

## LESSON-31 FINANCIAL STATEMENTS ANALYSIS-AN INTRODUCTION

### SUMMARY

The Trading and Profit & Loss Account is known as Statement of Profit and Loss. After preparation of the financial statements, one may be interested in analysing the financial statements with the help of different tools such as comparative statement, common size statement, ratio analysis, trend analysis, fund flow analysis, cash flow analysis, etc. In this process a meaningful relationship is established between two or more accounting figures for comparison.

### FINANCIAL STATEMENT OF A COMPANY

The way in which the various items of Statement of Profit and Loss and the Balance Sheet should be presented is given in schedule VI part I of the Companies Act 1956. Balance Sheet as prescribed in schedule VI part I of the Companies Act 1956 is broadly divided into two parts:

(I) Equity and Liabilities and (II) Assets

### 1. EQUITY AND LIABILITIES

**Equity:** It is the liability of the

company towards its shareholders and is called as 'Shareholders' Funds'. It includes Share Capital, Reserves & Surplus and Money Received Against Share Warrants.

**Liabilities:** It means external liabilities of the company or liabilities towards outsiders. In between Shareholders' Fund and Liabilities, Application Money Pending Allotment is placed as per the prescribed form of the Balance Sheet. Liabilities have further been divided into (a) Non-current Liabilities and (b) Current Liabilities.

Non-current Liabilities have been defined as liabilities which are not current liabilities. Current liability is that liability which is :

- i. expected to be settled in the company's normal operating cycle; or
- ii. due to be settled within 12 months after the reporting date *i.e.*, Balance Sheet date; or
- iii. held primarily for the purpose of being traded; or
- iv. there is no unconditional right to defer settlement for at least 12 months after the reporting date.

The various items that are presented under the various heads of liabilities are given below :

#### (a) Long-term Borrowings

- (i) Debentures;
- (ii) Bonds;
- (iii) Term Loans;

- (iv) Public Deposits and
- (v) Other loans and advances

(b) Current Liabilities :

- (i) Short-term borrowings;
- (ii) Trade Payables;
- (iii) Other Current Liabilities and
- (iv) Short-term Provision.

- (a) Fixed Assets;
- (b) Non-Current Investments;
- (c) Deferred Tax Assets;
- (d) Long-term Loans and Advances and
- (e) Other non-current assets.

## II. ASSETS

Like liabilities, assets are also divided into 'non-current assets' and 'current assets'. Non-current assets have been defined as assets that are not current. Current assets have been defined in Schedule VI of the Companies Act, 1956 as follows :

Current Assets are those assets which are :

- (I) expected to be realized in or intend for sale or consumption in the company's normal operating cycle; or
- (II) held primarily for the purpose of trading; or
- (III) expected to be realized within 12 months from reporting date *i.e.*, Balance Sheet date; or
- (IV) Cash and Cash equivalents unless they are restricted from being exchanged or used to settle a liability for at least 12 months after reporting date *i.e.*, Balance Sheet date.

Non-Current Assets are classified into the following five major heading as given below:

## FINANCIAL STATEMENTS ANALYSIS (MEANING, PURPOSE AND PARTIES INTERESTED)

In order to ascertain the financial status of the business every enterprise prepares certain statements, known as financial statements. Financial statements are mainly prepared for decision making purposes. Financial analysis serves the following purposes :

- **Measuring the Profitability**
- **Indicating the Trend of Achievements**
- **Assessing the Growth Potential of the Business**
- **Assess overall financial strength**
- **Assess solvency of the firm**

## TECHNIQUES AND TOOLS OF FINANCIAL STATEMENT ANALYSIS

Techniques of analysis of financial statements are mainly classified into three categories :

- **Cross-sectional Analysis**
- **Time Series Analysis**
- **Cross-sectional cum Time Series Analysis**

**COMMON SIZE STATEMENT  
AND TREND ANALYSIS**

The common size statements (Balance Sheet and Income Statement) are shown in analytical percentages. The figures of these statements are shown as percentages of total assets, total liabilities and total sales respectively.

**Common Size Balance Sheet**

The common size statement may be prepared in the following way.

- The total assets or liabilities are taken as 100
- The individual assets are expressed as a percentage of total assets i.e. 100 and different liabilities are calculated in relation to total liabilities.