

# DRIVING FINANCIAL PERFORMANCE



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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**

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- × **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**

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- ✘ 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**

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- ✘ **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**

# RATIO ANALYSIS

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- ✘ **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**

# PROFITABILITY RATIOS

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- ✘ **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.**



# 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**

# ACTIVITY / EFFICIENCY RATIOS

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- ✘ **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**

# 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**

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- ✘ **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.**

# 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]**



# SOLVENCY RATIOS

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- ✘ **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**

# KEY SOLVENCY RATIOS

**Interest  
Coverage**

- **$\text{PBDITA} / \text{Interest}$**

**Debt  
Coverage**


- **$\text{PBDIA} / \text{Due Installment} + \text{Int. on Long Term Debt}$**

**Debt  
Equity**

- **$\text{Total Outside Liability} / \text{Tangible Net worth}$**

# OWNERS RATIOS

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- ✘ **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.**
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# 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**

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- ✘ It is based on FS which are themselves 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

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- ✘ **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.**

# VERTICAL ANALYSIS

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- ✘ 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**

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- ✘ **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 come 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. ÷<br>total statutory charges | 165 ÷ 110     | 1.50 |
| From the balance sheet              |                                                             |               |      |
| Contingent liability ratio =        | Contingent liability value ÷ Reported<br>liability value    | 2,300 ÷ 6,900 | 0.33 |
| Off-balance sheet financing ratio = | Off-balance sheet finance ÷<br>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

$$\begin{aligned}\text{Shareholder Value} &= \frac{\text{Dividends} + (\text{Ending Price} - \text{Beginning Price})}{\text{Beginning Price}} \\ &= \text{Dividend Yield} + \text{Price Appreciation}\end{aligned}$$

## Example – Company XYZ

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

$$\begin{aligned}\text{Shareholder Value} &= 1.9125/30.86 + 5.20/30.86 \\ &= .0620 + .1685 \\ &= .2305 \text{ or } (23.05\%)\end{aligned}$$

# **PERIODICAL COMPLIANCES**

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- × **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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Thank You!

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