

1. Financial Statements of a Company

Financial statements (Income Statement and Balance Sheet) are summarised reports providing the operating results and financial position of a company.

Prescribed Form and Major Headings

A company's Balance Sheet is structured to show financial health at a specific point in time. The major headings as per the Companies Act, 2013 include:

I. Equity and Liabilities:

- **Shareholders' Funds:** Includes Share Capital and Reserves and Surplus.
- **Non-Current Liabilities:** Includes Long-term borrowings (like debentures) and Long-term provisions.
- **Current Liabilities:** Includes Short-term borrowings, Trade payables, and Short-term provisions.

II. Assets:

- **Non-Current Assets:** Includes Fixed assets (Tangible and Intangible assets like Goodwill), Non-current investments, and Long-term loans.
- **Current Assets:** Includes Current investments, Inventories, Trade receivables, and Cash and cash equivalents.

2. Financial Analysis: Meaning and Context

Meaning: It is the critical evaluation of financial statements to gain insight into profitability, operational efficiency, and financial health. It involves both **Analysis** (methodical classification of data) and **Interpretation** (explaining the significance of that data).

Significance and Purpose

- **Finance Managers:** Use analysis to study accounting data for operating policies, investment value, and credit ratings.

- **Top Management:** Measures success of operations and appraises individual performance.
- **Trade Payables:** Judge the firm's ability to meet short-term obligations (liquidity).
- **Lenders/Investors:** Assess long-term solvency, profitability, and future prospects.

Limitations of Financial Analysis

1. **Ignores Price-level Changes:** Analysis is based on historical costs and stable money measurement, ignoring inflation.
2. **Monetary Only:** Only quantitative information is considered; qualitative aspects (like management skill) are ignored.
3. **Accounting Practices:** Variations in accounting policies (like inventory valuation or depreciation) can make inter-firm comparisons misleading.
4. **Historical Nature:** Analysis is based on past records, which may not accurately predict future trends.

3. Tools for Financial Analysis

Comparative Statements (Horizontal Analysis)

These statements show profitability and financial position for different periods in a side-by-side format.

- **Method:** Lists absolute figures for two years, finds the absolute change (Increase/Decrease), and calculates the percentage change: $\frac{\text{First Year Figure} - \text{Absolute Change}}{\text{First Year Figure}} \times 100$.
- **Significance:** Identifies direction of changes and performance trends.

Common Size Statements (Vertical Analysis)

These express each item as a percentage of a common base, bringing figures to a common denominator for easier comparison.

- **Balance Sheet Base:** Total Assets or Total Liabilities (100%).
- **Statement of Profit and Loss Base:** Revenue from Operations (100%).



4. Accounting Ratios

Accounting ratios represent the mathematical relationship between two correlated accounting numbers. They serve as a "whistle blower" for problem areas.

I. Liquidity Ratios (Short-term Solvency)

- **Current Ratio:** Measures ability to meet current obligations. Ideal ratio is 2:1.
 - Formula = $\frac{\text{Current Liabilities}}{\text{Current Assets}}$
- **Quick/Liquid Ratio (Acid-Test):** A stricter measure of liquidity, excluding inventory and prepaid expenses. Ideal ratio is 1:1.
 - Formula = $\frac{\text{Current Liabilities}}{\text{Quick Assets}}$

II. Solvency Ratios (Long-term Solvency)

- **Debt-Equity Ratio:** Measures the relationship between long-term debt and shareholders' funds. Safe level is generally 2:1.
 - Formula = $\frac{\text{Shareholders' Funds}}{\text{Long-term Debt}}$
- **Interest Coverage Ratio:** Measures the safety margin for interest payments.
 - Formula = $\frac{\text{Interest on Long-term Debts}}{\text{Net Profit before Interest and Tax}}$

III. Activity/Turnover Ratios (Efficiency Ratios)

These measure the speed and effectiveness with which resources are utilised.

- **Inventory Turnover Ratio:** Frequency of inventory conversion into revenue.
 - Formula = $\frac{\text{Average Inventory Cost of Revenue from Operations}}{\text{Revenue from Operations}}$
- **Trade Receivables Turnover Ratio:** Speed of cash collection from debtors.
 - Formula = $\frac{\text{Average Trade Receivables}}{\text{Net Credit Revenue from Operations}}$

IV. Profitability Ratios

- **Gross Profit Ratio:** $\frac{\text{Net Revenue from Operations}}{\text{Gross Profit}} \times 100$.
- **Net Profit Ratio:** $\frac{\text{Revenue from Operations}}{\text{Net Profit after Tax}} \times 100$.
- **Return on Investment (ROI):** $\frac{\text{Capital Employed}}{\text{Profit before Interest and Tax}} \times 100$.

5. Cash Flow Statement

Meaning: A summary of actual cash movement (inflows and outflows) into and out of an organisation during an accounting period.

Objectives and Preparation

- Summarises causes for changes in cash position between two balance sheet dates.
- Involves three categories: **Operating**, **Investing**, and **Financing** activities [General

Knowledge, implied by tools like ratio analysis of solvency and liquidity 219].



Adjustments in Preparation

When preparing the statement, non-cash and non-operating items must be adjusted:

- **Depreciation and Amortisation:** Added back to net profit as they are non-cash expenses [General standard mentioned in prompt context].
- **Dividends and Taxes:** Final dividends are treated as financing outflows; taxes paid are deducted from operating activities [General standard].
- **Profit/Loss on Sale of Non-Current Assets:** Profit is deducted, and loss is added back to net profit to arrive at operating cash flow; the actual proceeds are recorded under investing activities [General standard].