DRIVING
FINANCIAL PERFORMANCE

CA. PRAMOD JAIN

B. COM (H). FCA, FCS, FCMA, LL.B, MIMA, DISA, IP

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CONTENTS

- Role of directors in enhancing financial performance
- Effective practices for driving financial performance
- Tools for monitoring performance
- Shareholder value creation

INTRODUCTION

- Previous session – Financial failures resulting from actions of misguided individuals
- Destruction of a business because of unintended wrong financial and business decisions
- Two perspectives of financial review
  - Time series analysis
  - Cross-section analysis
- Two styles of financial review
  - Horizontal
  - Vertical

FINANCIAL HEALTH

- Loans vis-à-vis Cash / Bank
- Inventory
- Immovable Properties
- Debtors
- Continued Losses
- Related Party Transactions
- Ratio Analysis
- Trend Analysis
- Comparison with Competitors

INTERPRETATION OF FINANCIAL STATEMENTS

- Major information required for decision making may be instantly available in various disclosures made in annual report
- Make Horizontal, Vertical and Ratio Analysis of financial data's for last 4 years
- Make comparative study of financial data with base year or benchmarks already fixed
- Make cross section analysis of financial data with that of the other companies operating under similar conditions

INTERPRETATION OF FINANCIAL STATEMENTS

- Extra-ordinary High or Low figures may be replaced by the figures obtained through technique of interpolation/extrapolation
- Make necessary adjustments for changes in accounting policies, prior period adjustments and extra ordinary items.
- Make suitable adjustments for any departure from AS, GAAP etc.

TIME SERIES ANALYSIS

- Comparison of two P&L a/c's or two balance sheets of different periods of the same company
- Possibilities of distortion:
  - Outliers and irrational combinations of numbers
  - Periods of varying lengths
  - Major changes in the units' structures
  - Major happenings
  - Dissimilar formats and contents
- Time series analysis to be required by directors
  - when annual accounts are discussed and cleared
  - when operating budgets are approved

CROSS-SECTION ANALYSIS

- Comparison of two separate entities on same platform
- Same industry, same geography or some other similar facet like remuneration packages or age distribution
- Benefits of cross-section review of financials:
  - Tracing differences in the company's ratios to decisions & events
  - Ideas for bench-marking and improvement
- Two major techniques for cross-section analysis and time series analysis
  - Common size statements
  - Ratio analysis
- Single most preferred method: ratio analysis

FINANCIAL ANALYSIS USING RATIOS

- A window to a company's financial statements
- Examples of benefits of ratio analysis
  - To bankers and lenders (example: debt to equity)
  - To management (example: gross margin and expense ratios)
  - To creditors (example: quick ratio – cash compared to current liabilities)
  - To shareholders and investors (example: price to earnings)
- A sixth category of ratios of importance to directors: Compliance Ratios

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RATIO ANALYSIS

- Ratio is a statistical yardstick that provides a measure of relationship between two accounting figures. It may be expressed as a co-efficient, proportion & percentages.
- Types of ratios may be:
  - Liquidity Ratios
  - Solvency Ratios
  - Activity / Efficiency Ratios
  - Profitability Ratios
  - Owners Ratios

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PROFITABILITY RATIOS

- How far a Company is successful in its activities is largely dependent upon its profitability and comparison of the same with other companies in the segments and industry average.

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KEY PROFITABILITY RATIOS

Net Profit	• Net Profit / Sales
Gross Profit	• Gross Profit / Sales
Return on Total Assets	• EBIT / Total Net Assets
Return on Equity	• Net Income / Equity Share Capital

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ACTIVITY / EFFICIENCY RATIOS

- Activity Ratios measures the efficiency with which assets are converted into sales.
- Activity ratios are derived by dividing sales by the book value of the assets.
- These ratios are basically productive ratios in relation to fixed assets and liquidity ratios in relation to current assets

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KEY ACTIVITY RATIOS

Inventory Turnover	• Cost of Good Sold/ Avg. Inventory
Debtors Turnover	• Net Sales / Avg. Debtors
Fixed Assets Turnover	• Sales / Fixed Assets
Assets Turnover	• Sales / Total Assets

LIQUIDITY RATIOS

- Liquidity is the ability of a Company to meet its short term obligations like payment of Creditors, BP, Outstanding Exp. etc.
- A Co. may be profitable and yet not liquid.
- A Co. which is not liquid may sooner or later find itself in a situation of insolvency.
- Thus liquidity in a way is more important than profitability.

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KEY LIQUIDITY RATIOS

Current / Working Capital	• Current Assets / Current Liabilities [Id - 2:1]
Cash	• Cash + Bank + Mkt Sec / Current Liabilities [Id - 1:1]
Operating Cash Flow	• Op. Cash Flow (Net Income (+/-) change in WC + Non-cash expenses) / Current Liabilities [Id – 1:1]
Acid Test / Quick	• Quick Assets (Cash + Govt. Sec. + Receivables)/ Current Liabilities [Id – 1:1]

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SOLVENCY RATIOS

- These ratios concerns regarding the long term risk of the company i.e. Its ability to service long term debts. These ratios measure :
  - Ability to cover current cost of debt from income generated by existing operations
  - Current level of financial leverage

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KEY SOLVENCY RATIOS

Interest Coverage	• PBDITA / Interest
Debt Coverage	• PBDIA / Due Installment + Int. on Long Term Debt
Debt Equity	• Total Outside Liability / Tangible Net worth

OWNERS RATIOS

- These ratios are useful to Stakeholders to judge the current status of their investment.
- Based upon the analysis, they may take a decision to hold their investment until an opportune time, buying further shares or dispose off their existing holding.

KEY OWNERS RATIOS

Earning per Share	• Net Income / No. of Eq. Shares
Price Earning	• Market Price / EPS
Market Book	• Market Price / Book Value per share
Dividend Pay out	• Dividend Payout / EPS

LIMITATION OF RATIO ANALYSIS

- It is based on FS which are them selves subject to several limitations.
- In case of inter-firm comparison, no two firms are similar in age, technology adopted, size & product profile.
- Both inter-period & inter-firm comparisons are affected by price level changes. Change in price-level can affect the validity of ratios calculated for different time periods.

TREND ANALYSIS

- FS are compared for a no. of years to find out the trend. Since such FS constitute a time series in statistical sense. It is also known as Time Series Analysis.
- Each item in Co's FS is placed horizontally for no. of years. This facilitates increase / decrease in particular item for two periods or over a period.
- Such comparison may be made with help of absolute figures or by percentages.

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VERTICAL ANALYSIS

- Here we consider, FS for a single year.
- It is a method of FS analysis in which each entry for each of the three major categories of accounts, or assets, liabilities & equities, in a B/S is represented as a proportion of the total account
- Such converted statements are also called common size statements

CROSS SECTIONAL ANALYSIS

- It is comparison of performance of a Co. with that of a similar Co. or performance of the industry as a whole.
- Compare ratios of Co. with that of competing co. or industry as a whole.
- Data for cross sectional analysis - CMIE, CII, Stock Exchange etc.
- Cross sectional analysis is difficult in case of diversified company as they do not came under single industry umbrella.

COMPLIANCE RATIOS

Statutory compliance performance and loss arising from non-compliance			
From Profit & Loss Account			
PONC or Price of Non-conformation =	Fines & penalties ÷ PAT	2.5 ÷ 125	0.02
Dispute ratio =	Value of notices, demands etc. ÷ total statutory charges	165 ÷ 110	1.50
From the balance sheet			
Contingent liability ratio =	Contingent liability value ÷ Reported liability value	2,300 ÷ 6,900	0.33
Off-balance sheet financing ratio =	Off-balance sheet finance ÷ Reported value of financing	540 ÷ 5,400	0.10

ROLE OF DIRECTORS IN DRIVING PERFORMANCE

- Key role: Protect the interests of the Company and the external investors in the short and the long term
- Actions
  - Oversight of strategy and strategic decisions
  - Participation in CEO appointment, succession planning, managerial remuneration
  - Oversight of financial reporting and legal compliance
  - Performance monitoring through review of ratios
- Independent directors to take financial review seriously and ask questions on the Company's financial performance

EFFECTIVE PRACTICES

- Active involvement in Board meetings by preparing well and attending every meeting and asking questions, particularly on financial matters
- Board Agenda to focus on key strategic issues/ value drivers and risks – focus the Board time available on what is critical
- Demanding structured information from the executive management in regard to financial performance and position
- Bringing an external perspective using relevant experience

MEASURING SHAREHOLDER VALUE

$$\text{Shareholder Value} = \frac{\text{Dividends} + (\text{Ending Price} - \text{Beginning Price})}{\text{Beginning Price}}$$

$$= \text{Dividend Yield} + \text{Price Appreciation}$$

Example – Company XYZ

Ending stock price (31/3/2013)	Rs 36.06
Beginning stock price (1/4/2012)	Rs 30.86
Capital gain on XYZ stock	Rs 5.20
Dividend	Rs 1.9125

Shareholder Value = 1.9125/30.86 + 5.20/30.86

= .0620 + .1685

= .2305 or (23.05%)

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PERIODICAL COMPLIANCES

- GST Deposits & Returns
- Labour Laws dues and deposits
- TDS / TCS deposit and returns
- SFT Returns
- IT Returns
- Company Law / LLP Compliances
- SEBI Compliances
- RBI / FEMA Compliances

SUMMARY

- A non-executive director's question: when I am only involved at the strategic level, why am I held responsible for operational issues and failures?
- All directors answerable for the financial performance of the company
- Lack of involvement in ground-level decisions not an excuse
- Driving performance with the help of numbers not rocket science

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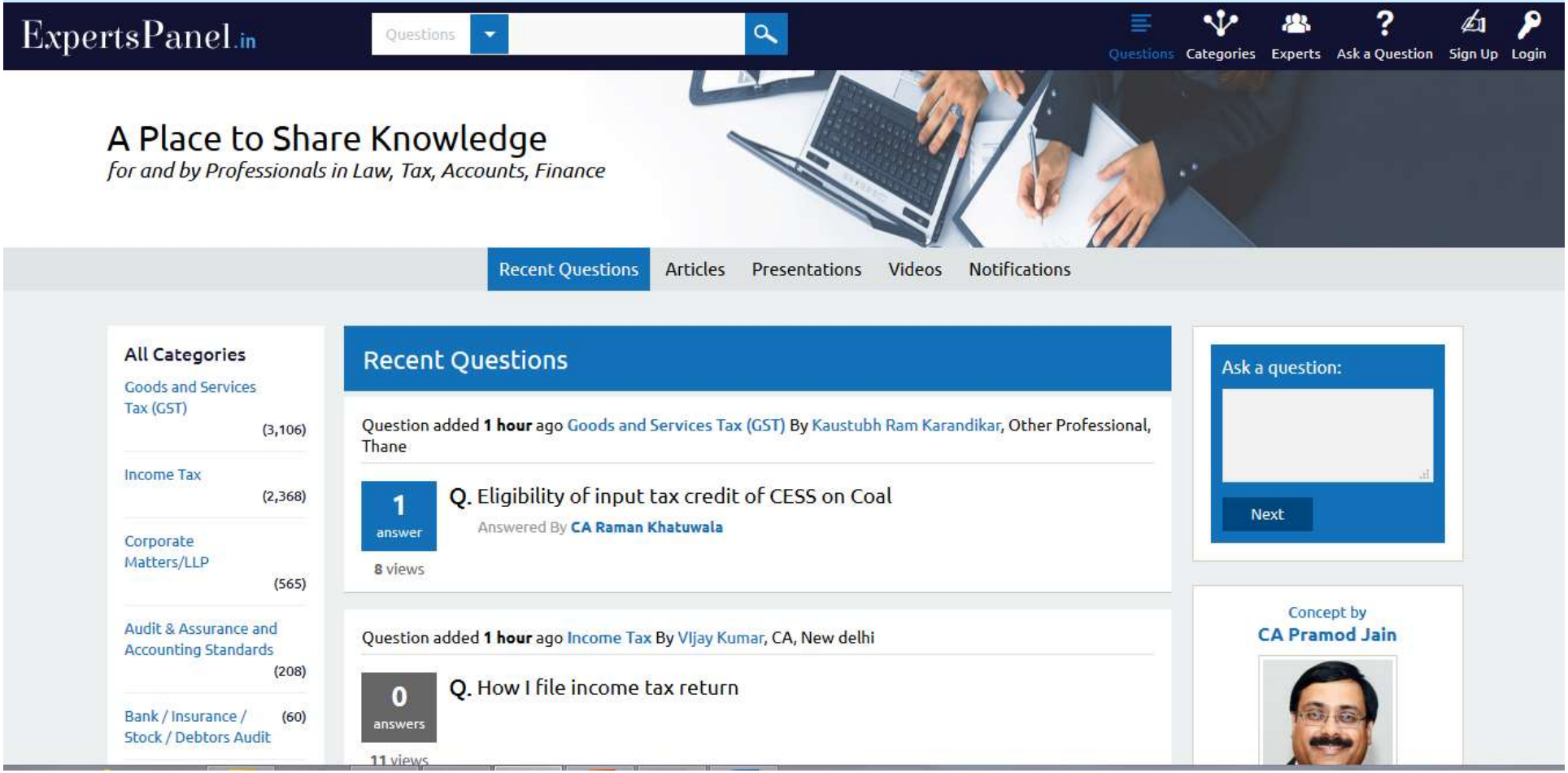

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Thank You!

CA. Pramod Jain

pramodjain@lunawat.com

+91 9811073867

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