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FINANCIAL PERFORMANCE APPRAISAL

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2.1 WHAT IS FINANCIAL APPRAISAL :

Financial appraisal is an objective evaluation of the profitability and financial strength of a Business unit. Many a times, the terms financial performance appraisal and financial statement analysis are used as synonymous. The techniques of financial statement analysis are used for the purpose of financial appraisal. Therefore, financial appraisal is the process of scientifically making a relevant, comparative and critical evaluation of the profitability and financial health of a given firm through the application of the techniques of financial statement analysis. The accounting system is concerned with the classification, recording, summarizing and presentation of financial data. This data is analysed for the purpose of evaluation and appraisal of the performance.

Financial statement analysis attempts to unveil the meaning and significance of the items composed in profit and loss account and the balance sheet so as to assist the management in the formation of sound operating financial policies.¹

Undoubtedly, the analysis and appraisal of financial statements reveal the significant facts relating to financial strength, profitability, corporate efficiency, weaknesses, managerial performance, solvency and other such factors relating to a company. The technique of appraisal is applied to the analysis and study of accounting data with an idea of answering the questions like : (1) Is investment in the company safe ?

(2) Does the company earn adequate profit ? (3) Is the company solvent enough to meet its obligations whenever they mature ? (4) Does the company earn enough to build reserves for future growth ? (5) Is the company properly capitalised ? To quote Roy Foulke : If a train is moving forward at known rate of speed, it is reasonable to assume that it will continue to move at approximately the same rate unless some obstacle interrupts its progress abruptly or the motive power is increased or decreased. Similarly it is reasonable to assume that unless some drastic change takes place in a business, it will continue to move in the same general direction as indicated by its comparative trends.²

Appraisal is the useful measure of past performance. The source data, that is Management Information System is meant (1) to ensure adequate profitability. (2) to have an early warning of something going wrong. (3) to have basis for allocation of resources. (4) to evaluate managers. Performance evaluation is a central feature of an effective management information system. In a way, financial analysis is Decision information system. The appraisal is the evaluation of worth, quality and performance. The performance is evaluated with source data to check the quality of performance as well as to form a judgment of probable future performance. Appraisal of past answers two basic questions : (1) How well has the business done in comparison with what could be evaluated ? (2) What can be done to improve the future performance ? With this reference : Financial appraisal is a scientific evaluation of the profitability and financial strength of a business concern. Financial appraisal is the process of scientifically making a proper, critical and comparative evaluation of the performance, i.e. the profitability and financial health of

any business enterprise through the application of the techniques of financial statement analysis. Financial appraisal is a process of evaluating the summarized financial and business data to obtain a better understanding of a firm's position and performance.³

The first logical step towards financial analysis is the interpretation of financial statements. The basic data which are analysed are found in the financial statements. The ability to understand, analyze, interpret and use of information given in the financial statements depends upon the understanding of accounting and finance. With reference to this the definition of Accounting is worth noting : Accounting has identified wealth and performance as phenomena for which measurement and communication are warranted. Wealth is measured by direct attention to an entity's owners' equity and performance is measured by focusing on the effect of an entity's operating transactions on its owners' equity. The medium through which such information is communicated is known as financial statement.⁴

The American Institute of Certified Public Accountants defines accounting as the 'art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character and in interpreting the results thereof.'

Accounting is the science of recording and classifying business transactions and events, primarily of financial character, and the art of making significant summaries, analysis and interpretations of those transactions and communicating the results to the persons who must make decisions or form judgements.⁵

Accounting is a service activity. Its function is to provide quantitative information, primarily of financial nature about economic entities but are intended to be useful in making economic decisions, in making reasoned choices among alternative courses of action. (AICPA).

Financial statements are prepared for the purpose of presenting a periodical review or report by the management and deal with the status of investment in the business and the result achieved during the period under review. They reflect a combination of recorded facts, accounting conventions and personal judgment and conventions applied which affect them materially. The soundness of the judgment necessarily depends on the competence and integrity of those who make and on their adherence to generally accepted accounting principles and conventions.⁶

The basic purpose of financial statements is to transmit reliable and useful information to interested groups, both external and internal.⁷

The analysis and interpretation of financial statement is the last of four major steps of accounting. The first three steps, which involve the work of the accountant in the accumulation and summarization of financial and operating data and in the construction of financial statements, are as follows:

- 1) Analyse of each transaction to determine the accounts to be debited and credited and the measurement or valuation of each transaction to determine the amounts involved.
- 2) Recording the information in books of original entry, summarization in ledger, and preparation of a trial balance.
- 3) Preparation of financial statements.

All the above definitions and explanations reveal the fact that

Accounting is an information system where the process of identifying, measuring analyzing and communicating of the economic information of an organization to the users is involved. This monetary and financial data, information and statistics are used by various users who need it for various purposes. This is a basic data which is analysed, assessed and relevant conclusions are drawn with considered approach and an objective in mind. Accounting measures the transactions and events in terms of a common measurement unit. In a way, Accounting performs a basic function of a language by serving as a means of communication. It is an information system which communicates the financial/accounting information to the internal and external users to enable them to make reasoned decisions. In that sense, it is an input-output device which involves the important phase of processing the information encompassing recording, classifying, summarizing ,analyzing and interpreting of the facts and figures concerning any entity covering a specified period.

The basic function of recording has to ensure that all business transactions of financial character are recorded. This should be performed in an orderly manner. As per the nature and size of business, these books of basic records will have to be maintained. The next step of classification is concerned with the systematic analysis of the recorded data with a view to group transactions or entries of one nature at one place. This involves various Ledgers, which is the basic Book of accounting. Ledgers help in getting one figure/data relating to an account/item at one place. Hereby instant data is available without loss of much time. All such data is to be presented in an orderly manner which is

understandable and useful to the internal as well as external end-users. This is the summarizing function of the process. This will create two basic statements called income statement (profit & loss Account) and financial position statement (Balance sheet). These are also called financial statements.

Process of financial appraisal :

The data for financial analysis and appraisal basically emerge from financial statements. Such analysis covers :

- (1) Segregating of individual components of financial statements and groups of specified elements duly defined so that the computation can be clearly ascertained for checking and accuracy. The data contained in the income statement and the balance sheet are to be completely recast and presented in a condensed and unified form.
- (2) To establish significant relationships between the individual components of income statement and balance sheet. This is done through application of the tools and techniques of financial analysis.
- (3) Evaluation and interpretation of the comparative data obtained by application of the tools of financial analysis.

The analysis and interpretation of financial statements represent the last of four major steps of accounting. The first three steps involve : (1) analysis of each transaction to determine the accounts to be debited and credited and the measurement or valuation of each transaction to determine the amounts involved. (2) recording the information in books of original entry, summarization in ledger, and preparation of a trial balance. (3) preparation of financial statements. The fourth step of

accounting – the analysis and interpretation of financial statements – results in the presentation of information that will aid business executives, investors and creditors. The process of analyzing financial statements involves the compilation and study of financial and operating data and the preparation and interpretation of measuring devices such as ratios, trends and percentages. Analysis of statements consists in separating facts according to some definite plan, arranging them in groups according to certain characteristics, and then presenting them in a convenient and easily read and understandable form. In this way the analyst attempts to determine the significance and meaning of the financial statement data.

The financial statement figures consist not only of account balances, which usually are the result of many debit and credit entries for a variety of transactions, but also combinations of account balances. As a result, the figures often do not represent homogenous data. The accounting data is the result of countless transactions taking place right from beginning of the ledger till the last date of the accounting year. For proper interpretation, many a times this requires analysis of the data. For example, the claims of a business firm against Sales made are quantified under the head of debtors. But this absolute figure may not be of much utility in the sense that it is relevant to verify the position of debtors who have not paid for last 30 days, 60 days, 120 days, 180 days and so on. Such data only would be more meaningful to the management of the firm for taking a suitable decision. Interpretation requires comparison also. Mere examination of the components of a statement cannot be expected to lead to definite conclusions in regard to the financial status of a

business. After the statement has been dissected into its constituents, it is necessary to measure the relative magnitudes of the various items. For example, the current liabilities of a certain business at a particular date is a particular amount, and an opinion is desired as to whether it is probable that the business will be able to meet these obligations, the amount of the liabilities may be compared with the amount of assets that the business has available to pay them : the cash and such assets as receivables and the goods that will be converted into cash in the normal operation of the business during the coming year. If this amount is higher, the analyst would probably consider the debt-paying ability of the business satisfactory. However, on aging the amounts payable and receivable, if it is noticed that current liabilities become due before a sufficient amount of cash would be received from customers to pay them, the situation turns to be unsatisfactory.

It is thus seen that in order to interpret the position of an enterprise it is necessary not only to separate the totals given in its financial statements into their components but also to make comparisons of the various components and to examine their content. In addition, a study of the changes that have occurred in the business over several periods should be made., such a study is carried out by examining the trends of the various important factors in a series of statements. Financial statement analysis is, therefore, largely a study of relationships among the various financial factors in a business, as disclosed by a single set of statements, and of the trends of these factors, as shown in a series of statements.⁸

2.2 HISTORY OF FINANCIAL PERFORMANCE APPRAISAL :

The need for a summary of the accounts of a business enterprise was appreciated from the beginning of Accounting. Luca Pacioli, the author of the first published accounting treatise (published in 1494) insisted for the preparation of summaries, which he called ‘ inventory.’ In the sixteenth century the summary of the accounts was made an integral part of the ledger in the form of a balancing account. When the business enterprises were operating on a small scale, the summary contained in the balancing account was sufficient to show the results of operations which were referred to by the proprietors or partners. As the business enterprises assumed larger proportions during the latter part of the Nineteenth century and corporations began to have many investors, it became necessary to make copies of accounting summaries for distribution to all the shareholders, and so the balancing account was developed into the contemporary balance sheet. The forms used today for preparation of the financial statements were developed in the beginning of the twentieth century.

Until about the end of the Nineteenth century, financial statements were regarded merely as a proof of the bookkeeper’s work. By end of the Nineteenth century the bankers started insisting on their clients to submit the balance sheets on which they were basing their decisions for credit appraisals and approval. In February, 1895 New York State Bankers’ Association adopted a resolution insisting for getting a signed statement of assets and liabilities from the borrowers to be analysed by them for their decision to approve the credit. In 1900 the Association published a standard form for application for credit which included space for a

balance sheet. Certain bankers were using comparative statements also. An author referred : The statements must be thoroughly analysed by the credit manager by study and comparison : their weaknesses watched for and their strong points noted – he must understand them fully.⁹

With the passage of time, the standards of comparison like insisting for certain minimum quick ratio were developed. After banking and credit, there was awareness of reliance on data and objective analysis of such data developed among the investors in industries like railroads, automobiles and others. Certain books and publications were published containing what they called modern analytical methods. The Art of Wall Street Investing by John Moody published in 1906 is worth mentioning. However, such analysis and reliance on logical accounting data was not followed by all the bankers. This was brought out in the study of special committee appointed by Federal Reserve Board in 1910. The Federal Reserve system was established by Federal Reserve Act, 1914 and rediscounting of the banks was allowed. In 1913 there was a revolt by the borrowers against the supremacy of current ratio as a criterion. In certain publications, it was mentioned that other things also need to be considered by the bankers in addition to the current ratio. It was stressed that other ratios, further analysis of financial statements, business conditions etc. are also relevant.

The presentation of an elaborate system of ratio analysis was made in 1919 by Alexander Wall, who published an article in which he criticised the bankers who based decisions in regard to granting of credit on current ratios alone. He pointed out that, in order to get a complete picture, it is necessary to consider relationships in financial statements

other than that of current assets to current liabilities. The relationships that he described might be measured quantitatively and used as checks on the current ratio. Wall became one of the foremost proponents of ratio analysis and elaborated his methods in several volumes.¹⁰ In 1923, the preface to a book by James H. Bliss stated that in every branch of industry there are certain characteristics financial and operating ratios, depending upon the nature of its activities. Such ratios might be determined by averaging the ratios of the concerns in the industry and that to enjoy the average measure of success a concern must approximate these ratios.

Subsequently, there has been so much of studies and improvements in the subject of ratio analysis. This technique is used and relied by so many analysts for various purposes and extensively used by the top management personnel, particularly in the field of accounting, costing and finance, in almost all industries.

The ratio measurements used in financial statement analysis falls in two groups. (1) those which measure the relationships among the items in a single set of statements, and (2) those which measure the changes in these items in successive statements. The first is a static analysis, measuring position at a point of time or for a period, the second is a dynamic analysis, measuring change of position.

In 1925 Stephen Gilman propounded a different type of analysis. This was dividing the magnitudes of significant items or groups of items in each of a series of statements by their magnitudes in one year in the series selected as the base, thus obtaining a series of trend relatives to the base year. This was trend analysis. Gilman argued that trend analysis was

comprehensive and presented broad view of the balance sheet relationships.

The history of the growth of financial statement analysis technique reveals that it has been developing over a period of more than eight decades. From the crude beginnings of rough comparison of statements in the beginning to the use of fairly definite procedures, employing latest scientific ways of analysis has gradually evolved. There are varied improvements in the classification, terminology, arrangement and presentations in the financial statements. In recent years the annual reports of well known companies have changed from merely formal, technical documents to attractive and interesting treasures of financial and business statistics. Instead of being directed merely to the shareholders, the modern reports are also prepared to interest general public, customers, government agencies, financiers, investors and the employees. The reports contain not only financial statements and other statistics, but also stories with respect to the company's activities, future programs, economic setting of the company, strengths, employees, technology, productivity and future strategy and vision of the company.

In the later part of the twentieth century, the content and presentation of the company annual reports have been thoroughly improved and recast to meet with the need of the time, to protect the investors as well as to improve the utility of annual financial statements and the annual reports. Directors report, Management discussion & analysis, MAOCARO audit report (now CARO Report, 2003), details of technology, energy conversation, various notes and details covering the corporate governance, notes and schedules to income statement and the

balance sheet, balance sheet abstract and company profile, cash flow statement, graphical and statistical details (like details of important parameters for last decade), compliance/reporting details relating to accounting standards today make the annual reports the statistical treasures for the management as well as various outside users of the data. These reported facts and data are being used to work out various ratios and other relevant analysis by the top management with reference to the issue before them for decision making. This data is also relied on by the investors in stock market, the banker of the company, financial institutions who sanction medium term and long term loans to the companies, trade associations, creditors, revenue authorities like income tax department, excise dept., competitors, customers, other govt. agencies interested in the activities of the company like the registrar of companies, rating agencies and research agencies.

Methods of Financial analysis :

The analysis and interpretation of financial statements is an attempt to determine the meaning and significance of the financial data to check the performance in past, forecast for the future business performance and verifying the financial strength of the firm. In other words, financial analysis is the evaluation of a firm's past, present and anticipated future financial performance and financial condition. Its objectives are to identify the firm's financial strengths and weaknesses and to provide the essential foundation for financial decision making and planning. The broad methods of analysis are :

- (1) **Horizontal analysis** : This is the comparison, analysis and interpretation of a similar item of a financial statements relating to two different accounting periods.
- (2) **Vertical analysis** : This is comparison, analysis and interpretation of two items or variables of financial statements relating to the same accounting period.
- (3) **Static and dynamic analysis** : Static analysis measures the relationships among the items in a single set of statements. Dynamic analysis measures the changes in such items in successive statements. Static analysis is vertical analysis and dynamic analysis is horizontal analysis.
- (4) **Internal and external analysis** : The internal analysis is the analysis of financial data by the management of the enterprise itself for internal decision making. External analysis means the analysis of the data from the financial statements done by any outsider like investors, banker, government revenue authority, any creditor, customers and others for taking a relevant decision.

2.3 TECHNIQUES OF FINANCIAL ANALYSIS :

Various techniques (also called tools) of financial analysis which have been frequently used and have become popular are :

1. **Ratio analysis** : A ratio is an arithmetical relationship between two figures. Financial ratio analysis is a study of ratios between various items or groups of items in financial statements. Ratios can be worked out to verify the profitability, liquidity, solvency, leverage, valuation and turnover of the firm.

- 2. Trend analysis, Common size statement analysis and comparative statement analysis :** Trend analysis is concerned with dividing the magnitudes of significant items or groups of items in each of a series of statements by their magnitudes in one year in the series selected as base, thus obtaining a series of trend percentages or relatives to the base year. By studying the variations from base year, a comprehensive view of the business can be obtained.
- 3.** Another variation is preparing common size financial statements, that is, common size income statement and common size balance sheet. For this, all items of the statement are compared with one common item, which is significant. For instance, in the income statement, sales may be taken as 100 and all other items in the statement are compared as percentage of sales. Similarly, in case of balance sheet the relation of each item to total assets/total liabilities is computed. Such common size statements or 100 % statements give useful proportions of each component of the total. The study of proportions and trend in the composition of proportions of various item and the meaning as well as reasons of changes of proportions can be analysed for relevant study. Trend analysis and common size statements will help in inter firm comparison.
- 4. Funds flow analysis :** Funds flow analysis or the statement of sources and uses of funds shows the sources of funds and applications of funds during the period. Funds flow analysis provides insight into the movement of funds and helps in understanding the changes in the structure of assets, liabilities and owner's equity.

5. **Cost - volume - profit analysis :** Cost volume profit analysis is an important tool of profit planning. It analyses the interrelationships of changes in profit when the volume of output is changing and ultimately the variable cost and fixed costs are also changing. It is a tool which analyses profitability under various situations having different volume of activity. This profit planning tool is also called break even analysis. It helps the management in taking relevant decisions under different levels of manufacturing activity, different prices and ultimate effect of the behavior of fixed and variable costs which make up the total cost at different levels of business activity. It helps in quantifying and understanding the various components of costs under different situations and hence become a guide for future planning of business and profit.
6. **Index Analysis :** In index analysis, the items in comparative financial statements (income statement and the balance sheet) are expressed as an index relative to the base year. All items in the base year assume a value of 100. This type of analysis facilitates comparison of progress or down trend of activities over a period, since various years' figures/performance is compared with 100.
7. **Leverage analysis :** As a general concept, leverage represents influence of power. In financial analysis leverage represents the influence of one financial variable over some other related financial variable. Financial leverage measures the effects in earning per share on account of changes in book profits. Operating leverage measures the effects in profit on account of changes in quantity produced and sold. Total leverage, that is, the combined

effect of financial and operating leverage can also be analysed. This will help in understanding the cost behaviour and level of activity for profit planning and strategic decisions.

- 8 Balanced Scorecard :** Now as a new development, most companies have a performance measurement system that includes financial measures as well as non financial measures. Financial measures are used primarily by senior management to monitor the performance of the firm as a whole. Non financial measures are employed mainly by operating managers to control short term operations. This integrated measurement framework is developed recently containing financial and non financial performance measures. The technique of Balance scorecard is strategy driven measure. In modern times, measurement focus of the scorecard is used to accomplish critical management processes. This tool of analysis focuses four important perspectives in a business, namely financial, customers, internal business and learning and growth. The technique of balanced scorecard links the objectives and measures thro cause and effect relationships existing in business. This way it is a comprehensive analytical tool of business activities measurement and performance appraisal.

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