***B.COM 4th SEMESTER (NON-CBCS)***

***COST AND MANAGEMENT ACCOUNTING (MANAGEMENT MAJOR)***

***PAPER - 405***

***GROUP- A: COST ACCOUNTING***

***UNIT –V***

***ANALYSIS AND INTERPRETATION OF FINANCIAL STATEMENT***

**Q1. What are financial statements?**

***Answer*** - Financial Statement is a summarized statement of financial data relating to a business unit. Such financial data are organized systematically, presented logically in the statement in order to convey some financial aspects of a business firm. It may show the financial position at a point of time like Balance Sheet or may reveal a series of activities over a period of time as in the case of income statement.

In the words of John N. Myer, “The financial statements provide a summary of the accounts of a business enterprise, the balance sheet reflecting the assets, liabilities and capital as on a certain date and the income statement showing the results of operations during a certain period.” Financial statements are prepared as an end result of financial accounting and are the major sources of financial information of an enterprise.

According to GAAP, financial statements include the following:

* A Balance Sheet;
* An Income Statement;
* A statement of changes in Owner’s Accounts;(Retained earnings) and
* A statement of changes in Financial Position i.e. Fund Flow and Cash Flow Statements.

**Q2. Explain the nature of financial statements.**

***Answer*** - The following points explain the nature of financial statements

**1. Recorded Facts** - ‘Recorded facts’ are those facts which have been recorded in financial books. The records are maintained on the basis of actual cost data. The original cost or historical cost is the basis of recording various transactions. The figures of various accounts such as cash in hand, cash in bank, bills receivables, sundry debtors, fixed assets etc. are taken as per the figures recorded in the accounting books. The assets purchased at different times and at different prices are put together and shown at cost prices. As recorded facts are not based on replacement costs, the financial statements do not show current financial condition of the concern.

**2. Accounting Conventions -** Certain accounting conventions are followed while preparing financial statements. The convention of valuing inventory at cost or market price, whichever is lower, is followed. The valuing of assets at cost less depreciation principle for balance sheet purposes is followed.

The convention of materiality is followed in dealing with small items like pencils, pens, postage stamps, etc. These items are treated as expenditure in the year in which they are purchased even though they are assets in nature. The stationery is valued at cost and not on the principle of cost or market price whichever is less. The use of accounting conventions makes financial statements comparable, simple and realistic.

**3. Postulates -** The accountant makes certain assumptions while making accounting records. One of these assumptions is that the enterprise is treated as a going concern. The other alternative to this postulate is that the concern is to be liquidated, this, is untenable if management shows an intention to liquidate the concern. So the assets are shown on a going concern basis. Another important assumption is to presume that the value of money will remain the same in different periods.

Though there is a drastic change in purchasing power of money the assets purchased at different times will be shown at the amount paid for them. While preparing profit and loss account, the revenue is treated in the year in which the sale was undertaken even though the sale price may be received in a number of years. The assumption is known as realization postulate.

**4. Personal Judgments -** Even though certain standard accounting conventions are followed in preparing financial statements but still personal judgment of the accountant plays an important part. For example, in applying the cost or market value whichever is less to inventory valuation the accountant will have to use his judgment in computing the cost in a particular case. There are a number of methods for valuing stock, viz.; last in first out, first in first out, average cost method, standard cost, base stock method, etc.

The accountant will use one of these methods for valuing materials. The selection of depreciation method, to use one of the several methods for estimating uncollectible debts, to determine the period for writing off intangible assets are some of the examples where judgment of the accountant will play an important role in choosing the most appropriate course of action.

**Q3. What are the objectives of financial statements?**

***Answer*** - Financial statements are the sources of information on the basis of which conclusions are drawn about the profitability and financial position of a concern. They are the major means employed by firms to present their financial situation of owners, creditors and the general public. The primary objective of financial statements is to assist in decision making.

**The Accounting Principles Board of America (APB) states the following objectives of financial statements:**

(i) To provide reliable financial information about economic resources and obligations of a business firm.

(ii) To provide other needed information about changes in such economic resources and obligations.

(iii) To provide reliable information about changes in net resources (resources less obligations) arising out of business activities.

(iv) To provide financial information that assists in estimating the earning potentials of business.

(v) To disclose, to the extent possible, other information related to the financial statements that is relevant to the needs of the users of these statements.

**Q4. Explain the advantages and limitations of Financial Statements.**

***Answer***- Though financial statements relevant and useful for the concern, still they do not present a final picture of the concern. The utility of these statements is dependent upon a number of factors. T he analysis and interpretation of these statements should be done very carefully otherwise misleading conclusion may be drawn. The financial statements suffer from the following limitations –

1. **Only Interim Reports:** These statements do not give a final picture of the concern. The data given in these statements is only approximate. The actual position can only be determined when the business is sold or liquidated.
2. **Do not give Exact Position:** The financial statements are expressed in monetary values, so they appear to give final and accurate position. The value of fixed assets in the balance sheet neither represent the value for which fixed assets can be sold nor the amount which will be required to replace these assets. The balance sheet is prepared on the presumption of a going concern. The concern is expected to continue in the future. So, fixed assets are shown at cost less accumulated depreciation.
3. **Historical Costs:** The financial statements are prepared on the basis of historical costs or original costs. The value of assets decreases with the passage of time current price changes are not taken into account. The statements are not prepared keeping in view the present economic conditions. Similarly, the profitability shown by the income statements may not represent the earning capacity of the concern. The increase in profits may be due to an increase in prices or due to some abnormal causes and not due to increase in efficiency.
4. **Impact of Non-monetary Factors Ignored:** There are certain factors which have a bearing on the financial position and operating results of the business but they do not become a part of these statements because they cannot be measured in monetary terms. Such factors may include the reputation of themanagement, credit worthiness of the concern, sources and commitments for purchases and sales, co-operation of the employees, etc. The financial statements only show the position of the financial accounting for business and not the financial position.
5. **No Precision:** The precision of financial statement data are not possible because the statements deal with matters which cannot be precisely stated. The data are recorded by conventional procedures followed over the years. Various conventions, postulates, personal judgments etc. are used for developing the data.

**Q5. What is meant by Financial Statement Analysis?**

***Answer***-The term ‘financial statement analysis’ includes both ‘analysis’, and ‘interpretation’. While the term ‘analysis’ is used to mean the simplification of financial data by methodical classification of the data given in the financial statements, ‘interpretation’ means, ‘explaining the meaning and significance of the data so simplified.’

Thus Analysis of Financial Statements means the process of critical evaluation of the financial information contained in financial statements. The purpose of such evaluation is to understand its significance and make decision regarding operating of the business.

It is basically a study of relationship among various financial facts and figures contained in the financial statements and the interpretation of the relationship to ascertain profitability and efficiency of the firm. It shows the weak and strong points of the enterprise which enable us to judge the general financial health of the business.

**Q6. State the significance or importance of Financial Statement Analysis.**

***Answer***-The primary objective of financial statement analysis is to understand and diagnose the information contained in financial statement with a view to judge the profitability and financial soundness of the firm, and to make forecast about future prospects of the firm. The purpose of analysis depends upon the person interested in such analysis and his object. However, the following purposes or objectives of financial statements analysis may be stated to bring out the significance of such analysis:

* To assess the earning capacity or profitability of the firm.
* To assess the operational efficiency and managerial effectiveness.
* To assess the short term as well as long term solvency position of the firm.
* To identify the reasons for change in profitability and financial position of the firm.
* To make inter-firm comparison.
* To make forecasts about future prospects of the firm.
* To assess the progress of the firm over a period of time.
* To help in decision making and control.
* To guide or determine the dividend action.
* To provide important information for granting credit.

**Q7. What are the objectives of Financial Statement Analysis?**

***Answer***- Objectives of financial analysis are related to solvency, profitability and efficiency of the business. The objectives of financial analysis are given below:

* To ascertain the strong areas and weak areas of the business.
* To assess the current profitability and efficiency of the business.
* To ascertain the relative importance of different components of the financial statements of the firm.
* To identify the causes for changes in the profitability and financial position.
* To judge the long term solvency of the business.
* To help the management for self-appraisal of the business.

**Q8. What are the limitations of Financial Statement Analysis?**

***Answer***- Following are the limitation of financial Statement analysis-

1. **It is prepared on Constant Price Level:** Financial statements are prepared on constant prices and ignores the price level changes. So the comparison between two or more periods will give misleading information because of changes in price level.
2. **Change in Accounting Policies**: If the accounting policies are changed from year then results of the periods become uncomparable and the purpose of analysis fails in this respect.
3. **Non-consideration of qualitative information:** Financial Statements contain monetary information only and ignores qualitative aspects. So the financial statement analysis does not give a true picture of the enterprise.
4. **Going Concern Principle**: Financial statement are prepared on Going Concern Principle and does not consider the market value or realizable values of the assets Consequently the financial statement analysis does not shoe the real current financial position of the enterprise.
5. **Inherent limitation of financial statements**: Financial statements are prepared on the basis of certain concepts, conventions and assumptions which permit, personal biasness of the accountant. This limitation adversely affects the analysis and gives a misleading result of analysis.
6. **Not much helpful in business forecasting**: Final Statements are historical in nature; therefore, analysis of such statements does not become much helpful in business forecasting as business environment changes constantly.
7. **Window dressing**: If the financial statements are prepared with window dressing objective, the analysis of them gives misleading results.

**Q9. Discuss about the different techniques/tools of Financial Statement Analysis?**

***Answer***- There are number of methods/tools/techniques for analyzing financial statements but no single tools is self sufficient for decision making purpose. So generally a combination of techniques is used in financial analysis. Following are the different methods/tools/techniques generally used-

### Comparative Statements - Comparative statements deal with the comparison of different items of the Profit and Loss Account and Balance Sheets of two or more periods. Separate comparative statements are prepared for Profit and Loss Account as Comparative Income Statement and for Balance Sheets.

### As a rule, any financial statement can be presented in the form of comparative statement such as comparative balance sheet, comparative profit and loss account, comparative cost of production statement, comparative statement of working capital and the like.

### Comparative Income Statement - Three important information are obtained from the Comparative Income Statement. They are Gross Profit, Operating Profit and Net Profit. The changes or the improvement in the profitability of the business concern are found out over a period of time. If the changes or improvement is not satisfactory, the management can find out the reasons for it and some corrective action can be taken.

### Common Size Statements - A vertical presentation of financial information is followed for preparing common-size statements. Besides, the rupee values of financial statement contents are not taken into consideration. But, only percentage is considered for preparing common size statement.

### The total assets or total liabilities or sales are taken as 100 and the balance items are compared to the total assets, total liabilities or sales in terms of percentage. Thus, a common size statement shows the relation of each component to the whole. Separate common size statement is prepared for profit and loss account as Common Size Income Statement and for balance sheet as Common Size Balance Sheet.

### Trend Analysis – Trend analysis means forecasting of future possibilities in respect of profitability, solvency and growth. In this case, financial statements of several years are considered. A base year is selected which is a normal year. Each item in the statements is compared with the same item of the base year. Base year item is considered as 100 and the same item appearing in the financial statements in different years will be expressed in percentage of the base year. It will show the growth or decline in comparison to the base year. The changes in percentages value of the items will give a trend which will show an upward or downward trend and an opinion can be formed on the basis of such trends.

### Statement of Changes in Working Capital - The extent of increase or decrease of working capital is identified by preparing the statement of changes in working capital. The amount of net working capital is calculated by subtracting the sum of current liabilities from the sum of current assets. It does not detail the reasons for changes in working capital.

### Fund Flow Analysis - Fund flow analysis deals with detailed sources and application of funds of the business concern for a specific period. It indicates where funds come from and how they are used during the period under review. It highlights the changes in the financial structure of the company.

1. **Cash Flow Analysis** - Cash flow analysis is based on the movement of cash and bank balances. In other words, the movement of cash instead of movement of working capital would be considered in the cash flow analysis. There are two types of cash flows. They are actual cash flows and notional cash flows.
2. **Ratio Analysis** - Ratio analysis is an attempt of developing meaningful relationship between individual items (or group of items) in the balance sheet or profit and loss account. Ratio analysis is not only useful to internal parties of business concern but also useful to external parties. Ratio analysis highlights the liquidity, solvency, profitability and capital gearing.
3. **Cost Volume Profit Analysis** - This analysis discloses the prevailing relationship among sales, cost and profit. The cost is divided into two. They are fixed cost and variable cost. There is a constant relationship between sales and variable cost. Cost analysis enables the management for better profit planning.

**Q10. State the meaning of Ratio Analysis.**

***Answer***- Ratio Analysis is a technique of analysis and interpretation of financial statements. It is process of identifying the strengths and weaknesses of a firm by properly establishing the relationship between the items of the Balance sheet and Profit and Loss Account. It is undertaken by the management of a firm or by parties outside the firm, viz; creditors, owners, investors and others. The nature of such analysis will differ depending on the purpose of the analysis. Mere calculation of ratios does not serve any purpose unless they are analyzed and interpreted keeping in mind the objective of the analysis.

Thus ratios give quantitative relationship and analysis is done to make a qualitative judgement out of that quantitative relationship. For example – A firm has Rs 1,50,000 as current assets and Rs 50,000 as current liabilities. The ratio between them is 3:1 or 3. It indicates a quantitative relationship between current assets and current liabilities.

**Q11. Explain the advantages of Ratio Analysis.**

***Answer***- The advantages of Ratio Analysis are-

**1) Helps in understanding the efficacy of decisions**: The ratio analysis helps the management and other interested persons in understanding whether the management has taken right decisions in respect of operating investing and financial activities. It indicates improvement or otherwise in the performance of the business.

**2) Helpful in comparative analysis:** When ratios are calculated for a number of years and are set side by side, they show distinct trend and help in making future projections about the business.

**3) Simplifies complex figures and establishes relationship**: Ratios simplify complex accounting figures, bring about their relationship summarized financial information effectively. It shows managerial efficiency, credit worthiness and earning capacity of the business.

**4) Identifies problem areas**: Ratios help the business in indentifying the problem areas as well as the bright areas of the business. Problem areas need more managerial attention while bright areas need more encouragement to do better results.

**5) Enables strength – weakness opportunity threat analysis:** Ratios help in explaining the changes occurring in the business. The analysis of such changes helps the management in understanding current threats and opportunities.

**6) Helping comparative assessment:** Ratios help the users in understanding the betterment or otherwise of the performances of the business in respect of profitability, solvency and liquidity when the ratios are compared with bench marks (standard ratios).

**7) Help in controlling business affairs**: Ratios are used as a tool of control of the affairs of the business by using variances.

**Q12.** **Explain the limitations of Ratio Analysis.**

***Answer***-The ratio analysis is one of the most powerful tools of financial management. Though ratios are simple to calculate and easy to understand, they suffer from some serious limitations-

1. **Limited Use of a Single Ratio:** A simple ratio, usually, does not convey much of sense. To make a better interpretation a number of ration have to be calculate which is likely to confuse the analyst that help him in making any meaning conclusion.
2. **Inherent Limitation of Accounting:** Like financial statements, ratios also suffer from the inherent weakness of accounting records such as their historical nature. Ratios of the past are not necessarily true indicators of the future.
3. **Change of Accounting Procedure:** Change in accounting procedure by firm often makes ratio analysis misleading, e.g., a change in the valuation of inventories, from FIFO to LIFO increases the cost of sales and reduces considerably the value of closing stocks which makes stock turnover ratio to be lucrative and an unfavourable gross profit ratio.
4. **Window Dressing:** Financial statements can easily be window dressed to present a better picture of its financial and profitability position to outsiders. Hence, one has to be very careful in making a decision from ratio calculated from such financial statements. But it may be very difficult for an outsider to know about the window dressing made by a firm.
5. **Personal Bias:** Ratios are only means of financial analysis and not an end in itself. Ratios have to be interpreted and different people may interpret the same ratio in different ways.
6. **Uncomparable:** Not only industries differ in their nature but also the firms of the similar business widely differ in the size and accounting procedures, etc. It makes comparison of ratios difficult and misleading. Moreover, comparison is difficult due to differences in definitions of various financial terms used in the ratio analysis.
7. **Absolute Figures Distortive:** Ratios devoid of absolute figures may prove distortive as ratio analysis is primarily quantitative analysis and not a qualitative analysis.
8. **Price Level Changes:** While making ratio analysis, no consideration is madeto the changes in price levels and this makes the interpretation of ratios invalid.
9. **Ratios no Substitutes:** Ratio analysis merely a tool of financial statements. Hence, ratios become useless are separated from the statement from which they are computed.
10. **Clues not Conclusion:** Ratio provides only clues to analysis and not final conclusion. These ratios have to be interpreted by these experts and there are no standard rules for interpretation.

**Q13. Explain briefly the uses/ significance of Ratio Analysis.**

***Answer***- **(a)** **Managerial Uses of Ratio Analysis:**

1. **Helps in decision-making:** Financial statements are prepared primarily for decision-making. But the information provided in financial statements is not an end in itself and no meaningful conclusion can be drawn from these statements alone. Ratio analysis help in making decision from information provided in these financial statements.
2. **Helps in Financial Forecasting and Planning:** Ration analysis is of much help in financial forecasting and planning. Meaningful conclusion can be drawn for future from these ratios. Thus, ratio analysis helps in forecasting and planning.
3. **Helps in communicating:** The financial strength and weakness of a firm are communicated in an easier and an understandable manner by the use of ratios. The information contained in the financial statements is conveyed in a meaningful manner to the one for whom it is meant. Thus, ration help in communication and enhance the value of financial statement.
4. **Helps in Co-Ordination:** Ratios even help in co-ordination which is of utmost importance in effective business management. Better communication of efficiency and weakness of an enterprise results in better co-ordination in enterprise.
5. **Helps in Control:** Ratio analysis even help in making effective control of the business. Standard ration can be based upon proforma financial statements and variances or deviation, if any, can be found by comparing the actual with the standard o as to take a corrective action at the right time. The weaknesses or otherwise, if any, come to the knowledge of the management which help in effective control of the business.
6. **Other Uses:** These are so many other uses of ratio analysis. It is an essential part of budgetary control and standard costing. Ratios are of immense importance in the analysis interpretation of financial statements as they bring the strength or weakness of the firm.
7. **Utility to Shareholders/Investors:**

An investor in the company will like to assess the financial position of the concern where he is going to invest. His first interest will be the security of his investment and then a return in the form of dividend or interest. For the first purposes he will try to assess the value of fixed assets and the loans raised against them. The investor will feel satisfied only if the concern has sufficient amount of assets. Long-term solvency ratios will help him in assessing financial position of the concern. Profitability ratios, on the other hand, will be useful to determine profitability position. Ratio analysis will be useful to the investor in making up his mind whether present financial position of the concern warrants further investment or not.

**(c) Utility to Creditors:**

The creditors or the supplier’s extent short-term credit to the concerns. They are interested to know whether financial position of the concern warrants their payments at a specified time or not. The concern pays short-term creditors out of its current assets. If the current assets are quit sufficient to meet current liabilities then the creditors will not hesitate in extending credit facilities. Current and acid-test ratios will give an idea about the current financial position of the concern.

1. **Utility to Employees:**

The employees are also interested in the financial position of the concern especially profitability. Their wage increases and amount of fringe benefits are related to the volume of profits earned by the concern. The employees make use of information available in financial statements. Various profitability ratios relating to gross profit, operating profit, net profit, etc. enable employees to put forward their viewpoint for the increase of wages and other benefits.

**(e) Utility to Government:**

Government is interested to know the overall strength of the industry. Various financial statements published by industry units are used to calculate ratios for determining short-term, long-term and overall financial position of the concerns. Profitability indexes can also be prepared with the ratios. Government may base its future policies on the basis of industrial information available from various units. The ratios may be use as indicators of overall financial strength of public as well as the private sector. In the absence of the reliable economic information, government plans and policies may not prove successful.

**(f) Tax Audit Requirement:**

Section 44AB was inserted in the Income Tax Act by the Finance Act, 1984. Under this section every assesses engaged in any business and having turnover or gross receipts exceeding Rs 40 lakh is required to get the accounts audited by a chartered accountant and submit the tax audit report before the due date for filing the return of income under Section 139(1). In case of a professional, a similar report is required if the gross receipts exceed Rs 10 lakh. Clause 32 of the Income Tax Act requires that the following accounting ratios should be given-

1. Gross Profit/Turnover
2. Net Profit/Turnover
3. Stock-in-trade/Turnover
4. Material Consumed/Finished Goods Produced.

Further, it is advisable to compare the accounting ratios for the year under consideration with the accounting ratios for the earlier two years so that the auditor can make necessary enquiries, if there is any major variation in the accounting ratios.

**Q14. Explain briefly:**

1. Current Ratio
2. Stock/Inventory Turnover Ratio
3. Operating Ratio
4. Interest Coverage Ratio
5. Capital Gearing Ratio/ Gearing Ratio
6. Debt- Equity Ratio
7. **Current Ratio** - Current Ratio is the relationship between Current Assets and Current Liabilities. It measures the general liquidity of a firm in a short period. Current Assets are those assets which are converted into cash within a short period of time usually within one year. They normally include cash and bank balances, marketable securities, debtors, bills receivable, inventory, prepaid expenses and accrued incomes. Current Liabilities are those liabilities which include trade creditors, bills payable, outstanding liabilities, income received in advance, dividend payable, contingent liabilities, bank overdraft, provision for income tax and other unclaimed liabilities. They are normally payable within one year.

Current Ratio is calculated as under:

Current Ratio = Current Assets

Current Liabilities

***Significance*** – This ratio measures the short term solvency or liquidity of a firm. It shows availability of current assets per rupee of current liabilities. Higher is the ratio, greater is the amount of current assets per rupee of current liabilities. This gives a safe margin for the short term creditors. An ideal ratio is 2:1. The surplus of current assets over current liabilities is to cover the risk of covering then into cash.

1. **Stock/Inventory Turnover Ratio** – This ratio indicated the number of times the stock has been turned over during a period and evaluates the efficiency with which a firm is able to manage its inventory. It is calculated as follows:

Inventory Turnover Ratio = Sales or Cost of Goods Sold

Average Inventory

Average Inventory = Opening Inventory + Closing Inventory

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Average Debtors Collection Period = Average Debtors

Average Daily Sales

It measures the velocity of conversion of stock into sales. A high inventory ratio indicates better inventory management; as a result less funds are needed in inventory. On the other hand, a low inventory ratio indicates a bad buying policy, obsolete stock and it is a danger signal.

1. **Operating Ratio –** Operating Ratio establishes the relationship between the cost of goods sold and others operating expenses in one side and the Sales on the other side, expressed in percentage. Operating cost comprises (Cost of goods sold + Administrative Expenses Selling + Selling and Distributing Expenses). Again cost of goods sold means – (Opening Stock + Purchases + Direct Expenses –Value of Closing Stock). Cost of operating is determined by excluding non operating income and expenses such as loss on sale of assets, interest paid, dividend received, loss by fire, speculative losses or gains. It is calculated as under:

Operating Ratio = Cost of Goods Sold + Operating Expenses x 100

Net sale

***Significance* –** It indicates the percentage of net sale which is consumed by operating cost. The remaining percentage of net sale is known as Operating Profit. This Operating Profit is to cover Interest, Income Tax, Dividend and Reserve. It measures the operating efficiency of a firm. Therefore lower is the operating ratio, higher is the operating profit.

1. **Interest Coverage Ratio** – It is a ratio which deals with the servicing of interest on loans and measures the security of interest payable on long term debts. It expresses the relationship between profits available for payment of interest and the amount of interest.

It is calculated as = Net Profit before Interest and Tax

Interest on Long Term Debts

***Significance*** – It reveals the number of times the net profit before interest and tax covers the interest payable on long term loans. Higher is the ratio, higher is the security of payment of interest. It also indicates the amount of surplus available for shareholders.

1. **Capital Gearing Ratio/ Gearing Ratio** - Capital Gearing Ratio is a ratio between Capital having variable cost and capital having fixed cost. Capital having variable cost refers to equity shareholders fund because return on equity shareholders is not fixed; it varies on the availability of profit and the policy of management.

Capital having fixed cost refers to Preference Share Capital, Debentures, Bonds and other long term loans because dividend on Preference Share Capital and interest on long term loans are fixed in nature. It is calculated as:

Capital Gearing Ratio = Equity Shareholders Fund

Fixed Interest Bearing Funds

1. **Debt-Equity Ratio** - Debt- Equity is a ratio between long-term debt and shareholders fund. It shows the capital structure of the business and a capital structure with less debt and more equity is considered favourable to long term creditors because it reduces the chances of bankruptcy. It is considered safe if the ratio is 1:1. It is computed as follows:

Debt- Equity Ratio = Long Debt

Shareholders Fund

Long-term Debt = Debentures + long-Term loan

Shareholders Fund = Equity Share Capital + Preference Share Capital + Reserves and Surplus – Fictitious Assets.

***Significance*** – This ratio measures the degree of indebtedness of an enterprise and shows the degree of security of the debt. A low debt-equity ratio reflects more security and a high ratio shows risk in meeting the obligations to creditors.

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