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ASSESSING THE FINANCIAL VIABILITY / PERFORMANCE OF BUSINESS

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Meaning and Definition

Financial performance is a subjective measure of how well a firm can use assets from its primary mode of business and generate revenues. This term is also used as a general measure of a firm's overall financial health over a given period of time, and can be used to compare similar firms across the same industry or sectors.

Financial statements for businesses usually include income statements, balance sheets, and cash flows. Financial statement analysis is the process of reviewing and evaluating a company's financial statements (such as the balance sheet or profit and loss statement), thereby gaining an understanding of the financial health of the company and enabling more effective decision making.

The balance sheet is a snapshot showing what is owned and owed at a single moment. It provides an overview of how well the company is managing assets and liabilities. The income statement provides a summary of operations for the entire year which starts with sales or revenue and ends with net income. The cash flow statement is a combination of both the income statement and the balance sheet.

Practical utility

- Help to identify trends by comparing ratios across multiple time periods and statement types
- This helps to measure liquidity, profitability, company-wide efficiency and cash flow.
- This is important for all companies with different scale of operations which help to project the financial health of the company.
- The cash flow analysis provides financial information in assessing the selected enterprises/ activity group's liquidity, the quality of earnings and solvency**.**
- The income statement can be used to calculate a number of metrics, including the gross profit margin, the operating profit margin, the net profit margin and the operating ratio.
- It is a valuable tool to monitor operations. Together with the balance sheet and cash flow statement, the income statement provides an in-depth look at a company's financial performance and position.

Key words:

Cash Inflow, Cash Outflow, income statement, profit and loss statement, Net worth, balance sheet.

Data requirement and software support:

The cash flow statement utilizes monthly data on revenue generation which includes cash sales, credit sales, interest accrued, advances received, and other inflows and all the outflows like operating expenses, tax payments, loan repayments are collected. The ending cash balance can be calculated by summarizing all the monthly cash values. The monthly data set is combined in an Excel sheet in which we can easily calculate the financial statement for the year. An income statement uses data on revenues/ gains and expenses/losses.

The money earned from the primary and secondary activities and the gains received from the appreciation of assets etc are needed for calculating the profit statement and the losses incurred from the primary and the secondary activities and the monetary losses due to depreciation of assets are included in the loss statement. The balance sheet utilizes the assets and liabilities of the company segregated as current assets, intermediate assets and long term assets and liabilities as current liabilities, intermediate liabilities and long term liabilities. The net worth statement is assessed mainly on quarterly or yearly basis based on the quantum of business.

A. Cash Flow Statement

A statement of cash flows is a financial statement which summarizes cash transactions of a business units/ enterprise's during a given accounting period (usually 1 year) and classifies them under cash inflows and cash outflows which shows how cash moved during the period. The cash flow statements can be segregated as cash flows from operating, investing and financing activities which helps to analyze the revenue gains and losses in the activities of the group. The cash flow analysis is done on a monthly basis.

- ❖ Cash inflow - cash sales, receivables, credit sales, loans as well as equity.
- ❖ Cash outflow - cash expenditure, tax payments and loan repayments.

Sample of a cash flow budget

Sl No	Particulars	J	F	M	A	M	J	J	A	S	O	N	D
1.	Cash Inflows												
	Cash balance												
	Credit sales												
	Cash sales												
	Other cash inflow												
	Total												
2.	Cash outflows												
	Operating expenditure												
	Loan repayment												
	Tax payments												
	Total												
3.	Cash available												
	New borrowing												
	Interest												
	Depreciation												
4	Ending cash balance												

Worked out example:

A tentative cash flow statement of "Abhaya garment and textiles "Theeramythri activity group which is funded by Society for Assistance to Fisherwomen is given below for the year 2016.

MONTH			J	F	M	A	M	J	J	A	S	O	N	D
Cash Inflow	Cash sales		10000	15600	12680	18500	12500	25650	18650	22960	19360	15640	18960	14680
	Credit sales		2880	2000	1500	800	900	500	3500	1200	9450	850	600	580
	Interest accrued		1000				1000				1000			1000
	Advance		2500					5000	3500		4000			
	Loans- banks, revolving fund, others		10000											25000
	Contribution by members		5000	1000				4000				3000		
	Other assistance from SAF								10000					
	New investment													
	Others		800	3800	4000	2550	3950	8500	5210	9850	1590	6780	1000	2050
Total			**32180**	**22400**	**18180**	**21850**	**18350**	**43650**	**40860**	**34010**	**35400**	**26270**	**20560**	**43310**
Cash Outflow	Operating Expenditure	Rent	1000	1000	1000	1000	1000	1000	1000	1000	1000	1000	1000	1000
		Water charges	200	250	300	200	200	200	200	200	250	200	200	200
		Electricity charges	1500	1800	1600	1500	1400	1500	1650	1860	1620	1540	1280	1200
		Transportation cost	1000	1000	850	1500	1000	1500	1500	2500	2000	1000	2000	1000
		Purchase of raw materials	5000				10000	1000	5000	4000			4000	
		Packing material												
		Payment for credit purchase	500											
		Maintenance charges / Service charges												
	Labour Component	No of man days	26*3											
		Wages	15000	15000	15000	15000	15000	24000	15000	24000	15000	15000	15000	15000
		Profit sharing	0			1500			3000					3000
	Loan Component	Bank loan repayment												
		Interest on loan		1000				1000		1000		1000		
		Revolving fund repayment	1000	1000	1000	1000	1000	1000	1000	1000	1000	1000	1000	1000
		Loan to members			6000									
	Other Outflows	License fee												
		Taxes												
		Fixed procurement							10000					
		Others	500	100	200	800	1000	850	200	150	600	850	100	250
Total			**25700**	**21150**	**25950**	**22500**	**30600**	**32050**	**38550**	**35710**	**21470**	**21590**	**24580**	**22650**
Ending cash balance(Total Inflow- Total Outflow)			**6480**	**1250**	**-7770**	**-650**	**-12250**	**11600**	**2310**	**-1700**	**13930**	**4680**	**-4020**	**20660**

Inferences:

The financial statement for the year 2016= Total cash inflow - Total cash outflow

Ending balance for the year 2016 =Rs. 34,520.

If the cash from operating activities is consistently greater than the net income, the company's net income or earnings are said to be of a "high quality". When the cash outflows during a period are higher than the cash inflows during the same period there is a negative cash flow.

B. Income Statement/ Profit or Loss Statement

An Income statement or profit and loss statement (P&L) is a financial statement that summarizes the revenues, costs and expenses incurred during a specific period of time, usually a fiscal quarter or year. These records provide information about the enterprise's ability – or lack thereof – to generate profit by increasing revenue, reducing costs, or both. The P&L statement is also referred to as "statement of profit and loss", "income statement," "statement of operations," "statement of financial results," and "income and expense statement."

Souhridha Poultry and Fish Farm Group Income Statement
For Five months ended May 31st 2016

Particulars	Amount (in Rs.)
I. **Receipts**	
A. ***Returns from the sale of fish***	57,000
B. Revenue from poultry	8,000
C. Revenue from other enterprises	12,000
D. Gifts	2,000
E. Appreciation in the value of assets	3,000
Gross Income(GI)	**82,000**
II. **Expenses**	
A. **Operating expenses or costs**	
(i) Hired human labour	10,500
(ii) Machine labour	1,500
(iii) Seed	1,100
(iv) Feed	5,000
(v) Manures and Fertilizers	3,000
(vi) Veterinary aid	500
(vii) Irrigation	1,000
(viii) Miscellaneous	2,000
(ix) Interest on working capital	2,100
Total Operating Cost(TOC)	**26,700**
B. Fixed expenses or costs	
(i) Depreciation	3,000
(ii) Land revenue	200
(ii) Interest on fixed capital	3,200
(iii) Rental value of owned land	10,000
Total fixed cost(TFC)	**16,400**
III. **Net cash income (NCI)**	79,000 - 26,700 = **Rs.52, 300**
IV. **Net operating income (NOI)**	82,000 - 26,700 = **Rs.55, 300**
V. **Net farm income (NFI)**	55,300 - 16,400 = **Rs.38, 900**

Inferences:

Net income= Revenue- Expenses

Net income is the bottom line and Revenue and expenses are the top line.

Net profit = Percentage of sales after deducting all expenses and overheads.

C. Balance Sheet/ Net worth Statement

The balance sheet shows the financial condition and stability of the business at a particular point of time.It gives an account of the total assets and liabilities.The snapshot of balance sheet indicate the net worth or net defecit of the enterprise.

- Assets include
  - Current assets (12 months)
  - Intermediate assets (1-10 years)
  - Fixed or long term assets (more than 10 years)
- Liabilities include
  - Current liabilities (12 months)
  - Intermediate liabilities (1-10 years)
  - Fixed or long term liabilities (more than 10 years)

Format of Net Worth Statement

Sl.No.	Liabilities (A)(Rs.)	Assets (B)(Rs.)
1.		
2.		
3.		
Total =		Total =
Networth (B - A) =		

Worked out Example: The net worth statement of a Food Self help groups.

Liabilities (A)			**Assets (B)**	
1. Current			**Current**	
Short term loans :			Cash in bank	8,000
Hand loans	2,000		Cash on hand	9,000
Revolving fund	25000		Account receivable	12,000
Sub-total	27,000		Sub-total	29,000
2. Intermediate		**Intermediate**		
Loans on machinery and equipments	10,000		Machinery and and equipments	50,000
Loans on purchase of stock	6,000		Stock	15000
Sub-total	16,000		Sub-total	65,000
3. Long term (fixed)		**Long term (fixed)**		
Nil	-		Building (shop)	
Sub-total	-		Sub-total	
Total liabilities	**43000**		**Total assets**	**94000**

Inferences

Solvency Ratios

- *Quick ratios=(Current Assets- Inventories)/ Current liablities*

  The quick ratio measures a company's ability to meet its short-term obligations with its most liquid assets. The higher the quick ratio, the better the position of the company.

- *Current Ratio = Current Assets / Current Liabilities*

  This is used to determine the company's ability to pay back its short term liabilities. If the ratio is below 1, it raises a warning sign as to whether the company is able to pay its short term obligations when due.

- ***Debt/Equity Ratios***

  Total Debt/Equity Ratio = Total Liabilities / Shareholders Equity

  Long Term Debt/Equity Ratio = Long Term Debt / Shareholders Equity

  Short Term Debt/Equity Ratio = Short Term Debt / Shareholders Equity

  A high ratio means that the company has been growing due to debt.

Activity Ratios

Activity financial ratios measure how well a company is able to convert its assets in the balance sheet into cash or sales.

- *Days Sales Outstanding (DSO)= (Receivables / Revenue) x 365*

  A low DSO number means that it takes a company fewer days to collect its accounts receivable. A high DSO number shows that a company is selling its product to customers on credit and taking longer to collect money.

- *Days Inventory Outstanding = (Inventory / COGS) x 365*

  This financial ratio is used to measure the average number of days a company holds inventory before selling it.

- *Days Payable Outstanding = (Accounts Payable / COGS) x 365*

  Days Payable Outstanding shows the time in days a business has to pay back its creditors. On the flip side, it also shows how long the company can utilize the cash before paying it back.

- *Cash Conversion Cycle = DIO + DSO – DPO*

  The entire cash conversion cycle is a measure of management effectiveness. The lower the better and a great way to compare competitors.

Turnover Ratios

- **Receivables Turnover = Revenue / Average Accounts Receivables**

  The receivables turnover ratio is one that is categorized as an activity ratio because it measures the company's effectiveness in collecting its credit sales.

- *Inventory Turnover = COGS / Average of Inventory*

  Inventory turnover is important for companies with physical products and is best used to compare against peers.

- *Average Age of Inventory (days)= Average of Inventory / Revenue*

  Average age of inventory is just the inverse of Inventory Turnover.

- ***Inventory to Sales Ratio***

  Inventory to Sales = Inventory / Revenue

  The objective is to see how inventory is being managed as it will signal potential problems with cash flow. An increase in the inventory to sales ratio can indicate that

- The investment in inventory is growing more rapidly than sales
- The sales are dropping

  Vice versa, if the inventory to sales ratio drops, it could mean that

- The investment in inventory is shrinking in relation to sales
- The sales are increasing

Debt to Equity Ratios

These ratios have trended in order to understand whether the company is in a difficult situation or not. If a company operates on high leverage and has maintained a high debt ratio, it is not as alarming as a company with a low debt ratio suddenly showing a spike in the debt ratio.

- *LT-Debt to Total Debt = Long Term Debt / Total Debt*

  The long term debt ratio is an indicator that the company does not have enough cash to run future operations.

- *ST-Debt to Total Debt = Short Term Debt / Total Debt*

  If the short term debt ratio is high, this is a big warning sign. The debt payment is coming due and has to be re-negotiated or paid off with a new loan.

- *Total Liabilities to Total Assets = Total Liabilities / Total Assets*
- *Price to Working Capital = Price / Working Capital per Share, where Working Capital = Current Assets – Current Liabilities*

  A high working capital ratio shows whether the business can continue to operate without troubles.

Suggested Readings

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