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STATUTORY FINANCIAL RATIOS IN FINANCIAL REPORTING OF ANNUAL REPORT

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ABSTRACT

Financial statements are often known for showing a true and fair view of the financial position, information and performance of a company. The term Statutory Financial ratios refer to those ratios that are mandatory to be reported in the annual report along with financial statement. These ratios cover the holistic financial strength of company that includes ability to meet short term obligations and long-term obligations of the company involving short term solvency ratios, long term solvency ratios, turnover ratios and profitability ratios. The quality of presentation and preparation of financial statements play a vital role in reducing the occurrence of corporate frauds. Though Ministry of Corporate affairs and other professional bodies are very proactive to take necessary steps to ensure corporates are reporting true and fair but however frauds and scams are identified only when the books of accounts are subjected to forensic auditing and not immediately. The Government of India is very progressive to take into cognizance of the transparency in financial reporting and amending Companies Act from time to time. The present paper makes an attempt to discuss those ratios that have become mandatory to be a part of annual report of a company.
Key Words: *Financial statements, Annual report, Corporate frauds, Forensic auditing*

Introduction

In recent times reliability and trust on the financial statements has been quizzed many a times on account of corporate frauds to name few Satyam computers 2009, PMC bank scam 2019, Karvy stock broking 2019. In this context the role and importance of financial statements is more relevant and practical especially the cash flows to the future of investment decisions. The term Financial Statement in relation to a company means to include a Balance sheet, Profit and Loss Statement, Cash flow statement, Statement of changes in equity and notes carrying information about significant accounting policies. Financial statements are the only window through which for an investor / prospective investor and a stake holder to understand the financial strength of a corporation and thereupon deciding to make investment or not. This is the stage wherein the accuracy and reliability of the financial statements pays an important role. Therefore, financial statements of a company are prepared to provide true and fair financial information and complying with Indian Accounting Standards. The changes made by the Companies Act regarding the preparation and presentation of financial statements from Schedule VI Companies Act 1956 to Schedule III Companies Act 2013 and recent amendments enclosed in the newly issued Companies (Auditors and Report Order) 2020 and the Companies (Indian Accounting Standards) Amendment Rules, 2020 is an attempt to ensure stakeholders as well companies' compliance with disclosers and transparency to reflect true and fair recording and presentation of financial transactions during the year. Thus, Financial statements are prepared by providing comparative information and consistency of presentation to enable readers of financial statements to make investment decisions.

In order to enable investment decisions to be more accurate and practicable a Profit and loss statement is prepared during an accounting period and Balance sheet is prepared at a particular point of time. It should be noted that while preparing financial statements due regard is to be taken not only with accounting concepts like Going concern, Accrual basis of accounting and Materiality and aggregation but also to the promoters' details about shareholding pattern and ageing schedules.

The occurrence of corporate frauds can be reduced by recognizing the quality of presentation and preparation of financial statements since frauds committed by corporates not only contributed to cash loss but more so to the erosion of confidence of investors and deterioration of wealth also. Corporate frauds are one of the major contributors to the slowdown of the economy.

Companies indulge in multiple fraudulent practices of significant overstatement of expenses and underreporting of profits, diversion of funds and accounting of invoices of fake. generating fictitious accounts of companies which borrowed small sums of money and created fake reports to suppress from the bye laws and regulatory supervision.

Corporate investment decisions involve incurring expenditure at one point of time whereas benefits of expenditure are realised at different points of time in future. It is concerned with the allocation of the firm's scarce financial resources among the available market opportunities.

The investment decisions include expenditure incurred to acquire non-current assets and raise capital. The various aspects of corporate investment decisions are the exchange of current funds for future benefits and funds are invested in long-term assets. Investment decisions affect the firm's value when the outcome of investment leads to an increase in profit and wealth. These are ultimately reflected in the financial statement, thus forming a tool for investment decisions.

The evaluation of the prospective profitability of new investments must also to be perceived before selecting a particular investment based on expected return on investment on capital employed, stream of estimated cash flows and cost of capital. Investment decisions for a corporate are often projects and need to have clarity of meaning for project as definite beginning and definite end and not perceived generally as series of activities. Further since the decisions on investments involved are long-term commitment of funds and irreversible in nature, require sound investment evolution criterion the following factors i) all cash flows to ascertain the true profitability of the projects ii) must provide for an objective and unambiguous way of separating good project from bad projects. iii) must enable ranking of projects according to their accurate profitability iv) would recognize the fact that bigger cash flows are preferable to later ones v) Finally it should help to choose among mutually exclusive project that project which maximizes the shareholders/stakeholder's wealth.

The perceived relevance of the financial statement is to provide information about the financial position, performance, and changes in financial position of a firm that is useful to a wide range of users in making management and investment decisions. One of the important roles of financial statements in investment decisions is to avoid financial reporting fraud and

scandals that might hinder effective decision-making process by management and other users of reports.

The Companies Act 2013 prescribed financial statements of every company must be prepared in accordance with Schedule III of the Companies Act,2013 and Annual report must include Statutory disclosers consists of Board's report, Director's Responsibility Statement, Management Discussion and Analysis, Report on Corporate Governance, Business Responsibility, CSR, Secretarial Audit, Auditor's Report, Balance sheet, Profit and Loss Statement, Cash flow statement AS3, Accounting policies AS1, Segment Report AS17 and Voluntary disclosures, which are discretionary accounting information over and above the mandatory disclosures, are also provided by management namely Human Resource Accounting, Accounting for changing prices, Value added Statements, Social Accounting Report.

Though Ministry of Corporate affairs and other professional bodies are very proactive to take necessary steps to ensure corporates are reporting true and fair but however frauds and scams are identified only when the books of accounts are subjected to forensic auditing and not immediately. In order to win the goodwill of stakeholders over financial statements, corporates must focus their investment on forensic technology and make financial transactions free from fraud and scams must invest to drive digital transformation.

The part of financial statement analysis in making investment judgments shouldn't be overlooked as it helps investors to establish the financial strength and weakness of an establishment. One of the effective ratios being Investment income percentage to measure the effectiveness of company's investment activities wherein taking into cognancies of timing differences in the receipt of funds that would

otherwise shift the income to some future period and skew the resulting measurement, the dividend and interest income must be recorded on the accrual basis. Financial statement analysis can reveal the red flags of an investment occasion. On the other hand, they can also reveal the strength of a company as well as the implicit profit of investing with a particular company. Emphasis to be made to calculate Gross profit index to detect significant company's gross profit percentage from period to period, which can be a sign of fraudulent financial reporting. By their nature, financial statements are retrospective, which means an investor should in no way look at a single statistic or metric in making investment opinions. For case, a factual or implicit investor must dissect the balance distance, to assess the company's asset, arrears, and power equity /net worth at a particular point in time. Also, he'll assess the income statement to know the company's expenditure income and profit or loss over a specified period. He'll also assess the cash inflow statement, to find out how the company raised up cash through investors or creditors; how the cash is used to acquire means and force; how the asset and force allow the company to induce cash to pay for business charges; and eventually how the cash is returned to investors and creditors. Also, the purpose of cash inflow analysis is to estimate the quantum of plutocrat an investor would admit from an investment, grounded on unborn free cash- inflow protrusions for the company, at least in the short term. A focus must be made to ascertain cash flow returns on sales for determining the company's ability to generate cash flow at various levels of sales volume. The term cash flow includes Net income and non-cash expenses minus non-cash sales. Another important

aspect to focus on is the amount of cash flow that a company is consistently plowing back into the business by calculating cash reinvestment ratio. The outcome of the ratio shall indicate how strong or otherwise the commitment of the owners to build the corporate business.

The Government of India, Ministry of Corporate Affairs Notification New Delhi dated 24th March, 2021 G.S.R. (E) In exercise of the powers conferred by sub-section (1) of section 467 of the Companies Act, 2013 (18 of 2013),

the Central Government hereby made the following further amendments to the Schedule III to the Companies Act with effect from 1st day of April, 2021, namely: -
Financial ratios

a. Current Ratio, this ratio is a very good measure of the short-term solvency of the company. It indicates the ability of the corporation to pay its current obligations in time and amounts to be realised within 12 months from the reporting date. This ratio is used by lenders to determine whether a company has a sufficient level of liquidity to pay its liabilities. A current ratio of 1:1 is the absolute minimum level of acceptable liquidity, whereas ratio of 2:1 is preferred. However, the company must be cautious as sometimes it might be misleading if the company's current assets are heavily weighted in favor of inventories since this current asset may be difficult to liquidate in the short run. At this point inventory to working capital ratio shall be helpful.
b. Debt-Equity Ratio, this ratio is an important long-term solvency ratio as it indicates the extent to which the company management is willing to fund its operations with debt, rather than equity. lenders are particularly concerned about this ratio, since an excessively high ratio of debt to equity we'll put the loans at a risk of not being repaired. Companies must take steps and the solution would have been the use of restrictive covenants that force excess cash flow into debt repayment, restrictions on alternative uses of cash, and a requirement for investors to put more equity into the company. This ratio helps in assessing the risk arising from the use of debt capital. A more restrictive way of having your formula is to include only long-term debts in the numerator, on the assumption that this variation gives a better picture of a company's long-term date to equity structure.

c. Debt Service Coverage Ratio: This ratio indicates the number of times interest is covered by the profits available to pay installments and interest charges. This ratio is used to test the servicing capacity of a company. If the ratio is less than one, it indicates that a company will probably be unable to make its debt payments.
d. Return on Equity Ratio: This ratio is used by the investors to determine the amount of return they are receiving from their capital investment in a company. To evaluate the ability of the company to generate a return from operating activities only, then we take net income from operations to the total equity.
e. Inventory turnover ratio: inventory is the largest component of any company's working capital and a constituent of current assets. Therefore, if the inventory is not used at a reasonable pace, then it infers that the company has invested a large part of its cash in an asset that may not be turned out into cash in the short duration. Accordingly, it is always suggested to keep close track of the rate of inventory turnover has a significant fact of

function of management. A low ratio indicates inventory not being utilized or sold optimally and therefore remaining with the company for longer periods inferring blockage of capital.
f. Trade Receivables turnover ratio: This ratio is crucial as it refers to the speed with which a company can obtain payment from customers for outstanding receivable balances. The ratio also enables us to measure the times that receivables are converted to cash during a given period. A very high level of Trade receivable turnover indicates that the company's credit and collection's function is very effective at avoiding potentially delinquent customers, as well as collecting overdue funds. Conversely a low ratio could be the result of inefficient collection processes, inadequate credit policies, or customers who are not financially viable or creditworthy.
g. Trade payables turnover ratio: This ratio being one of the important turnover ratios. The ratio indicates the velocity with which the creditors are turned over in relation to purchases. The lower the ratio, the better is the liquidity position of the company and higher the ratio, less liquid is the position of the company.
h. Net capital turnover ratio: This ratio is employed to measure the efficiency of the assets of a company that have been utilized. This ratio is a clear indicator of a company's ability to generate sales or cost of sales to the long-term investment. A company is considered efficient in utilisation of resources if this ratio is higher.
i. Net profit ratio: This ratio is one of the most important profitability ratios that measure the results of business operations and the overall performance and effectiveness of the firm. This ratio is also known as Net Profit Margin ratio. This ratio determines the proportion of revenue that finds its way into profits after meeting the expenses and income tax. However, sometimes this ratio is measured by taking profit before tax as well. Indicates overall firm's profitability. The higher the ratio, the better is the result.
j. Return on Capital employed: The performance of a company can be assessed in relation to other concerns by making interfirm and intrafirm comparisons. This ratio is very important as it is a measurement of inter relationship of profitability ratios and expressed as a percentage by considering Earnings before interest and tax and capital employed. The term capital employed includes long-term loans and shareholders' funds. This ratio also puts emphasis on Gross capital employed i.e., Fixed assets plus Current assets and Net capital employed derived from Fixed assets minus current liabilities. This ratio enlightens the management of the company whether the efforts are resulting financially as desired by the stakeholders towards corporate objective of profit maximisation. This ratio also helps management of the company to take policy decisions for expansion and diversification.
k. Return on Investment: It is the percentage of return on funds invested in the business by its owners. This ratio evaluates whether the company is financially sound or otherwise as this ratio considers comparing earnings / returns / profit with the investments of the company. If the ratio is not in favor of company, it indicates necessary steps must be initiated by the management of the company by improving Profitability ratio and Investment turnover ratio.
It is further mandatory to provide an explanation for any change in the ratio of more than 25% as compared to the preceding year.

Conclusion

There are eleven basic financial statement ratios that we can use to see how well a company is performing. They are the current ratio, the quick ratio, earnings per share, debt-to-assets ratio, and the return on equity. The first ratio is called the current ratio, or the working capital ratio. Financial ratios are vital for gauging a company's financial health and potential. From liquidity to profitability ratios, these metrics offer insights into various business performance aspects.

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