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Techniques to Improve Financial Reporting and Analysis

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Introduction

- **Important questions:**
  - Do your internal financial reports provide all of the information needed to most effectively manage your company?
  - Could decision making be improved if better financial analysis were performed?

Introduction

- **Going beyond the basic statements.**
  - The balance sheet and income statement are only the starting point for successful financial management.
  - Applying other financial statement analysis methods is a necessary step in analyzing the success, failure, and progress of your business.
  - It is also critical for a company to understand and utilize detailed reports available in its accounting system.

Introduction

- **Improved financial statement analysis can help:**
  - Locate and correct accounting errors.
  - Identify areas/segments for business improvement.
  - Identify problem areas and react to problems more quickly.
  - Better understand the interrelationship of accounts, which in turn will help you to devise better solutions to the problems identified.
  - Help to identify business opportunities.
  - Establish better terms for proposals and contracts.
  - Monitor performance of the company as a whole and specific divisions, offices, contracts, and employees.

Introduction

- **Objectives of the presentation.**
  1. Improve your basic financial statements.
  2. Use ratio analysis and industry benchmarking.
  3. Include budgets and forecasts as part of your financial analysis.
  4. Evaluate detailed reports that should be produced.
  5. Consider who should receive financial reports.
  6. Improve timeliness of report distribution.
  7. Perform analysis!
  8. Stimulate an actual plan to help achieve your financial goals.

Basic Financial Statements

- **Reports included in basic internal financial statements.**
  - Balance sheet.
  - Income statement.
  - Cash flow statement – rarely included but can be very useful for managing cash position!
  - Reporting by segment or division.
    - Reports should be prepared for all meaningful divisions or locations.
    - Consolidated statements should also be presented, especially if consolidated statements are used at year-end.

The Balance Sheet

- Represents a snapshot of the financial position of the company at a specific point in time.
- Can be utilized by business owners to evaluate their company's financial standing
- Demonstrates the basic accounting equation whereby:
  - **Assets – Liabilities = Stockholder's Equity**

Income Statement

- A period-to-date summary of revenues and expenses that calculates the net income or loss for the period.
- Representative of a company’s financial performance.
- **“Bottom line”** net income or loss often is not truly representative of the company’s profitability due to discretionary bonuses paid to the company’s owners at year-end, in addition to other discretionary expenses.

Income Statement

- **Specific key elements of a company's income statement:**
  - Gross revenue – Represents gross fees billed to customers.
  - Net revenue – Defined as the company's gross revenue less returns, allowance, and other revenue adjustments.
    - For a professional service firm, direct expenses and outside consultant costs would also be subtracted.
    - This is the revenue earned on the company's efforts and is used as a basis for providing "common-sized" income statement comparisons and comparisons with industry standards.

Income Statement

- **Cost of sales – Represents direct costs of producing the product or services that is sold.**
  - Materials
  - Direct labor
  - Overhead
- **Gross margin – Defined as the company's net revenue less cost of sales.**
  - Also called contribution margin as it represents the company's "contribution" to cover operating expenses and provides for net profit.

Income Statement

- **Operating expenses.**
  - Also referred to as selling, general and administrative expenses.
  - Includes those expenses related to the operations of than the business that are not part of cost of sales.
- **Income from operations.**
- **Other income (expense).**
  - Includes interest income, interest expense, and other non-operating sources of income or expense.
- **Income before income taxes, income tax expense, and net income.**

Statement of Cash Flows

- A period-to-date summary of sources and uses of the company's cash.
- Calculates the change in cash from the beginning of the period to the end of the period.
- Illustrates the sources and uses of the company's cash between three broad categories of activities.
  - **Operating activities** – Include the sales and operating expenses and related cash collected and paid.
  - **Investing activities** – Include primarily the purchase and/or sale of property, plant and equipment.
  - **Financing activities** – Include inflow of cash from banks and shareholders and the outflow of cash for debt repayments and dividends or distributions.

Improved Financial Statement Analysis

- **Improve your basic monthly financial statements.**
  - Include comparisons to prior years.
    - Statements should include fluctuations showing both dollar changes and percentage changes.
    - Income statements should present both current month and year-to-date amounts, as well as comparisons to prior years.
  - Provide the **appropriate** level of detail on the balance sheet and income statement.
  - Prepare reports for all meaningful divisions or locations.

Improved Financial Statement Analysis

- **Types of Financial Statement Analysis:**
  - Fluctuation analysis.
  - Common size financial statements.
  - Budgets and forecasts.
  - Ratio analysis.
  - Industry comparison.
  - Use of detailed financial reports.

Fluctuation Analysis

- Fluctuation analysis represents the study of changes in amounts from period to period.
- Analyze **<u>both</u>** dollar changes and percentage changes.
- <u>Use statements with fluctuation data presented</u>.
- Understand relationships among different balances.
  - These relationships can help to explain a significant fluctuation.
  - In addition, they can lead you to investigate why a balance **<u>did not change</u>** from year-to-year as expected based on changes in related balances.

Fluctuation Analysis –Budget Comparisons

- **It is difficult to run a business without a plan!**
- **Goals need to be established.**
- **It also critical that reports compare actual data to budgets**.
  - With appropriately detailed budgets, variances between actual and planned performance easily can be identified.
  - With proper analysis of the cause of the variance, management can respond to get operations back on track.
  - Too often significant time is spent preparing budgets that aren't used during the year.
  - Remember that budgets are only useful if they are used in analysis!

Common Size Financial Statements

- Common size financial statements are statements showing only percentages rather than dollar amounts. These percentages are based on a key amount on the statement.
- The common size ratios give a starting point. You can quickly get a feel for any unusual changes that have occurred, adjusted for the overall size of assets and the relative amount of sales.
- When comparing the financial statements of different companies, particularly if one is much larger, it is useful to prepare statements showing only percentages. By doing this, changes in proportions are clearer, making efficiencies and inefficiencies easier to identify.
- In addition, it is often effective to compare year-to-year financial statements of your company in percentages terms.

Common Size Financial Statements

COMMON SIZE BALANCE SHEETS

	2021	2020
Assets		
Current assets:		
Cash	2.4%	2.8%
Accounts receivable	28.2%	39.1%
Inventory	33.8%	26.1%
Prepaid expenses	3.1%	1.9%
Total current assets	67.5%	69.9%
Fixed assets	32.5%	30.1%
Total assets	100.0%	100.0%
Liabilities and Stockholders' Equity		
Current liabilities:		
Line of credit payable	4.6%	8.0%
Accounts payable	28.1%	25.2%
Accrued liabilities	20.1%	12.1%
Current portion of long-term debt	4.5%	5.1%
Total current liabilities	57.3%	50.4%
Long-term debt	17.5%	20.1%
Total liabilities	74.8%	70.5%
Stockholders' equity		
Common stock	0.9%	1.2%
Paid in capital	4.6%	6.1%
Retained earnings	22.5%	25.9%
Less: Treasury stock	-2.8%	-3.7%
Total stockholders' equity	25.2%	29.5%
Total liabilities and equity	100.0%	100.0%

Common Size Financial Statements

COMMON SIZE INCOME STATEMENTS

	2021	2020
Sales	100.0%	100.0%
Cost of goods sold:		
Materials	39.8%	41.2%
Labor	10.2%	10.4%
Overhead	18.3%	19.1%
Total cost of goods sold	68.3%	70.7%
Gross profit	31.7%	29.3%
Operating expenses	22.3%	22.4%
Income from operations	9.4%	6.9%
Other income (expense)		
Other income	1.2%	1.6%
Interest income	1.4%	0.8%
Interest expense	-4.5%	-5.1%
Total other income (expense)	-1.9%	-2.7%
Income before income taxes	7.5%	4.2%
Income tax expense	3.0%	1.7%
Net income	4.5%	2.5%

Ratio Analysis

- Financial statements can be analyzed using key financial ratios.
- Financial ratios are a numeric calculation involving the comparison of meaningful amounts from the financial statements.
- Ratios are not ends in themselves but provide insights into the operation of a business.

Ratio Analysis

- **They serve as “benchmarks” against which the company can evaluate itself and are typically only useful when:**
  - Compared with the same ratios for the same company from previous periods.
  - Compared with some predetermined standard.
  - Compared with the same ratios for other companies in the same industry.
  - Compared with average ratios for the industry within which the company operates.

Usefulness of Ratios

- In isolation, a financial ratio is a useless piece of information. In context, however, a financial ratio can give a financial analyst an excellent picture of a company's situation and the trends that are developing.
- Use these ratios to drive your company's strategies and shape its business plan.
- A ratio gains utility by comparison to other data and standards.
  - Taking our example, a gross profit margin for a company of 25% is meaningless by itself.
  - However, if we know that this company's competitors have profit margins of 10%, we know that the company is more profitable than its industry peers, which is quite favorable.
  - If we also know that it has been increasing steadily over the last few years, this would also be a favorable sign that management is implementing effective business policies and strategies.

Ratio Categories

- Financial analysts group ratios into categories, which tell us about different facets of a company's finances and operations.
- Following is an overview of some of the ratio categories along with formulas for key ratios.
- In additional to general ratios applicable to most companies, there are several ratios applicable to specific industries.

Leverage and Solvency Ratios

- Leverage ratios show the extent that debt is used in a company's capital structure.
- Solvency ratios give a picture of a company's ability to generate cash flow and pay its financial obligations.
- Formulas for important leverage and solvency ratios include:

$$\text{Debt to Equity Ratio} = \frac{\text{Total Liabilities}}{\text{Total Equity}}$$

$$\text{Interest-Bearing Debt to Equity Ratio} = \frac{\text{Interest Bearing Debt}}{\text{Total Equity}}$$

$$\text{Times Interest Earned} = \frac{\text{Net Income} + \text{Interest} + \text{Income Taxes}}{\text{Interest Expense}}$$

$$\text{Debt Service Coverage} = \frac{\text{Net Income} + \text{Interest} + \text{Depreciation} + \text{Amortization} + \text{Income Taxes}}{\text{Interest Expense} + \text{Current Maturities of Debt}}$$

Liquidity Ratios

- Give a picture of the company's short-term financial situation or solvency.
- These ratios provide an indication of the company's ability to meet its current obligations, which will come due in the next 12 months.
- Formulas for important liquidity ratios include:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$\text{Quick Ratio} = \frac{\text{Cash} + \text{Securities} + \text{Receivables}}{\text{Current Liabilities}}$$

Operational Ratios

- Use turnover measures to show how efficient a company is in its operations and use of assets.
- Formulas for important operational ratios include:

$$\text{Receivable Turnover} = \frac{\text{Net Credit Sales}}{\text{Average Trade Receivables}}$$

$$\text{Days Sales in Receivables} = \frac{\text{Ending Trade Receivables}}{\text{Net Credit Sales / 365 days}}$$

$$\text{Inventory Turnover} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

$$\text{Days COS in Inventory} = \frac{\text{Ending Inventory}}{\text{Cost of Sales / 365 days}}$$

Profitability Ratios

- Use margin analysis and show the return on sales and the capital employed.
- Formulas for important profitability ratios include:

Return on Equity	=	$\frac{\text{Net Income}}{\text{Average Owners' Equity}}$
Return on Total Assets	=	$\frac{\text{Net Income + Interest Expense (Net of Tax)}}{\text{Average Total Assets}}$
Earnings per Share	=	$\frac{\text{Net Income}}{\text{Average Number of Shares of Common Stock Outstanding}}$
Gross Margin	=	$\frac{\text{Gross Profit}}{\text{Net Sales Revenue}}$
Net Profit Margin	=	$\frac{\text{Net Income}}{\text{Net Sales Revenue}}$

Market Ratios

- Use stock price data, dividends, and earnings to analyze returns to a shareholder.
- Formulas for important market ratios include:

$$\text{Price/Earnings Ratio} = \frac{\text{Current Market Price per Share}}{\text{Earnings per Share}}$$

$$\text{Dividend Yield Ratio} = \frac{\text{Dividends per Share}}{\text{Market Price per Share}}$$

$$\text{Dividend Payout Percentage} = \frac{\text{Dividends per Share}}{\text{Earnings per Share}}$$

Medical Industry Ratios

- Formulas for important medical industry ratios include:

Gross Revenue Per Physician	=	$\frac{\text{Gross Charges}}{\text{Number of FTE physicians}}$
Net Revenue Per Physician	=	$\frac{\text{Net Charges}}{\text{Number of FTE physicians}}$
Average Patient Visits Per Day	=	$\frac{\text{Annual Number of Patient Visits}}{365}$
FTE Staff Per Physician	=	$\frac{\text{FTE Staff}}{\text{FTE Physician}}$

Design and Construction Industry Ratios

- Formulas for important design and construction industry ratios include:

Overhead Rate	=	$\frac{\text{Overhead (Indirect)}}{\text{Total Direct Labor}}$
Direct Labor Cost Per Chargeable Hour	=	$\frac{\text{Direct Labor}}{\text{Chargeable Hours}}$
Utilization Rate	=	$\frac{\text{Direct Labor}}{\text{Total Labor}}$
Multiplier	=	$\frac{\text{Net Fees}}{\text{Direct Labor}}$

Targeted Financial Ratios

- Use targeted financial ratios as a means to meet your company's goals for profitability.
- For example, accompany might target the following specific ratios:
  - Gross profit percentage – 24%
  - Inventory turnover – 8.5%
  - Return on equity – 16%
  - Days Sales on AR – 45 days
- Targeted financial ratios can be a useful part of your budgeting and long-term planning process.

Targeted Financial Ratios

- Continuous "improvement" of certain ratios is often not beneficial to the company or its owners. Take the following ratios, for example:
  - **Interest coverage ratio -** The interest coverage ratio compares the funds available to pay interest to the total amount of interest that has to be paid. The funds available for interest are the company's profits before interest and taxes.
    - **Creditor's perspective** - The higher this ratio is, the more comfortable creditors feel.
    - **Company's perspective** - From the company's point of view, whether an increase in the interest coverage ratio is an improvement or not depends on their attitude toward risk and profits.

Targeted Financial Ratios

- **Accounts receivable turnover ratio** - The accounts receivable turnover ratio identifies the number of times during the year the accounts receivable balance turns, or is collected.
  - A higher accounts receivable turnover indicates quicker collection of accounts receivable. This is generally a goal of most organizations.
  - If too much pressure is placed on the accounts receivable manager to improve collections, turnover may improve but profitable sales may be lost.
  - **Target level of accounts receivable turnover** - This is a ratio that you should try to improve to an acceptable level without losing profitable customers. Remember, the main goal is to increase profits and company value, not accounts receivable turnover.

Additional Guidance on Ratio Analysis

- Determine which ratios are relevant to your company.
- A single ratio or fluctuation will not give you enough information to make a judgment about the company. You must have additional data to make these judgments. The source of this data might be from comparing the ratios to the industry average or past company performance.
- Clearly, ratios can't be interpreted in a vacuum. The ratio merely points out what needs to be investigated. The ratio doesn't provide answers in and of itself.
- Document not only the ratios and fluctuations, but also your analysis and the conclusions that you reach.

Additional Guidance on Ratio Analysis

- Keep track of changes in ratios over time.
- Analyze *why* a ratio changed, don’t just explain the mathematical calculations.
- For instance, inexperienced analysts will often simply explain that accounts receivable turnover is down because receivables increased by more than sales.
- While that may be true, it is necessary to analyze why receivables increased by more than sales.

Industry Comparison

- In an industry comparison, we look at the company's performance in relationship to its competitors.
- By comparing the company to others, differences in their operating efficiency will show up.
- Once a problem is identified, the company can take action to correct the problem.
- Industry comparison **<u>must</u>** be part of your company's financial analysis.

Industry Comparison

- **Types of industry comparisons:**
  - Compare your company to industry average data.
  - Compare your company to selected guideline companies.
- **Data that can be compared to the industry:**
  - Financial statement amounts, such as sales volume.
  - Year-to-year fluctuations and trends, such as growth rate of sales.
  - Common size financial statements.
  - Ratios.

Industry Comparison

- **Sources of industry data:**
  - Risk Management Association (RMA) industry statistics.
  - Industry publications.
  - Filings for publicly traded companies.
  - Internet websites.
- **Selecting industry data:**
  - Identify comparable industry using SIC or NAICS code or description.
  - Obtain data for companies of a similar size.
  - Verify that guideline companies are truly comparable.

Industry Comparison

- **Key issues to consider:**
  - Consideration should be given to operational differences such as owning versus leasing of facilities.
  - Use the same time frame in making any comparison. If you don't use the same time frame, effects caused by recessions or seasonal fluctuations could result in erroneous conclusions or judgments.
  - Gain an understanding of the source of the industry data to verify that it is reliable.
  - Gain an understanding of the composition of the industry data to verify that it is relevant and comparable to the subject company.

Budget and Forecasts

- **It is difficult to run a business without a plan!**
- **Goals need to be established!**
  - Strategic planning is critical for all organizations.
  - The notion that a written, formal strategic/long-range plan is only for the larger, more established entities, is an erroneous one.
  - A simple written plan is a useful management tool for a company of any size.
  - The strategic plan must be the basis for short-term planning including annual budgeting and forecasting.

Annual Operating Budgets

- **Detailed monthly and annual budgets can be prepared within the accounting software.**
  - This allows for easy comparison to actual data.
  - However, flexibility is generally limited.
  - Care should be exercised not to budget in more detail than will be used in analysis.
- **Specialized budgeting software can be utilized.**
  - Actual data can often be imported from the accounting system.
  - Flexibility and reporting are generally very good.
  - Scenario analysis can be performed.
- **A high-level budget can be prepared in Excel.**

Compare Actual Data to Budget

- With appropriately detailed budgets, variances between actual and planned performance easily can be identified.
- With proper analysis of the cause of the variance, management can respond to get operations back on track.
- Too often significant time is spent preparing budgets that aren't used during the year.
- Remember that budgets are only useful if they are used in analysis!

Produce Detailed Financial Reports

- The basic financial statements are not sufficient to effectively manage the company!
  - A company must analyze more than just its balance sheet and income statement and the high-level ratios discussed above.
  - Detailed reports must be utilized by personnel throughout the company.
- Accounting software packages can produce many different detailed reports that can be tailored to the specific needs of your company.
- For all reporting, consider meaningful breakdowns, including by division, location, type of client, and type of product or service.

Detailed Reports

- Categories for detailed accounting reports include:
  - General ledger reports.
  - Subsidiary ledgers and reports.
    - Accounts receivable
    - Work in process
    - Accounts payable
  - Journals
    - Sales
    - Purchasing
    - Cash disbursements
  - Analysis reports broken down by meaningful criteria.
    - Geographic area
    - Product type
    - Manager
    - Customer

Customer Profitability Analysis

- **Why do you need to perform Customer Profitability Analysis?**
  - Do you know who your most profitable customers are?
    - Your biggest customers?
    - Your smallest customers?
  - Does higher gross profit margin for a customer always translate into higher profit?
  - Are overhead and administrative costs significantly different for different customers or customer segments? Do costs differ for:
    - Advertising
    - Sales
    - Distribution
    - Returns and allowances
    - Collection

Customer Profitability Analysis

- Quantify customer acquisition costs such as advertising, promotions, and direct marketing.
- Quantify distribution and administrative costs and identify activities that drive costs.
- Identify and assess customer behavior and purchase patterns.
- Evaluate your customer segments to determine cost differences by segment.
- Analyze specific customer’s behavior to determine differences in activity levels for cost drivers.
- Perform detailed analysis and quantify profitability for customer segments and/or specific customers.

Customer Profitability Analysis

- **Effective Customer Profitability Analysis allows you to:**
  - Nurture your profitable customers.
  - Work with less profitable customers to make them more profitable.
    - Educate your salespeople to avoid inefficient activities.
    - Change customer habits, especially those that provide no benefit to the customers.
    - Provide incentives to customers to promote desired behaviors.
    - The last resort-firing customers.
- **When combined with product/service profitability analysis and management of the product and service mix, the impact on bottom line profitability can be significant.**

Timing and Distribution of Reports

- **Financial reporting is only effective if the right people get the right reports!**
- **Frequency of reports.**
  - Reports should be produced at least monthly.
  - Depending on the capabilities of your systems and the nature of your business, more frequent reports may also be appropriate.
  - Revenue, staff utilization and other types of reports may be needed daily or weekly as explained below.

Timing and Distribution of Reports

- **Periods included.**
  - Current month.
  - Year-to-date.
  - Any other meaningful grouping, including possibly quarter to date or rolling twelve months.

Timing and Distribution of Reports

- **Report distribution.**
  - It is critical to determine which reports are relevant for specific personnel and groups of personnel.
  - Ensure personnel understand and are effectively using data.
  - Obtain feedback on how reporting can be improved.
  - Distribute electronically!

Timing and Distribution of Reports

- **Timeliness.**
  - Reports need to be provided soon enough to be relevant for decision making!
  - In no event should monthly statements take longer than two weeks into the following month!
  - Some reports, such as employee utilization, might be produced on a weekly or even daily basis.
  - If certain data or reconciliations delay the financial statements, make estimates and adjust in the following month.

Analyze and Take Action

- **Effective financial analysis is a four-step process:**
  - Prepare the proper reports.
  - Distribute the reports to appropriate personnel timely.
  - Perform analysis.
  - Make management decisions based on the analysis.

- **It is critical that actual analysis is performed.**
  - Unfortunately, many companies stop somewhere between step 1 and step 2!
  - Consider how much time is spent producing financial data versus the time spent using that data.
  - Make the time to perform analysis!

Analyze and Take Action

- **Financial analysis should be documented.**
  - This allows the analysis to be distributed to others in the company.
  - In addition, such analysis will be useful to the person performing as they do there work in future periods.
  - Such analysis can take many forms and you should consider what is easiest for the person performing the analysis and those that will use it. It could be in the form of:
    - E-mails.
    - Formal memos.
    - Notes in an Excel spreadsheet.
    - Explanations written in the margins of a report.

- **Financial analysis is only effective if you follow through by taking action based on your analysis.**

Conclusion

- **Effective financial analysis is a four-step process.**
  - Prepare the proper reports.
  - Distribute the reports to appropriate personnel timely.
  - Perform analysis.
  - Make management decisions based on the analysis.
- **Evaluate the financial analysis performed by your company.**
  - Consider whether the proper reports are being produced and whether they are being distributed to the appropriate people.
  - Review the actual financial analysis that is performed and consider improving the documentation of this analysis.
  - Be sure that action is taken and decisions are made based on the financial analysis that is performed.

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