

INTRODUCTION AND RATIO ANALYSIS

30.1 INTRODUCTION

You have learnt about preparation of financial statements in previous lessons. After preparation of the financial statements, one may be interested in knowing the position of an enterprise from different points of view. This can be done by analysing the financial statements with the help of different tools of Analysis such as ratio analysis, funds flow analysis, cash flow analysis, comparative statement analysis, etc. In this process, a meaningful relationship is established between two or more accounting figures for comparison. In this lesson, you will learn about the analysis of financial statements and ratio analysis.

30.2 OBJECTIVES

After studying this lesson, you will be able to:

- recall the meaning of financial statements;
 - explain the meaning and need for analysis of financial statements;
 - identify the parties interested in analysis of financial statements;
 - enumerate the different techniques of analysis;
 - state the meaning of the term "Accounting Ratio";
 - describe the significance of Accounting Ratios.
-

30.3 MEANING AND NEED FOR ANALYSIS OF FINANCIAL STATEMENTS

As you know financial statements are those statements which provide information about the profitability and the financial position of a business. It includes the two statements, i.e., Profit and Loss A/c or Income Statement and Balance Sheet or position Statement.

The Income Statement presents the summary of the income earned and the expenses incurred during a financial year. Position Statement presents the financial position of the business at the end of the year.

Before understanding the meaning of Analysis of Financial Statements, it is necessary to understand the meaning of 'Analysis' and 'Financial Statements'.

Analysis means establishing a meaningful relationship between various items of the two financial statements with each other in such a way that a conclusion is drawn. By Financial Statements, we mean two statements - (i) Profit and Loss A/c or Income Statement, and (ii) Balance Sheet or Position Statement. These are prepared at the end of a given period of time. They are indicators of profitability and financial soundness of the business concern. Thus, analysis of Financial Statements means establishing meaningful relationship between various items of the two financial statements, i.e., income statement and position statement.

Need for Analysis of Financial Statements

Analysis of Financial Statements is an attempt to assess the efficiency and performance of an enterprise. For this purpose, it is necessary to know the-

1. Earning capacity or profitability

The overall objective of a business is to earn a satisfactory return on the funds invested in it. Financial analysis helps in ascertaining whether adequate profits are being earned on the capital invested in the business or not. It also helps in knowing the capacity to pay the interest and dividend.

ii. Comparative position in relation to other-firms

The purpose of financial statements analysis is to help the management to make a comparative study of the profitability of various firms engaged in similar business. Such comparison also helps the management to study the position of their firm in respect of sales expenses, profitability, and using capital, etc.

iii. Efficiency of management

The purpose of financial statement analysis is to know that the financial policies adopted by the management are efficient or not. Analysis also helps the management in preparing budgets by forecasting next year's profit on the basis of past earnings. It also helps the management to find out the shortcomings of the business so that remedial measures can be taken to remove these shortcomings.

iv. Financial strength

The purpose of financial analysis is to assess the financial potential of the business. Analysis also helps in taking decisions:

- a) whether funds required for the purchase of new machinery and equipments are provided from internal resources of the business or not.
- b) how much funds have been raised from external sources.

v. Solvency of the firm

The different tools of analysis tell us whether the firm has sufficient funds to meet its short-term and long-term liabilities or not

Parties interested in Analysis of Financial Statements

Analysis of Financial Statements has become very significant due to widespread interest of various parties in the financial results of a business unit. The various persons interested in the analysis of financial statements are :-

i) Short-term Creditors

They are interested in knowing whether the amounts owing to them will be paid as and when fall due for payment or not.

ii) Long-term Creditors

They are interested in knowing whether the principal amount and the interest thereon will be paid on time or not.

iii) Shareholders

They are interested in profitability, return and capital appreciation.

iv) Management

The management is interested in the financial position and performance of the enterprise as a whole and of its various divisions.

v) Trade Unions

They are interested in financial statements for negotiating the wages or salaries or bonus agreement with the management.

vi) Taxation Authorities

These authorities are interested in financial statements for determining the tax liability.

vii) Researchers

They are interested in the financial statements in undertaking research in business affairs and practices.

viii) Employees

They are interested as it enable them to justify their demands for bonus and increase in remuneration.

You have seen that different parties are interested in the results reported in the financial statements. These results are reported by analysing financial statements through the use of different techniques like Ratio Analysis, Funds Flow Analysis, Cash flow Analysis, etc. Here, we will discuss Ratio Analysis only.

INTEXT QUESTIONS 30.1

- I. Fill in the blanks with suitable word or words:
- Financial Statements are and
 - The Income Statement presents the summary of the earned and the incurred during a financial year.
 - Position Statement presents the position of the business at the end of the year.
- II. Need of Analysis of Financial Statement arises to know -
-
 -
 -
- III. Two columns are given below. Column I lists the group of persons or parties interested in knowing about the business. Column II states the subject of their interest. Match the two columns:

Column I	Column II
(i) Short-term Creditors	(a) Whether the amounts owing to them will be paid as and when due.
(ii) Shareholders	(b) to justify their demand for Bonus.
(iii) Employees	(c) profitability and capital appreciation
(iv) Management	(d) performance of the enterprise as a whole

30.4 MEANING AND SIGNIFICANCE OF RATIO ANALYSIS

Meaning of Accounting Ratio

The ratio is an arithmetical relationship between two numerals. It is expressed as a proportion, or a fraction, or in percentage or in terms

of number of times. For example, expenses are 70% of sales, or sales of current year are 4 times than that of the last year, Net profits are 1/10th (one-tenth) of the capital employed, etc. Thus, accounting ratios are ratios formed out of figures taken from financial statements. These are calculated by placing two figures taken from financial statements in the form of ratio. They are tools in the hands of users and help the management in taking decisions.

Significance of Ratio Analysis

Analysing financial statements from various aspects of a business through the techniques of Accounting Ratios is called **Ratio Analysis**.

Ratio analysis is an important technique of financial analysis. It is a means for judging the financial health of a business enterprise. It determines and interprets the liquidity, solvency, profitability, etc. of a business enterprise. Let us see some uses of Accounting Ratios :

i. Simplification of Accounting Data

It becomes simple to understand various figures in the financial statements through the use of different ratios. For example, a profit of Rs. 20,000/- may not sound very impressive but if it is earned with the help of a capital of Rs.20,000/- it becomes easy to say that the profit is reasonably good by stating that it is 100% of the capital. Accounting ratios simplify, summarise, and systematise the accounting figures presented in financial statements.

ii. Helpful in comparative study

With the help of ratio analysis, comparison of profitability and financial soundness can be made between one firm and another in the same industry. Similarly, comparison of current year figures can also be made with those of previous years with the help of ratio analysis and if some weak points are located, remedial measures are taken to correct them.

iii. Focus on trends

If accounting ratios are calculated for a number of years, they

will reveal the trend of costs, sales, profits and other important facts. Such trends are useful for planning. For example, if sales of a firm during this year are Rs.10 lakhs and average amount of stock kept during the year is Rs.3 lakh i.e., 30% of sales and the firm wishes to increase sales next year to Rs.15 lakh, it must be ready to keep a stock of Rs. 4.5 lakh, i.e., 30% of 15 lakhs.

iv. Setting Standards

Accounting ratios, based on a desired level of activities, can be set as standards for judging actual performance of a business. For example, if owners of a business aim at earning profit @ 25% on the capital which is the prevailing rate of return in the industry then this rate of 25% becomes the standard. The rate of profit of each year is compared with this standard and the actual performance of the business can be judged easily.

v. Study of financial soundness

Ratio analysis discloses the position of business with different viewpoints. It discloses the position of business with the liquidity viewpoint, solvency viewpoint, profitability viewpoint, etc. With the help of such a study, we can draw conclusions regarding the financial health of the business enterprise.

INTEXT QUESTIONS 30.2

A. Fill in the blanks with suitable word or words :

1. The relationship between two numerical figures expressed in arithmetical terms is called
 2. The relationship between two numerical figures when taken from the financial statements is called
 3. Ratios may be expressed in (i), (ii), (iii), and (iv)
 4. Analysing Financial Statements from various aspects of a business through the techniques of Accounting Ratios is called
-

- B. Give any four points which tell us that Ratio analysis is important:
- i)
 - ii)
 - iii)
 - iv)
-

30.5 WHAT YOU HAVE LEARNT

1. Analysis of Financial Statements means establishing meaningful relationship between various items of the two financial statements, i.e., income statement and position statement.
 2. Need of Analysis of financial statements is :
 - i) To know the earning capacity or profitability;
 - ii) To make comparative study with other firms;
 - iii) To know the efficiency of management;
 - iv) To know the financial strength of the business;
 - v) To know the solvency;
 3. Parties interested in Analysis of financial statements are -
 - i) Short-term Creditors, ii) Long-term Creditors,
 - iii) Shareholders, iv) Management,
 - v) Trade Unions, vi) Taxation Authorities,
 - vii) Govt. Agencies, viii) Researchers,
 - ix) Employees.
 4. Meaning of arithmetical Ratio - Relationship between two numerical figures expressed in arithmetical terms.
 5. Meaning of Accounting Ratios - Accounting ratios are ratios formed out of the figures taken from financial statements. These
-

can be expressed in any one of the following forms :

- (i) percentage, e.g., 25%
 - (ii) in fractions, e.g., $1/3$
 - (iii) in proportion e.g., 3:4
 - (iv) in number of times e.g., 5 times.
6. **Meaning of Ratio Analysis** - Analysing the financial statements from various aspects of a business through the technique of Accounting ratios.
7. **Significance of Accounting Ratios** - (i) simplification of accounting data, (ii) helpful in comparative study, (iii) focus on trends, (iv) sets standards, (v) study the financial soundness.

30.6 TERMINAL QUESTIONS

- 1. Give the meaning and need for 'Analysis of Financial Statements'.
- 2. Explain, in brief, the parties interested in analysis of financial statements'.
- 3. What is meant by Accounting Ratio? Describe the significance of Accounting Ratios'
- 4. Imagine Yourself to be a shareholder and state how will the Ratio Analysis be useful for you ?

30.7 ANSWERS TO INTEXT QUESTIONS

30.1

- I. (a) Income statement or Profit & Loss A/C, position statement or balance Sheet
 - (b) Income , expenses
 - (c) financial
 - II. (a) earning capacity or profitability,
 - (b) efficiency of management,
-

- (c) the solvency of business,
- (d) comparative study with other firms.

(Any three from above)

- III: (i) - (a) (ii) - (c)
(iii) - (b) (iv) - (d)

30.2

- A. 1. ratio
2. accounting ratio
3. (i) percentages, (ii) fraction, (iii) proportion, and (iv) number of times.
4. Ratio Analysis.
- B. (i) Simplification of accounting data,
(ii) Helpful in comparative study,
(iii) Focus on trends,
(iv) Sets standards,
(v) Study the financial soundness.

(Any four from above)