANCIAL**

### **STATEMENTS ANALYSIS**

- 1.1 MEANING OF FINANCIAL STATEMENTS**
- 1.2 CONCEPTS FO FINANCIAL STATEMENTS**
- 1.3 OBJECTIVES OF FINANCIAL STATEMENTS**
- 1.4 TYPES OF FINANCIAL STATEMENTS**
- 1.5 IMPORTANCEOF FINANCIAL STATEMENTS**
- 1.6 USERS OF FINANCIAL STATEMENTS**
- 1.7 LIMITATIONS OF FINANCIAL STATEMENTS**
- 1.8 CONCEPTS OF FINANCIAL STATEMENTS**
- 1.9 TYPES OF FINANCIAL STATEMENTS**
- 1.10 NEED AND AIMS OF FINANCIAL STATEMENTS**
- 1.11 TOOLS AND TECHNIQUES OF FINANCIAL STATEMENTS**
- 1.12 REFERNENCES**

## **1.1 MEANING OF FINANCIAL STATEMENTS**

Financial Statement generally consists of three basic statements the income statement, the profits and loss account and the Balance sheet. The statement of the earnings and sources and uses of funds statements financial statement taken to gather, give the financial statement, taken to gather, give accounting picture at the first operation and financial position. The package of finance statement includes such schedules as the relating to fixed assets, long term investment long term debts. Accrued liabilities. Cost of goods manufactured, selling expenses and administrative and general expenses. These schedules mainly supplement the information contained in the financial statement and are considered essential for the purpose of analysis. In addition, explanatory notes are also given as an integral part of financial statements when the information given in the financial statement and schedules are inadequate. The inventory valuation and depreciation, description of contingent liabilities etc.

## **1.2 CONCEPTS OF FINANCIAL STATEMENTS**

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 statement showing an organization's financial position and results of its operation. These financial statements are the end results of its operations. 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 procedure"<sup>1</sup>. Therefore, all the statements and accounting reports which the accountants prepare at the end of a period for a business enterprise may be taken as financial statements. But the principal financial statements, But the principal financial statements are the 'balance sheet' and the profit and loss account.

In the word at Howard and Upton” although any formal financial statements expressed in only values meant be thought at as financial statements, The term has come to be limited sheet’ and the ‘ profit and loss statements’ The balance sheet states the assets, liabilities and capital of the business profit and loss statements shows the results of reparations achieved during a certain period These financial statement may be of various types, but according to the financial statement may be broadly classified in the following manner:

1. The audited statement
2. The interim statement
3. The unedited year-end statement
4. The “estimated” statement

Accounting which is the process at evolution has there phases: (1) the recording at transaction in the books at original entry. (2) The classification at these rams action in ledges and (3) the summarization of the records. The construction at the financial statement is a part at the third phase at accounting techniques. Thus, financial statements summarized periodical reports at financial and operating data accumulated by an enterprise in its books at accounts financial statements are periodical statement and the period for which they relate is knows as accounting period, usually at one years’ duration.

### **1.3 OBJECTIVES OF FINANCIAL STATEMENTS**

The accounting principles board of America mentions the objectives of financial statement as follows:

1. To provide reliable financial information about economic resources and obligations at a business enterprise
2. To Provide reliable information about in net resources at on enterprise that results form its activates

3. To provide financial information that assist in estimating the earning potentials at a business.
4. To provide others needed information about changers in economic resources of obligation
5. To disclose, to the extent possible, others information related to the financial statements that is relevant to the needs at the users at these statements.

The above objectives and to suit the needs at the varied users, the accountant entrusted with the task of compiling and presenting financial statements must follow a set at guidelines to ensure consistency, completeness and fairness of the statements. This guideline is called statement. These guidelines use called “generally accepted accounting principles” in absence of these’ generally accepted accounting principles’ The statement prepared may be un-understandable and misleading for the various groups at users.

## 1.4 TYPES OF FINANCIAL STATEMENTS

The time is gone when leaflet or dance card' type of annual report and considered sufficient as a folders in which chairman and accountant' blessed' condensed financial summaries. But in the present the annual reports contain financial statements and the explanation at the various financial results.

These are two major financial statements which are vital to financial analysis and financial management i.e. profit and loss account and balance sheet. These statements contain various information's often needed by various persons intersected in the enterprise such as shareholder, government, debenture holder, management ET. They convey the finical condition and results operation of a enterprise for a given period and of a given data. In the annual report, to gather with these tow statement, these may be statements schedules of retained earnings, stockholders, equity statement or capital surplus fund, cash flow statement etc. Acco9unting is a language of 'finance' or 'monetary' A lay man who reds these statements is not able to understand the terminology uses in these statement.

### A. Balance Sheet:

The balance sheet is a statement at asset and liabilities of a rim or what it own and what it owes, as on a given data. In a bale sheet, the assets and liabilities are equal to each others in the word or pile, white and loosen "A balance sheet is so called because its tow sides must always bale, the sum of the assets shown on the bale sheet must equal liabilities plus owner equality. According to block and first," The balance sheet indicates what the firm owns, and how these assets are financed in the form of liabilities or ownership interest”<sub>2</sub>

The balance sheet is also known attempt of financial condition, 'statement of financial position, stamen of Assets and liabilities,' statement of assets, liabilities and capital,' statement of word and 'financial stamen' it is an instantaneous photograph of assets, liabilities and net girth It is a financial positions of a business of a specified moment of time it represents all assets owned by the business at a particulars moment of the and the claims at the omens and out spiders against those asset at that the financial condition at the business at that time.

## **B. Income Statements.**

The income statement, usually designated as profit and loss accounts for the relevant financial users, shows the net profit as net loss. Resulting from the operations at business during a special field period at time. The items appearing in it use in the nature of 'revenue'.

In the words at Walgenbach, Dietrich and Hanson, "To show the results at operations for a period, an income statement is prepared, which lists the revenues and expenses and presents the resulting net income amount.<sup>3</sup> Foulter defines income statement as' the mathematical interpretation at the policies, experience, knowledge, foresight. And aggressiveness of the management at a business enterprise.<sup>4</sup>

The income statement summarizes the changes that have taken place since the data at preceding bale sheet and that have affected the owner's share in the business either by gain or loss. It is a performance report seconding the changes in income. expenses, profit and loss as a result at business operations during the year between to balance sheet dates.

**3. Management Accountancy S.N.Maheswari – page no – 105**

**4. Management Accountancy S.N.Maheswari – page no - 105**

According to Guthmann, “The balance sheet might be described as financial cross sections taken at certain intervals and earnings statements as condensed history at the growth at decay between the cross sections.”<sup>5</sup>

**C. Statement at Retained Earnings.**

The Statement at retained earnings indicates the magnitude and causes net changes in retained earnings at a enterprise due to year’s activities the defined by walgenbhach and Dietrich “a retained earnings statement is an analysis at the restrained earnings accounts for the accounting period is usually presented with the others corporate financial statement.”<sup>6</sup> The stained earnings shown in the statement at retained earnings are retained by the enterprise primarily to expand business,

**D. Statement at changer in financial position**

The statement at changer in financial position is a logical adjunct to the bale sheet and income statement the according to grant” the statement of changes in financial position is most commonly used to indicate changes during the year in the companies’ working capitol position’. The statement of changer in financial position’ the stamen at changer in financial position indicate both the source and application of working capital. The statement may emphasize any at the following aspect relating to change in financial position at the business.

1. Changes in the firm’s working capital
2. Change in the firm’s cash position.
3. Change in the firm’s total finical position

5. Management Accountancy Sudhir Prakashan – page no – 342

6. Management Accountancy Sudhir prakashan – page no - 343

## 1.5 IMPORTANCE OF FINANCIAL STATEMENTS

The importance and usefulness of financial statements, from the point of view of various interested parties, are as follows

### A. Management:

Financial statements are at much greeted here to management in understanding the progress, position and prospects of business. Using analogy it can be said that financial statements serve the business management as gouger and charter serve the engineer. Financial statement, management can either plan nor fulfill easily the functions of operation and control.

### B. Investors:

Financial statements are also significant for investor both present and prospective the investor look to the financial position of business concern from a different angle. Investors are interested in two things firstly; they can't to invest in such situation where they feel the financial structure of a company is sound. Secondly, they want to invest only in such concern whose future is bright. Investor gives first attention to the profits after taxes in the profit and loss accounts.

### C. Bankers:

A banker is primarily concerned with the ability of paying current debts made the Current operation results he wants not only the payment at advance but he also wants that such advance should be repaid at proper time also.



**D. Government:**

Central and state Governments and local authorities are also interested in published financial statements in order to assess their revenues through various taxes to regulate capital issue and public utility equates.

**E. Trade Creditors:**

From the credited point at view the financial statements act as magic eye highlighting the credit worthiness, i.e., assurance whiter the company will honor obligations as and when thy nature.

**F. Labor unions:**

From Social solstice pint at view in the present time, the labor unions may know id the labor is getting its fair share at business earnings.

**G. Public:**

Financial statements are also valuable to the public who are interested in prospects at a concern, in one why or the other it is the sureties at the enterprise alone that are bought and sold on stock exchanges and the public is interested, mostly in their financial standing.

**H. Research Scholars:**

The financial analysts and research workers are interested in published financial statements for guiding management or for establishing certain principles. And management and offer constructive.

## 1.6 USERS OF FINANCIAL STATEMENTS

Different classes of people are interested in the financial statement analysis with a view to assessing the economic and financial position of any business or industry in terms at profitable liquidity as solvency.

### 1. **Share holders:**

Divorce between ownership and management and broad-based owner at capital due to dispersal at share holding have made share holders take more interest in the financial statement.

### 2. **Debenture holders:**

The debenture holder is interested in the short-term as well as the long-term solvency position at company. They have to get their interned payments periodically and at the end the return at the principle amount.

### 3. **Creditors:**

Potential suppliers at and material and others going business with the company are interested the liquidity position at the company.

### 4. **Important customers:**

Who want to make long standing contact with the company age interested in its financial strength?

### 5. **Employees and Trade unions:**

Are interested in the profitability position at the company

**6. Government Departments:**

Dealing with the industry in which the company is engaged are interested in the financial information relating to the company.

**7. SEBI and Stock Exchange:**

Are interested in the prospects and performance at listed companies with a view to protecting the interests of investors.

**8. Financial institutions and commercial Banks:**

These financial institutions are interested in the solvency-short-term as well as long – term and profitability position at the company.

**1.7 LIMITATIONS OF FINANCIAL STATEMENTS**

The nature at figures which are exported and the any in which they are repotted tend to give the impression to the Spades that financial statements are precise east and final. Financial statements are not from limitations.

1. Balance sheet reveals the facial position at a firm an a particulars day usually at the end at accounting year.
2. Financial statements reflect the seconded facts and figures these are not useful for control purpose.
3. Valuation at inventories, method depreciation, treatment at expend as capital or revenue etc., are based upon personal sidemen.
4. These contain some estimated and such as provision for doubtful debts act.

5. By following money measurements concept ' non- monetary events are not disclosed
6. By following cost concept. Hardest values fixed assets are not shown. Fixed assets are shown at cost less depreciation.
7. The financial statements do not keep pace with changing price levels.
8. Balance sheet shows the deeded expenses such as preliminary expenses. These are not really assets.
- .
9. Many a times, consistency is not followed and hence the profitability is not comparable from years to year. Debt-equity ratio as prescribed by the controller at capital issue is not mentioned in the financial statements.

## **1.8 CONCEPTS OF FINANCIAL STATEMENTS**

Financial Analysis is the analysis of financial statement, viz. Balance sheet and profit and loss account amide at diagnosing the profitability and financial addition business concern satisfactory diagnosis can resell be made in the basis at information which are included financial statements alone because are dumb.

Information contained in balance sheet and profit and loss account often in the form at raw data than as information useful for making. The process of converting the raw data contained in the financial statement analysis.

Profit and loss account is a dynamic statement which shows income expenses between two bale sheets likewise balance sheet is a 'static' statement that shows the financial position on a certain data. Is instantaneous photograph at the and liabilities at an enterprise particular unit at time.

Financial analysis is a process of synthesis and intellectual activity it is a techniques at X- raying the financial position as well as the progress at a company. An analysis at both these statements gives a comprehensive understanding at business operations and their impact at the financial health it the business operations results in profits the toil investments is enhanced bringing prosperity to shareholders, increase in goodwill and strengthening at credit.

## **1.9 TYPES OF FINANCIAL STATEMENTS**

Financial analysis can be classified into different categories depending upon.

- (A) On the basis of material used
- (B) The modus operandi at analysis

### **(A) On the basis of material used**

According to this basis, financial analysis can be at two types.

#### **1. External analysis:**

This analysis is done by those who are outsiders for the business the term outsiders includes investors, credit agencies, government agencies and other creditors who have no access to the internal records at the company. The position of these analysis's for increased governmental control over companies and governmental regulations disclosure of information by the companies at financial statements.

#### **2. Internal analysis:**

This analysis is done by persons that have access to the books of account and other information related to the business. The analysis is done depending upon the objective to be achieved through this analysis.

**(B) On the basis at modus operandi:**

According to, financial analysis can also be at two types.

**(1) Horizontal Analysis:**

In case at this types at analysis, financial statements for a numbers of years, are seriated and analyzed. The current year's figures are compassed with the standard or base year the analysis statement an analysis gives the management considerable insight into levels and areas of strength and weakness.

**(2) Vertical Analysis:**

In case at this type of analysis a study is made at the quantitative relationship at the various items in the finical statements in a particular data such an analysis is useful in comparing the performance at several companies in the same group, or divisions or departments in the same company since this analysis depends on the data for cone period, this is not very conducive to proper analysis at the company's financial position

## **1.10 NEED AND AIMS OF FINANCIAL STATEMENTS**

Analysis at financial statements is an effort to find answers to a variety of practical and important questions such as prospects for future earnings, ability to pay interest, debt maturities-both current as well as long-term and profitability at a sound dividend policy, etc. The main importance at the strengths and weakness at a business enterprise at financial statement i.e., Balance sheet and profit and loss account

### **Need for management:**

- (I) Measuring the success or the failure at the operation as a whole,
- (i) Making sound decisions relating to all the phases of operations.
- (ii) Controlling operations and,
- (iii) Efficiency at departments and process.

### **Need for outside parties:**

- (i) Creditors use analysis as a basis for granting credit.
- (ii) Investors use it to come to a decision at buying, selling or holding shares in a company and
- (iii) Government uses it for purposes at regulations and administration.

### **Aims:**

The Main aims at financial analysis are listed as follows:

- (i) To judge the financial health at the undertaking or management, creditors and bankers.
- (ii) To judge the earnings performance at the company and facility with which dividends can be paid from out of earned profits.



- (iii) In case at institutional interstaters the analysis is carried cover a long period with a view to identifying companies making growth potential and a sound financial base.
- (iv) To judge the ability at the company to away the principal and interest, arrangements for amortization at debt and the security available for the loans extended
- (v) To judge the solvency at the undertaking, the trade creditors are mainly interested in assessing the liquidity positing for which they look into the following.
  - (a) Whether the current assets are sufficient to pay at the current liabilities,
  - (b) The proposition liquid assets to current assets.

To business prospects with reentrance to the future growth and earning.

## **1.11 TOOLS AND TECHNIQUES OF FINANCIAL STATEMENTS**

There are many techniques which may be used for analyzing the financial statements. These techniques may be classified as follows.

### **(A) Accounting Techniques:**

Accounting techniques okra tool which may used for financial analysis are many such as ratio analysis, common size statement analysis, trend analysis, comparative statement analysis, value added analysis etc. The users pick up the techniques to suit their seamier. Meats and also on the basis data available to them. The accounting techniques which are proposed to be used for the analysis of financial statements.

#### **(1) Ratio Analysis:**

The evaluate the financial condition and performance of an enterprise the financial analyst needs certain under sticks cone at such rustics frequently used is a ratio or index, seating two pieces at financial data to each others. Ratios, as a tool at financial management, can be expressed as (a) percentage, (b) fraction, and (c) a stated comparison between numbers

According to batty, “The term “accounting ratios is used to describe significant relationship which exist between figures shown an s island sheet, in a profit and loss account, in a budgetary control, system, or in any other past at the accounting organization”<sup>8</sup>

Financial ratios can be divided into certain categories on the basis at the items which are used for ratios. Four types at financial rations are commonly used

1. Liquidity ratios,
2. Profitability ratios,
3. Activity ratios, and Leverage ratios

**(2) Common-size statement:**

The common-size statements are know as ‘component percentage statements or know as’ component percentage statements or vertical statements. In this technique, the total assets or liabilities and the figure or net sales are taken equal to one hundred and the percentages at individual items are calculated liar wise.

In the common-size income statement, the net sales are assumed to be 100%and other items are expressed, as a percentage at sales. Similarly in the common-size balance sheet the total assets as total liabilities are assumed to be 100% and other items at assets and liabilities are expressed as a percentage at this total

**(3) Comparative statement Analysis:**

Comparison at financial statements for two or more years is another’s techniques used in analyzing data comparative financial statements are statements at financial position at a business so designed as o position at a business so singe as to provide time perspective to the consideration at various elements at financial positing embodied in such statements for this purpose the balance sheet and profit and loss the balance sheet and profit and loss account are prepared in comparative form, comparative statements may be made to show.

- Absolute data ( rupee amount or money values,)
- Increase or decrease in absolute values data in terms at money values, and
- Increase or decrease in absolute data in terms at percentages.

**(1) Trend Analysis:**

Trend analyses , so easy to understand the changes in an items or a group of items over a period of time and to draw conclusion squaring the changes in data for this purpose, a base year is chosen and the amount at that time seating to the base year is taken equal to one hundred and index numbers are to one hundred and index numbers are calculated for other years based on the amounts at that item in those years it is a dynamic method at analysis showing the changes over a period of time for props trend analysis, the trend shod be studied at least over a period at not less tam fovea ears/ This method at analysis indicates the directing in which a concern is gaveling and up9on this basis for future can be made.

**(2) Value added analysis:**

The value added technique to judge the efficiency at an enterprise is at its infancy in India it indicates the net value or wealth created by the manufactures during a specific period. No enterprise can survive as grow, if it fails to generate wealth. An enterprise can survive or grow, it is fails to generate wealth an enterprise may exist without making profit but cannot survive without adding value. The enterprise, not making profit, shall become sill but not adding value may cause its death over a period at time thus the value added is basis and board thus the value added is basic and board measure at judging the performance at an enterprise.

**(3) Funds flow analysis:**

Funds flow analysis has become an important tool in the analytical kit at financial analysis, credit granting institutions and financial managers. This is because the balance sheet at a business reveals its financial status at a particular point at time. However, a financial analyst must know the purpose for which the loan ands utilized and the source from which it was obtained. This will help him in making a better estimate about the company financial position and policies.

Funds flow analysis reveals. The changes in working capital position. Ti about the sources from which the working capital was obtained and the purposes for which it was used. It brings out in open the changes which have taken place behind the balance sheet. Working capital being the life-blood at the business, such an analysis is extremely useful. The technique and the procedure involved in funds flow analysis has been discussed in detail later in the book.

**(4) Cash flow Analysis:**

A cash flow analysis is another important technique at financial analysis it involves preparation at cash flow statement for identifying sources and application at cash flow statement may be prepared on the basis at actual estimated data in the latter case, it is termed as ‘ projected cash flow statement’, which is synonymous with the term ‘cash budget’.

**(B) Statistical Techniques:**

Use at statistical techniques has become a normal phenomenon in any type at analysis. The statistical techniques, which are proposed to be used in financial statement analysis.

(1) **Measures of central tendency:**

The measures at central tendency occupy an important place in the techniques at statistical analysis because many other techniques statistical analysis depend upon this measure.

There are five measures at central tendency (I) arithmetic mean (ii) median (iii) mode (IV) geometric mean (v) harmonic mean,

(2) **Measures of dispersion:**

There are four common measures at dispersion. These are quartile deviation, average deviation standard deviation. The measures at dispersion, which are expressed in terms of the original units of a series, are known as 'absolute measure' relative measures at dispersion are obtained as ratios or percentages known as 'co-efficient' which are pure numbers independent of measurement.

(3) **Correlating and re-assessing Analysis:**

Correlating analysis is a technique used to test the association between two sets of paired data while regression analysis is a technique to test the functional relationships between two sets of paired data. Re-assessing analysis, on the other hand, hypothesizes a particular direction of the relationship with one variable is determined by the others.

(4) **Analysis at time series:**

The time series is an arrangement of statistical data in accordance with the time of its occurrence. The variation at time series is usually broken down into four component elements; secular trend, seasonal, cyclical variation and random or irregular influences.

(5) **Analysis at variance:**

The analysis at variance. One of the most important tools at statistical analysis, has been developed specially to test the hypothesis whether the means at several samples have significant differences or not in the words at Levin, 'analysis at variance is the test for the significance at the difference between more than two sample means'<sup>10</sup>

(6) **Chi-square Test:**

The chi-square test ( $\chi^2$ ) is one of the simplest and most widely used non-parametric test in statistic. According to Sesame D. Braveman "the chi-square distribution is a continuous probability distribution which has the value zero at its lower limit and extraction negative value chi-square is impossible."<sup>11</sup>

(7) **Kraal Wallis one way analysis at variance test:**

According to James V. Bravely "this test in the rank randomization analysis at the observation randomization test" William J. Stevenson states, it is a one way analysis at variance test that employs ranks rather than actual measurements, and its assumptions concerning data use selectively weak"<sup>12</sup>

10. Research Methodology C.R. Kothari page No – 330

11. Statistical Methods for Educational Research page No – 251

12. Statistical Methods for Educational Research page No – 349

**(8) Index Numbers :**

According to croton and crowned' index numbers are devices for measuring differences in magnitude at a group at stated variables"<sup>13</sup> While as per , Morris Homburg ' in its simplest form an index number is nothing more than a relative number, or a ' sedative' which expresses the relationship between two figures, where one of the figures is used as a base"<sup>14</sup>

**(9) Diagrammatic and graphic presentation of data:**

Diagrams and graphs are visual aids, which give a bird's eye view at a given set of numerical data. They present the data in simple secondly comprehensible and intelligible form graphic presentation of statistical data given a pictorial effect to what would otherwise be just a mass of figures diagrams and graphs depict more information than the data shown in the table.

**(10) Mathematical techniques :**

The use of various mathematical techniques is also made frequently for financial analysis. The mathematical tools generally applied are- programmed evaluation and review techniques (PERT), critical path method (CPM), linear programming etc. These techniques could not be applied in present study for want of necessary data.

13. Statistical Methods for Educational Research page No – 36

14. Statistical Methods for Educational Research page No - 36



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