

Boosting Your Business Performance Analysis

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Abstract

By analysis, the investor tries to understand the business system, financial parameters, challenges and value drivers of the business. The business enterprises and startups have always faced specific challenges like cash flow management, competition, financing, credit control, capacity constraints, fluctuating market demand and technological changes, etc. Also, with the global Covid -19 crisis, these challenges have been deeply intensified. Consequently, all economies and businesses are severely impacted in the world demanding the better understanding for value judgement.

This article offers insights into the businesses as well as financial performance analysis. It will enable readers to understand the key yardsticks & respective strategies for timely investing decisions in a beneficial way.

1. Concept of a Business Operation:

❖ Any business is a system of financial relationships and cash flows which are activated by management decisions over time.

❖ **Process of managing any enterprise:**

Economic Choices→trading off costs & benefits→shifts in physical & financial resources supporting the business→shifts cause movements of cash→final economic result.

❖ **Business has infinite variety like-**

- **Manufacturing**
- **Trading**
- **Financial**
- **Service institutions, etc.**

with different legal structures, like

- **Proprietary**
- **Partnership**
- **Company**
- **Non-profit**

As an Analyst or Banker, we need **Value creating Organization/company** because, earning profit by investor/bank completely depends on profitability of the company.

2. Value Creating Company

Key attributes of a successful company are:

Purpose, System, Optimisation, Achievement, Rewards

- i. **Purpose:** defined as an organisation in which management has achieved **integration of the interests and actions** of its key stakeholders, that is, **Shareholders, Managers, Employees, Customers, Suppliers, Creditors, & Community;**
- ii. **System/policies:** this integration is based on managing through sound decision-making, business-system, economic trade-offs, implicit in this system;
- iii. **Optimisation/activities:** company achieves, as nearly as possible, an optimisation of the system's performance over-time driven by
 - a sound business model,
 - strategies with a sustainable competitive advantage,
 - superb operational execution;
- iv. **Achievements:** this optimisation resulted in achieving positive cash flows as well as expectations of future cash flows pattern that exceed the cost of capital;
- v. **Rewards:** eventually, this will provide
 - superior returns to shareholders,
 - superior rewards for managers & employees,
 - excellence in customer satisfaction,
 - first rate performance & loyalty from suppliers,
 - superior credit relations for company.

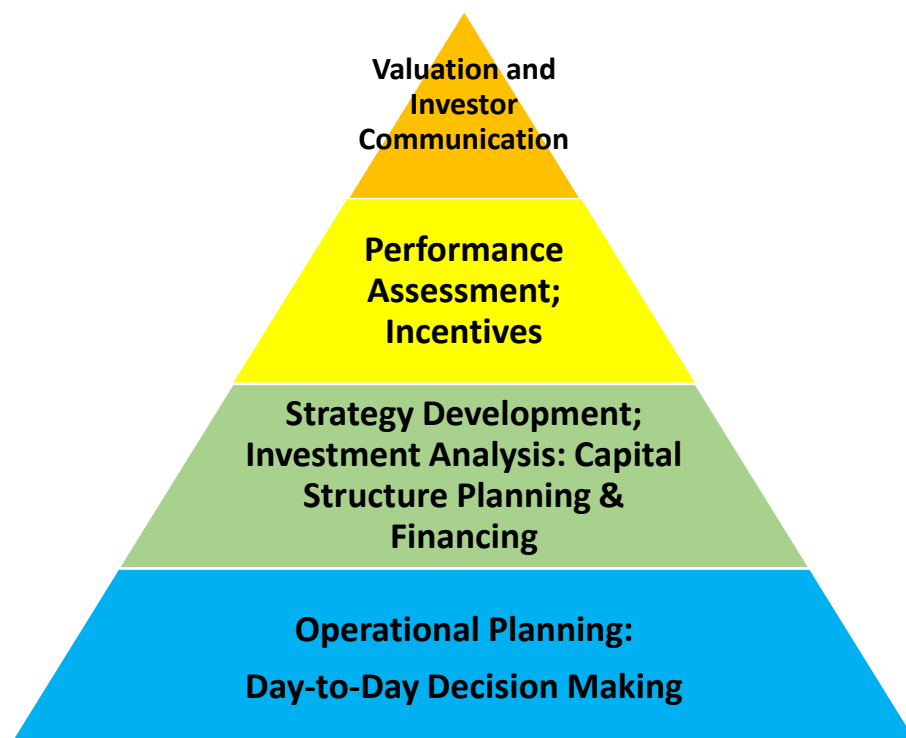
Value Creating Company requires several **Supportive Management Practices**, like,

- **Sharing of relevant information** by entrusting people at all levels for sound decision in the interest of value creation,
- **Decision support** by financial staffs as
 - ✓ an attitude of business advisor and facilitator of decision support,
 - ✓ as business consultants working closely with the line managers to make appropriate trade-offs, and
 - ✓ making non-financial managers to understand principles for profitable decisions but not to simply delegate the analytical aspects to experts.
- **Accounting Vs Cash (economic data)** by clearly defining results in terms of accounting for reporting & by analysing dynamics of Cash-flows for decision-making which are recognised as the real key to building value.

3. Financial/Economic Analysis of Business- Why required

- I. The process in understanding the financial implications and economic trade-offs.
- II. Understanding business economies of a company relating to:
 - Business model used, including customer needs & attributes;
 - The supply chain;
 - Competitive positioning;
 - Company's operational design & effectiveness all within larger societal setting;
 - Insights about the specific contributions & requirements of the various stakeholders;
 - The obligations the organization owes;
 - To identify and prioritize key value drivers that are essential to the long-term success of the business;
 - **Value drivers** can be:
 - sustainable cost and/or quality advantage,
 - technical expertise of a product development team or a group of service providers,
 - attribute of the business model which is hard for others to emulate, etc.

4. Areas of Financial Analysis



Challenges involved in Analytical Area:

First; outside analysts & managers alike must understand and properly apply the principles of valuation.

Second; the story of company's performance & future expectation within the legal & regulatory constraints.

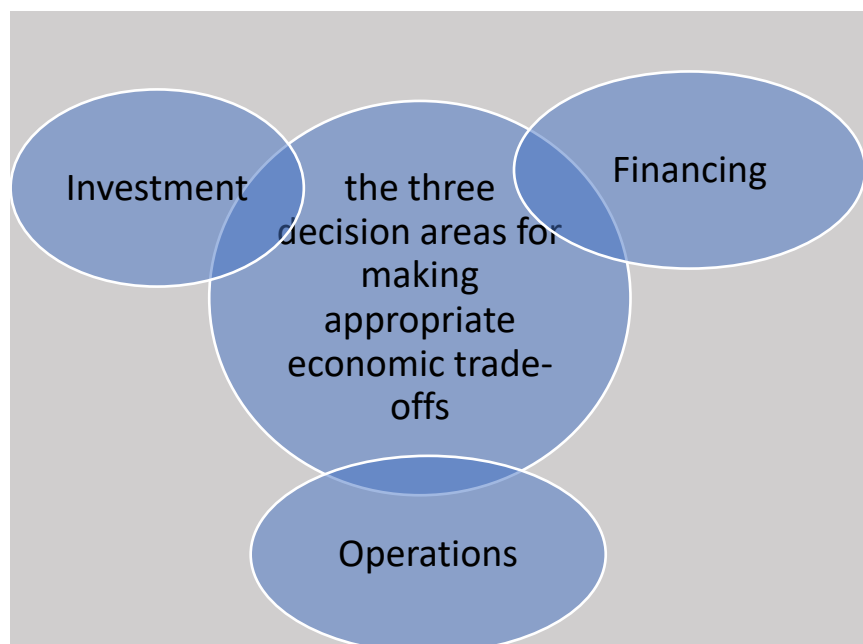
Approaches to face challenges:

- Understanding the business model & its key attributes;
- An appreciation of the strategies in place & any changes expected;
- An assessment of key performance criteria;
- A feel for the competitive realities;
- The future environment of the industry;
- A judgement about the position and likely success of the company within this environment.
- Existing performance must be projected over a time horizon befitting the nature of the business and its industry segment.
- It is best done in a cash-flow framework

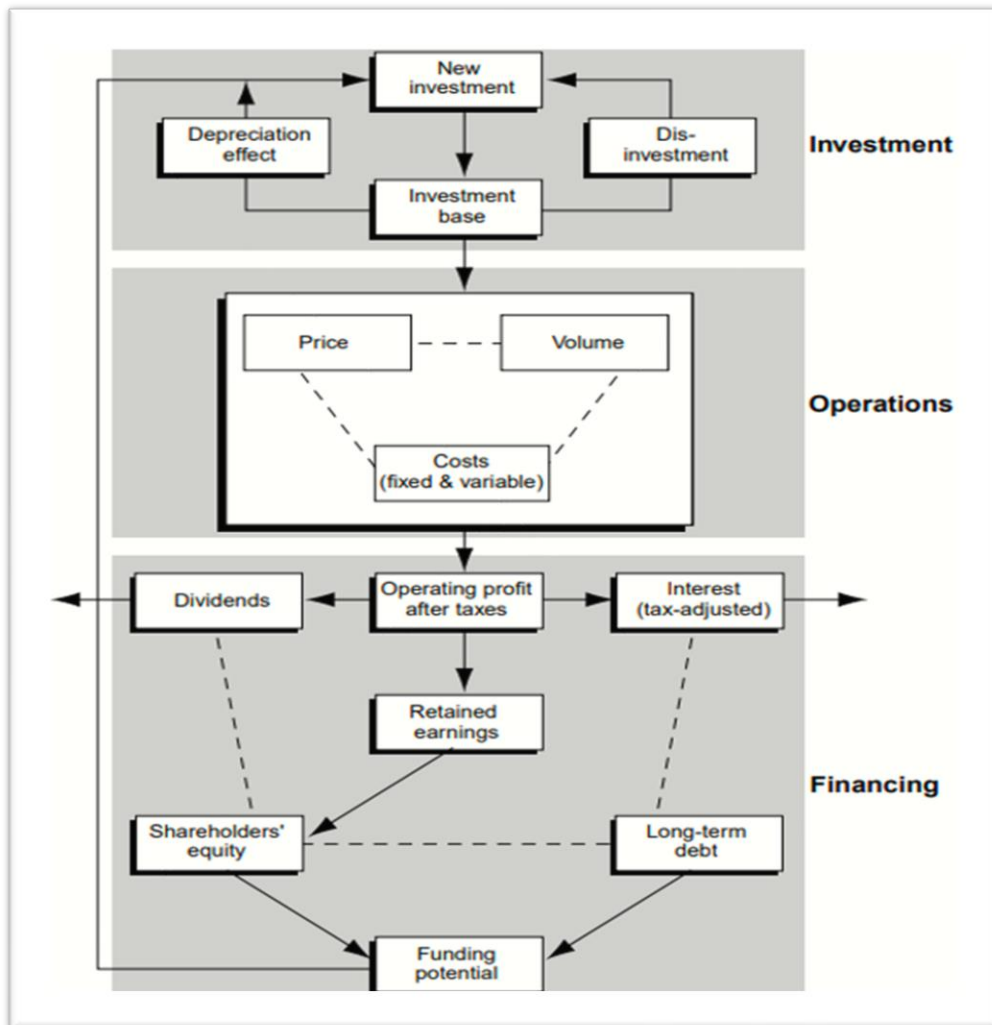
5. Business as a Management System

Basic economic purpose of sound management system is **strategic deployment of selected resources** in order to create, over time, **economic value sufficient to recover all of the resources employed** while **earning an acceptable economic return** on these **resources** under conditions that match the **owners' expectation of risk**.

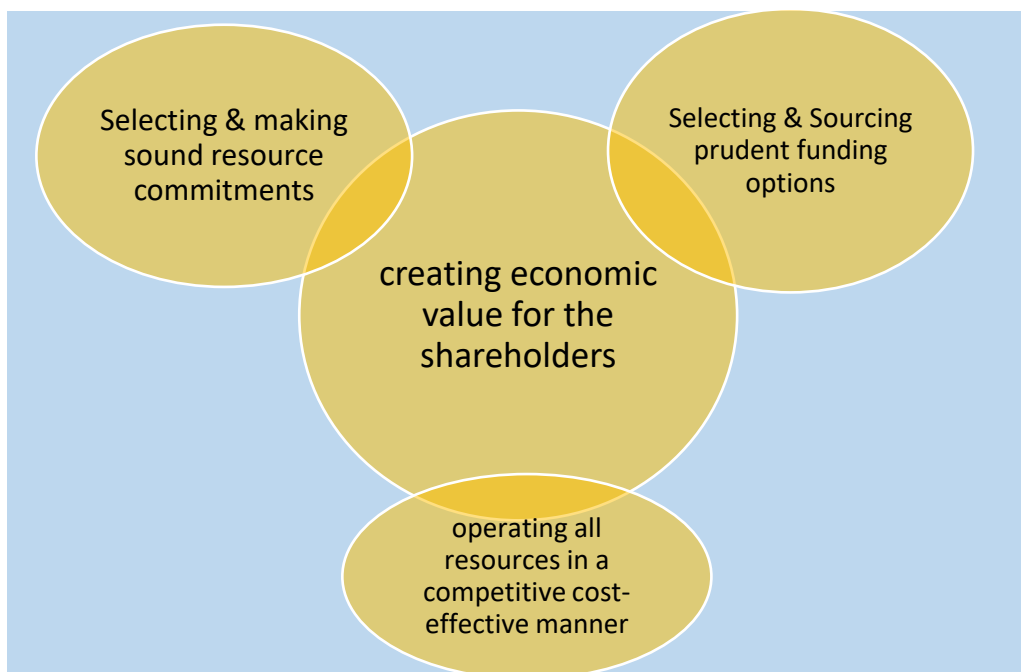
These boils down to **3 Basic Business Decisions by Management**



Business System: An Overview



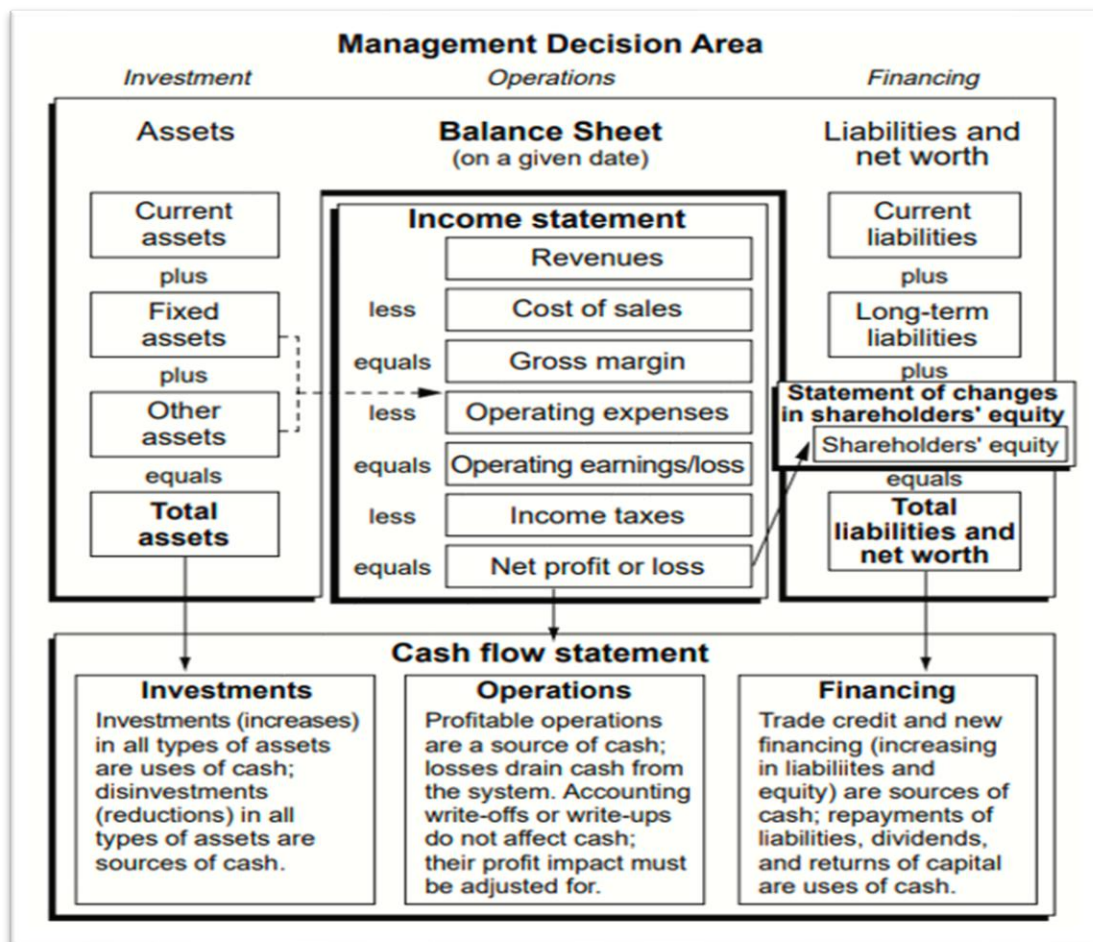
The Process of Value Creation on the basis of business decisions



These decision displays **resource movements** in monetary terms, based on the periodic accounting statements of **financial condition and Profit & Loss**, provides a basis for judging **management effectiveness**.

The true study of effective resource movements by management within financial statements over time is called **Funds Flow Analysis (FFA)**.

Business as a System of Funds Flow



Funds basically means "Cash" or Cash equivalents. Broadly, it covers all measurable resources including cash, inventories, current credit, etc which can be used as per Management decisions.

FFA allows us to reconstruct many important resource decisions from account statements made regarding- **investment, operations & financing**.

FFA is a comparative process which identifies:

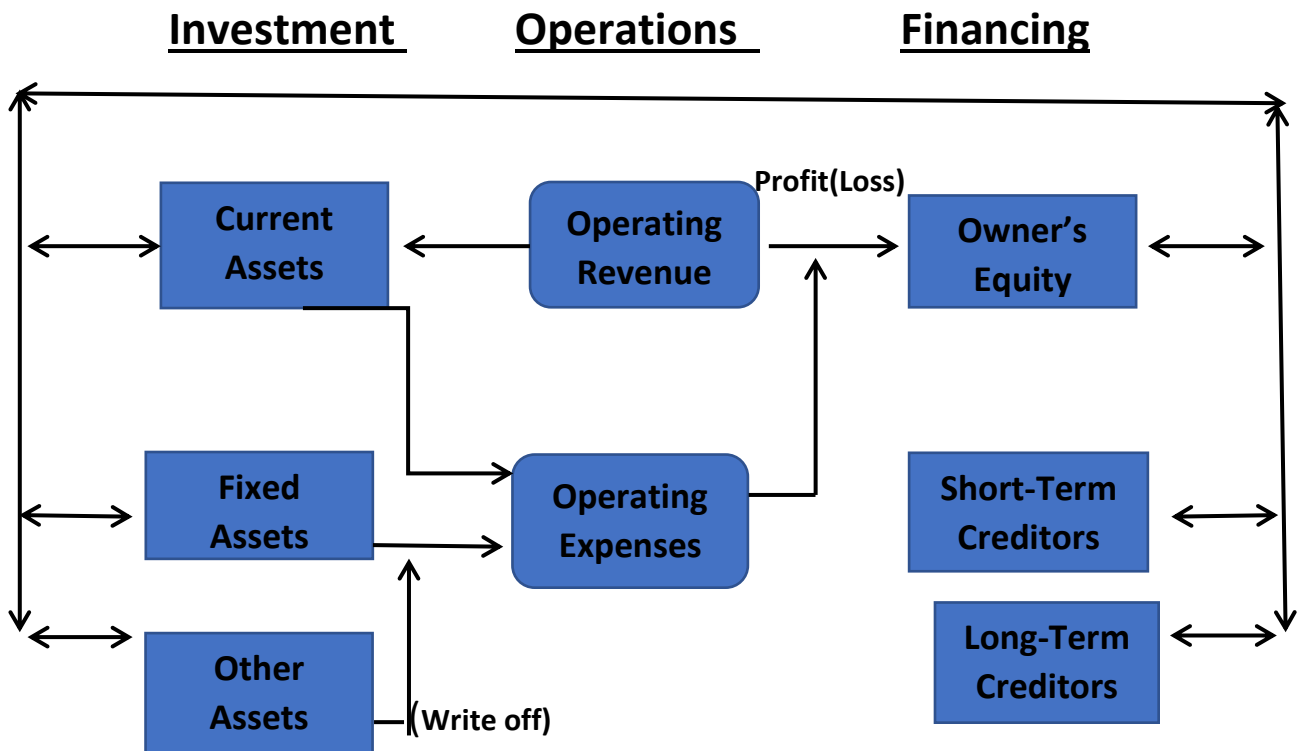
- shifts in financial condition & impact of operations,
- sorts these into a framework of resource(funds) uses or applications,
- resource (funds) sources or provisions.

FFA techniques rest heavily on an understanding of commonly accepted accounting methods, since accounting statements generally have to serve as the raw material for analysis.

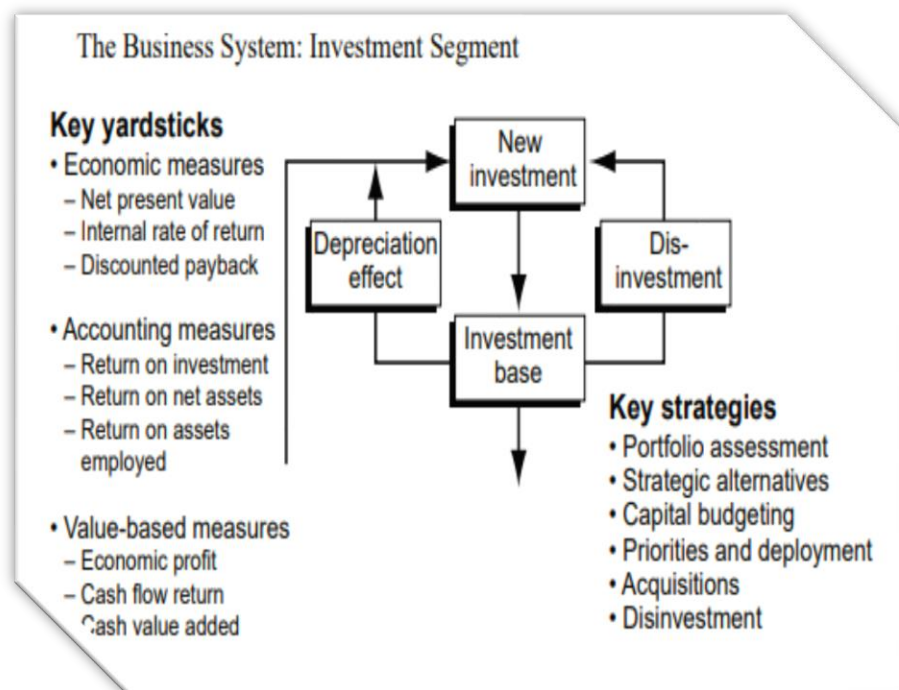
FFA is a more natural way of characterising business operations & conditions than the standard accounting statements.

Generalised Funds Flow Model

Management Decisions



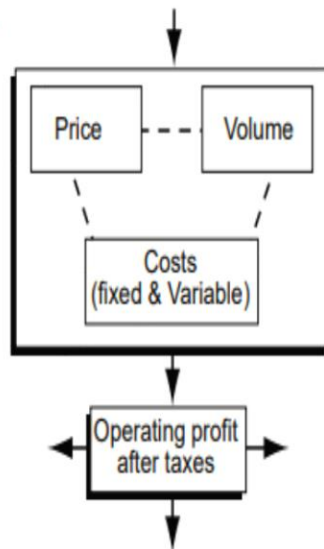
Business performance in different segments depends on measuring key yardsticks and adopting the appropriate strategies for sustainable success as under:



The Business System: Operations Segment

Key yardsticks

- Operating ratios
- Contribution analysis
- Activity analysis
- Effectiveness criteria
- Benchmarking



Key strategies

- Product/service excellence
- Competitive positioning
- Core capabilities
- Resource deployment
- Market selection
- Pricing strategy
- Cost effectiveness
- Operating leverage
- Outsourcing; partnering

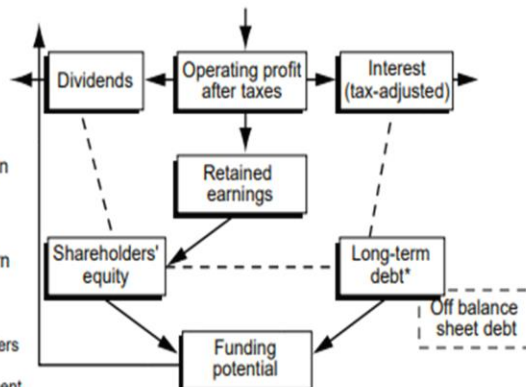
The Business System: Financing Segment

Key yardsticks

- Earnings per share
- Cash flow per share
- Dividend payout
- Interest coverage
- Return on equity
- Return on capitalization
- Debt/equity ratio
- Debt service
- Cost of capital
- Total shareholder return

Key strategies

- Disposition of profit:
 - Dividends to shareholders
 - Interest to lenders
 - Retention for reinvestment
- Capital structure targets:
 - Types of equity capital
 - Types of debt capital
 - Off-balance sheet debt
 - Financial leverage
 - Risk/reward trade-off



*Assumes a continuous rollover of debt (refinancing), that is, there is no reduction in existing debt levels from repayments, as new funds are raised to cover these, unless a policy change in debt proportions is specified. No specific provision is made here for use of off-balance sheet debt, such as operating leases.

Reference:

1. Financial Analysis Tools and Techniques: A guide for Managers by Erich A. Helfert