TECHNIQUES OF ANALYSIS OF FINANCIAL STATEMENTS

A **Financial Statement** is an organized collection of data according to logical and consistent accounting procedures. Its purpose is to convey an understanding of some financial aspects of a business firm. It may show assets position at a moment of time as in the case of balance sheet, or may reveal a series of activities over a given period of times, as in the case of an income statement.

Financial Analysis is defined as being the process of identifying financial strength and weakness of a business by establishing relationship between the elements of balance sheet and income statement. The information pertaining to the financial statements is of great importance through which interpretation and analysis is made.

The income statement, having been termed as profit and loss account is the most useful financial statement to enlighten what has happened to the business between the specified time intervals while showing, revenues, expenses gains and losses**.**

Balance sheet is a statement which shows the financial position of a business at certain point of time. The distinction between income statement and the balance sheet is that the former is for a period and the latter indicates the financial position on a particular date.

The various tools and techniques available for financial statement are mentioned below -

1. **Comparative Financial Statement Analysis (Horizontal Analysis**):-
   As the name suggests, comparative analysis provides a year-on-year review of the various financial statements. For example, in the Income Statement, the Sales figure may be compared over a period of consecutive years to understand how the sales

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figures have grown (or declined) over the year. It should be noted that horizontal analysis compares the internal performance of the company.
Horizontal analysis is also regarded as Dynamic Analysis**.**

2. **Common-size Financial Statement Analysis (Vertical Analysis):-**
   Vertical analysis is applicable for internal performance review as well as for comparison to peers and bench-marking. In vertical analysis all the items in a particular statement are represented as a percentage of a particular item.
   It is also called as static analysis**.**

3. **Ratio Analysis**: Ratio analysis is the most widely used tool of financial statement analysis. A ratio gives relationship between two numbers, in this case items in the financial statements. Ratios are popular because they readily allow internal evaluation as well as comparison across firms. The ratios are categorized according to activities or functions they perform or the information they provide. For example, profitability ratios measure the profit making capability of the company.

4. **Graphical Analysis**: Graphs provide visual representation of the performance that can be easily compared over time. The graphs may be line graphs, column graphs or pie charts.

5. **Trend Analysis**: Trend analysis is used to reveal the trend of items with the passage of time and is generally used as a statistical tool. Trend analysis is used in conjunction with ratio analysis, horizontal and vertical analysis to spot a particular trend, explore the causes of the same and if required prepare future projections.

6. **Regression Analysis:** Regression analysis is a statistical tool used to establish and estimate relationship among variables.

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Generally, the dependent variable is related to one or more independent variables. In case of financial statement analysis, the dependent variable may be, say, sales, and it is required to estimate its relationship with the independent variable, say, a macroeconomic factor like Gross Domestic Product.

The various tools and techniques are there to enable the decision making. Different companies may have different accounting methods and hence, comparison with peers has to be done carefully. Moreover, a holistic use of various techniques should be done to arrive at any conclusion.

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WORKING CAPITAL

Meaning of Working Capital

Every business needs funds for two purposes for its establishment and to carry out its day-to-day operations. Capital required for a business can be classified under two main categories viz.

(i) Fixed capital

(ii) Working capital.

Long-term funds are required to create production facilities through purchase of fixed assets such as plant and machinery, land, Building etc. Investments in these assets represent that part of firm's capital which is blocked on permanent basis and is called fixed capital.

Funds are also needed for short-term purposes for purchase of raw materials, payment of wages and other day-to-day expenses etc. These funds are known as working capital which is also known as Revolving or circulating capital or short term capital. According to Shubin, "Working capital is amount of funds necessary to cover the cost of operating the enterprise".

Working Capital = Current Assets – Current Liabilities

When current assets exceed the current liabilities the working capital is positive and negative working capital results when current liabilities are more than current assets. Examples of current liabilities are Bills Payable, Sunday debtors, accrued expenses, Bank Overdraft, Provision for taxation etc. Net working capital is an accounting concept of working capital.

CONSTITUENTS OF CURRENT ASSETS

1) Cash in hand and cash at bank
2) Bills receivables
3) Sundry debtors

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4) Short term loans and advances.

5) Inventories of stock as:

a. Raw material

b. Work in process

c. Stores and spares

d. Finished goods

6. Temporary investment of surplus funds.

7. Prepaid expenses

8. Accrued incomes.

9. Marketable securities.

CONSTITUENTS OF CURRENT LIABILITIES

1. Accrued or outstanding expenses.
2. Short term loans, advances and deposits.
3. Dividends payable.
4. Bank overdraft.
5. Provision for taxation , if it does not amt. to app. Of profit.
6. Bills payable.
7. Sundry creditors.

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The Need or Objects or Working Capital

The need for working capital arises due to time gap between production and realisation of cash from sales. There is an operating cycle involved in sales and realisation of cash. There are time gaps in purchase of raw materials and production, production and sales, and sales and realisation of cash. Thus, working capital is needed for following purposes.

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