

DRIVING FINANCIAL PERFORMANCE



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Cleared self-assessment test for
Independent Directors Database

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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**

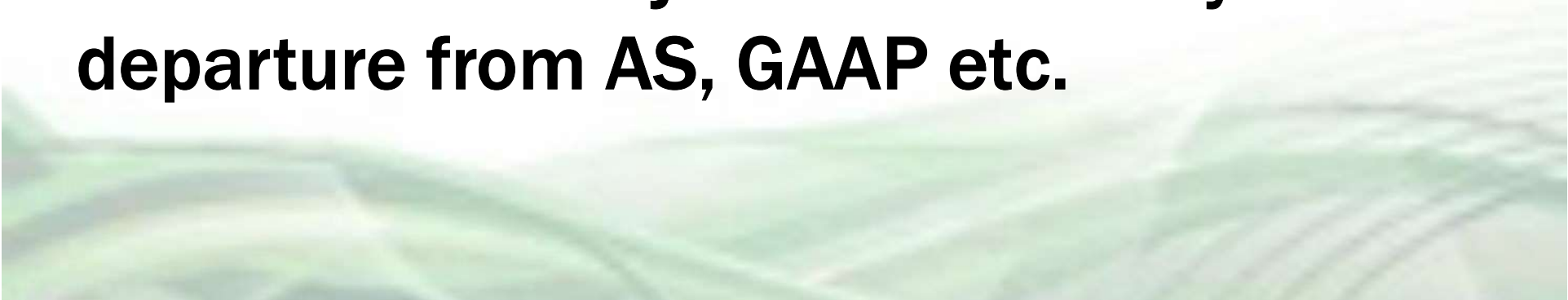
FINANCIAL HEALTH

- ✖ **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**

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

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.**



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

- ✖ **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

- ✖ **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

- ✖ 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

- ✖ **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

- $\text{Net Income} / \text{No. of Eq. Shares}$

Price Earning

- $\text{Market Price} / \text{EPS}$

Market Book

- $\text{Market Price} / \text{Book Value per share}$

Dividend Pay out

- $\text{Dividend Payout} / \text{EPS}$


LIMITATION OF RATIO ANALYSIS

- ✖ 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

- ✖ **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

- ✖ 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 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. ÷ 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

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

Example – Company XYZ

Ending stock price (31/3/2013) Rs 36.06

Beginning stock price (1/4/2012) Rs 30.86

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

- ✖ **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**

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answer

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Thank You!

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