THE INTERNATIONAL JOURNAL OF
BUSINESS & MANAGEMENT

Key Financial Indicators for Growth and Competitiveness

Anish Buche
India

Abstract:
The smooth running of a business depends a lot on how effective the cash flows of the company are being managed. Managing the receivables and payables i.e. Working Capital Management of the company is of prime importance for day to day activities. Managing the long term investment decisions is also important for the growth and future objectives of the firm.
This paper deals with the importance of key financial indicators for a firm's growth and to sustain in the competitive environment. The approach has been divided into two parts viz. Short Term Finance Management and Long Term Finance Management, along with the Key Financial Performance Indicators for both the approaches.

Keywords: *Finance management, working capital management, capital budgeting*

1. Introduction

The importance of effective finance management has always been there right from the barter system of trading and also in present era of currency system. In fact, proper currency rate management is also an important tool for reducing the risk arising due to ex-change rate fluctuations, as they directly affect the firm's income.
Having a proper working capital management in place is very important for a firm's day to day working. The major areas to be concentrated for effective working capital management are Receivables Management, Payables Management and Inventory Management.
Effective Financial Management also deals with proper Capital budgeting decisions for company's future plans from the expansion as well as investment point of view. For e.g. if a firm is desirous of expanding its manufacturing facilities, this would form a part of capital budgeting decision. The decision considers calculation of projected Financial Statements from the newly unit to be setup and calculating the Financial Indicators such Net Present Value, Internal Rate of Return, Debt service coverage ratio etc. using the Free Cash Flow to Firm and Free Cash Flow to Equity Models. The methodology mostly preferred for calculation of Net Present Value from the Free Cash flow models is the Discounting Cash Flow technique.

1.1. Working Capital Management Analysis

The financial analysis of the companies from the short term point of view consists of analyzing the Liquidity Ratios and other profitability ratios.

1.1.1. Ratio Analysis

Keeping a proper track of Liquidity Ratios of a company gives a significant initial picture of the working capital position of a company. Few of the major liquidity ratios of a company which need to be observed are:

1.2. Current Ratio

It is the ratio of Current Assets to Current Liabilities of a firm. The significance of this ratio is how well the Current assets are able to finance the Current liabilities of a firm. Higher the ratio, the better it is. At times excessively high ratio might not also be good for a firm as the firm has lots of cash locked in account receivables or there may be lot of idle cash lying in company's accounts.

The current ratio should be analyzed by comparing the same with the industry standards of that particular sector in which the firm is operating. The Business Cycle varies from sector to sector and thus the ratio standards are different as per sectors. In general, the minimum required current ratio for a firm should be around 1.5 to 2 in order to meet its current liabilities requirement.

1.3. Turnover Ratios

The two prime turnover Ratios which need to be studied for understanding the Liquidity position of the firm are Receivables Turnover Ratio and Payables Turnover Ratio.

→ Receivables turnover ratio is calculated by dividing the net credit sales for a given time period by the average accounts receivables in that period. The significance of this ratio is to understand a company's ability to convert its credit sales in to cash inflows. Dividing 365 by this ratio gives the no of days of receivables outstanding.

A higher receivables turnover indicates the company is properly able to convert its receivables into cash flows and a lower ratio shows that a lot of cash which is due to company is blocked in the form of receivables. However excessive higher ratio indicates that the company has a very strict credit policy and this can be a barrier for developing a strong and wide customer base for the company.

→ Payables Turnover ratio is calculated by dividing the net purchases for a given time period by the average accounts payables for that time period. The importance of this ratio is to understand a company's ability to repay its current liabilities. Dividing 365 by this ratio gives the no of days of payables outstanding.

A higher payables turnover indicates the company is properly able to repay its current liabilities in a given period of time and vice versa. However excessive higher ratio indicates that the company has very strict policies due to which it is not able to maintain the sufficient cash balance required for its expenses.

Thus in order to have a proper working capital cycle, the company should have a properly receivables and payables system in place.

Apart from the working capital ratios, the other ratios which are important from the company's financial perspective are the profitability ratios. The important profitability ratios which are considered for short term financial analysis of the company are:

1.4. EBITDA Margin

The ratio of Earnings before Interest Tax Depreciation and Amortization to the total revenue is termed as EBITDA Margin. The basic motive of the ratio is to analyze the efficiency of the company for managing its basic operating costs.

1.5. Net Profit Margin

The ratio of Net profit to the total revenue of the company is termed as net profit margin. The Net profit margin is very important ratio from the overall performance of the company's perspective as it is the net cash inflow to the company after meeting up all its costs. Generally, for a short term investor, Net profit margin plays significant role.

2. Capital Budgeting Decisions

Every firm that is in operation consists of its well defined vision and mission statement. During the operational phase of the firm, all the major decision related to firm expansion or diversification or Selling off an Asset etc. are taken considering the predefined future plans associated with it. The decisions which are taken from long term perspective of the firms or the long term investments whose benefits are expected to be received for a more than a year are classified under Capital Budgeting Decisions.

In order for an organization to take proper decision from the long term perspective, the most preferred method for valuating a decision the Discounted Cash flow valuation technique. The DCF technique is used for calculating Net Present Value and the Internal Rate of return.

For calculating the Discounted Cash Flows, the most important parameter needed is the discount rate or the cost of capital. The discounted rate is calculated based on the capital structure of the project and the same is calculated by using weighted average rate.

*2.1. Discount Rate = (% of debt) *(Cost of Debt) *(1 – tax rate) + (% of Equity) *(Cost of Equity)*

The Cost of Debt used is post of tax rate as the interest cost on the debt availed is tax deductible.

2.2. Net Present Value

The Present Value of the Future Projected Net cash flows of a firm is termed as the Net Present Value. The Future projected cash flows are arrived based on the Projected Revenue and Costs associated, which are used to arrive at the Net Cash flows.

The Net Cash flows are discounted to get the Net Present Value. If the NPV obtained is positive, the project is a viable and if the NPV obtained is negative, then project is unviable.

2.3. Internal Rate of Return

The Internal Rate of Return or IRR is the discount rate at which the Net Present Value of the Project is zero. If the IRR calculated is greater than the Cost of Capital, then the project is viable and if the IRR is less, then the project is unviable.

The advantage of IRR calculation is that it shows the result is percentage which is the most desirable form of outcome for an investor, as it helps him to compare the return with the cost of capital.

The Internal Rate of Return calculated from both the Debt and Equity investor is term as Return on Capital Employed and the internal rate of return calculated from the Equity investor's perspective is term as Return on Equity.

The calculation of IRR can be complex at times when the project is having uneven cash flows as the generation of uneven cash flows may result is two IRRs for the project.

2.4. Profitability Index

The ratio of the present value of the generated cash flows to the initial investment of the project is termed as profitability index (P.I).

$$\text{Profitability Index} = \frac{\text{PV of Future Cash flows}}{\text{Initial Investment}}$$

If the index is greater than 1.0, then project is considered financially viable and if less than zero, the project is considered financially unviable. The basic advantage of this index is the ease of calculation as it involves the calculation of the only the required ratio.

2.5. Other Important Long Term Indicators

In addition to the key indicators elaborated above, in context of the long term analysis of the company, the other key performance indicators which help in analyzing the company from long term perspective are:

2.6. Asset Turnover Ratio

The ratio of Revenue to Average Assets is termed as Asset turnover ratio. This ratio tells us the Revenue generated by the Assets of the company. Higher the ratio, the more is the efficiency of assets for generating revenue.

$$\text{Asset Turnover Ratio} = \frac{\text{Total Revenue}}{\text{Average Assets}}$$

2.7. Debt Service Coverage Ratio

This ratio has its significance only when the company has long term debt obligations in its balance sheet. The Debt Service Coverage Ratio (DSCR) is used to analyze the debt repaying capacity of the firm. If DSCR is more than 1, the company has sufficient cash flows to repay its debt and if DSCR is less than 1, the company has insufficient cash flows to repay its debt. The following formula is used to calculate DSCR

$$\text{Debt Service Coverage Ratio} = \frac{\text{Profit after Tax + Interest + Depreciation}}{\text{Principal + Interest}}$$

3. Conclusion

For analyzing the financial effectiveness of a company, both short term and long term financial analysis play a crucial role for company financial effectiveness.

As short term analysis shows the efficiency of the company from its day to day operations point of view, the long term analysis shows the pace or its ability to grow and sustain in the competitive world.

Many companies' financial performances were analyzed in order to understand the most important parameters which need to be considered for short term and long term financial analysis

The key financial indicators for short term and long term analysis of a firm were discussed in this paper and for a strong financial base, the analysis of these indicators play a critical role for sustenance of the firm in the global competitive world.

4. References

i. Ms. Praveen Kaur, Importance of Finance Management for growth of Organization, IPASJ International Journal of Management (IIJM), Volume 2, Issue 9, September 2014

ii. Pedro M. Kono, DBA and Barry Barnes, PhD, The Role of Finance in the Strategic-Planning and Decision-Making Process, 2010 Volume 13 Issue 1, Graziadio School of Business and Management | Pepperdine University

iii. Karl Kepner and Allen Wysocki, Finance Management: Some Important Generalizations, University of Florida FRE343

iv. Samuel Okurebia & Etimfon Offiong, The Role of Financial Director in Effective Treasury Management, ISSN (E): 2321-886X; ISSN(P): 2347-4572, Vol. 3, Issue 3, Mar 2015, 109-120, © Impact Journals

v. Nurulhasanah Abdul Rahman*, Zulnaidi Yaacob, Rafisah Mat Radzi, Determinants of Effective Financial Risk Management in Small Business: A Theoretical Framework, Information Management and Business Review Vol. 7, No. 2, pp. 87-92, April 2015 (ISSN 2220-3796)

vi. Bryan Ziegler, Finance Management for the growing business, U.S. Small Business Administration