CHAPTER 4

CONCEPTUAL FRAMEWORK OF STRATEGIC FINANCIAL PERFORMANCE

The Indian software industry plays a significant role in the national economy generating substantial revenue for state and central government through income tax and service tax is an object of essential importance in all developmental activities. As one of the major industries, software industry contributes substantially to India’s industrial and economic development. To every development activity, from the operation of a small factory to the function of multi-purpose projects software is a momentous technology. Hence, it is ranked precisely as a necessary service industry.

The Indian Information Technology industry has not only been amongst the fastest growing industries globally, it has played a key role in transforming India from a mostly inward-looking economy to an emerging dynamic and entrepreneurial in the world. In 1991, the IT industry was modest sized, employing 12000 persons, and contributing an insignificant part of GDP. Between 2000 and 2004, it had emerged as the largest incremental contributor to GDP, with 6 percent coming from this sector. Around 95 percent of the absolute growth in foreign exchange inflows in the service sector during this period is estimated to have come from the IT and BPO industries alone.

Information Technology has emerged as the leader for financial growth in India because each development in computer technology has offered new opportunities for business. With many Indian businesses having their competitive edge in the global market by using IT as a key enabler. A
NASSCOM study has found that about 35 percent of the organizations have moved to a level where almost all processes have been automated. The NASSCOM IT User Survey 2005, which covered 300 organizations, has reported that 85 percent of the organizations believe that they have been able to derive benefits out of the IT implementation. Assessing the impact of IT implementation on the company productivity, the survey said 80 percent of the respondents felt that they have been able to trace productivity enhancements within their organizations.

The software industry in India has brought a marvelous triumph for the mounting national economy. The software industry is the core constituent of the information technology in India. Currently, there are about 135 software firms in the India which show the immense expansion that the Indian software Industry has experienced. In late 1990, Indian software boom has started. The Indian software boom started with the manifestation of Y2K predicament when an enormous number of the skillful workforce were required to accomplish the massive database-correction demand in order to deal with the arrival of the new millennium. The Indian IT services profile has been experiencing a transformation in the recent years, partly as it stirred up the value chain and partly as an outcome to the market dynamics. A decade ago, nearly all US companies would not even think about outsourcing some of their IT projects to external vendors. Now a decade later, a vast majority of the US companies employ the professional services of Indian software engineers in some mode through giant, middle or little companies or through folks recruited directly. The market contest is forcing companies to reduce overheads of products. The specialized IT services, on the contrary are progressively more expensive. The offshore software development model is the current trend whereas onsite professional services were a decade ago.
Software Industry in India has developed from the meager US $ 150 million in 1991-92 to the astounding US $ 5.7 billion in 1999-2000. None of the Indian industry has made so well against the international competition. According to statistics, software exports in India have achieved total revenues of Rs.46, 100 cores. The total share of India’s exports in the global market raise form 4.9 percent in 1997 to 20.4 percent in 2002-03. Two decades ago, software boom in India has started. Despite the global economic slowdown, in the Indian Information Technology, software and services industry is sustaining a steady speed of expansion. Software development activity is not restricted to a few cities in India, software development centers are made in the Metros like Delhi, Mumbai, Chennai and Kolkata and in non-metro cities like Bangalore, Hyderabad, Pune, Chennai, Calcutta, Noida, Gurgaon, Vadodara, Bhubaneswar, Ahmadabad, Goa, Chandigarh, and Trivandrum too are all growing rapidly.

Indian Government had a very important part in the advancement of the software Industry in India. In 1986, the Indian government broadcasted a new software policy which was intended to serve as a channel for the software industry. This was pursued in 1988 with the World Market Policy and founding of software Technology Parks in India (STP) scheme. Further, to draw foreign direct venture, the Indian Government permitted foreign equity of up to 100 percent and duty-free import on all inputs and products.

For sourcing software and IT enabled services, India has emerged as one of the most favored destinations. In contrast to other low-cost locations, India ranks high in numerous significant parameters including the height of government support, the superiority of the labor pool, cost benefit, entrepreneurial civilization, strong client relationships and exposure to innovative technologies. As per the ‘Top 20 IT software and service Exporters in India’ ranking by NASSCOM, TCS topped the list followed by Infosys,
Wipro, Tech Mahindra and HCL. These five companies have been consistently maintaining their ranks in the same order since 2002-2003.

When Indian software product companies were marking a considerable advancement in overseas markets such as West Asia and Africa, the $4.8 billion domestic in the market, with a vigorous forecast of a 25 percent growth continues to prove exclusive for the majority of the companies. These home based companies experienced that in spite of the advantages attached to preferring Indian vendors, together with their profound understanding of the home markets, and guarantee of strong onshore support, a measured result making procedure, excitement of the Indian consumer to opt for products offered by international companies and at times vast product price cuts offered by Multinational players to grasp considerable masses of market share, are features that are quoted as some restrictions when it move towards doing IT business in their individual market.

It is usual to find foreign players presenting enormous reductions to gain marketplace share. Known the economical proficiency of the Multinational companies in India finds it hard to combat on this features. The industries experienced this is for the reason that the international companies, while creating inroads into a new marketplace, may not be looking for profitability on each deal. In several cases where foreign joint venture partners are involved, particularly in the insurance business, the abroad companies may wish to go with an additional noticeable standard product from the worldwide market rather than opting a local one. Indian companies are, in fact, in a better position to serve customers in the local marketplace, but known the obstacles, product turn out to be a tough business in the Indian market.

The most high profile and commonly understood services in the ITES area are the call centers and the medical transcription services. ITES also
includes several other services via, Customer interaction services, Business Process Outsourcing, Back Office Operations, Transcription and Translation Services, Legal Databases, Digital Content Animation, Website Services, Remote Education, Data Digitization, Global Information Systems and Market Research.

4.1 Financial Structure of the Software Industry

The most important focus of financial structure analysis in the software industry centers on the following aspects:

- Source of finance.
- Structure of finance.

- Sources of Finance in the Software Industry

The sources from which capital is raised may be conventionally divided into two categories, viz., internal sources and external sources.

- Internal Sources

Internal sources refer to the funds generated within the company and they contribute significantly to the financing and growth of companies in general. The performance of internal funds minimizes solvency risk. The internal financing is inexpensive. The generation of internal funds reflects the soundness of financial health and buoyancy of a company. On the other hand, heavy dependence on external sources leads the enterprise into troubles. Internal sources are very much needed for financing the expansion and diversification activities of the enterprise. The growing importance of internal financing has condensed the confidence of business firms on outwardly raised capital so that they are hedged effectively against the ordinary fluctuations in
the capital market. Whenever there is a shortage of funds in the capital market, the only source available to the organizations is internal sources of funds. Rising of funds internally is possible only in the case of industries whose profit earnings are regular. The capacity of a company to generate internal sources depends much on the profitability besides the policy of management. The internal funds in the software industry include (a) retained earnings, (b) depreciation provision, (c) provision for tax and dividends, and (d) reserves like development reserve and general reserve. As final the internal funds are reserve and surplus, depreciation and provisions.

**External Sources**

External funds refer to the sources of financing external to the firm. External Finance plays a crucial role in financing the requirements of those companies which are poor in the generation of funds through internal sources. The external funds in the software industry include equity share capital, preference share capital, debentures and borrowed funds, trade dues and other current liabilities. Of the various external sources, borrowings usually form the prime source. A distinction could also be made between the outstanding claims i.e., long term and short term debts. The former includes debentures and term loans from financing institutions whilst the latter consists of bank loans, non-bank loans and trade creditors. As final external funds are share capital, long-term loans and current debts.

**4.2 Structure of Finance in the Software Industry**

In order to have a clear understanding of the financing methods and practices followed in the Software industry, the emphasis has been focused on the study of sources and structure of finance. It enables the analyst to keenly observe the shifts in the financial pattern and also to ascertain the significance
of diverse internal and external sources of finance in the software industry in India. Only year wise changes in the amounts of various internal and external sources of funds are incorporated for the present analysis.

- **Strategic Financial Performance**

  Managing a company’s financial wealth in order to attain its business goals and capitalize on its value. Strategic financial performance involves a defined sequence of steps that encompasses the full range of a company's investments, by defining goals and identifying sources, investigating data and creating financial decisions, to follow the difference between actual and budgeted outcome and identifying the reasons for the variance. The term "strategic" has a long-term prospect in this approach to financial management.

  At the most fundamental level, financial management is startled with administration an organization's assets, liabilities, revenues, profitability and cash flow. Strategic financial performance goes a step further in ensuring that the organization remains on track to attain its short-term and long-term goals, while maximizing value for its shareholders.

  Strategic financial performance also means that short-term goals may occasionally need to be sacrificed to meet longer-term goals. A classic instance is when a loss-making business reduces its asset base via industrial unit closures or FTE reduction so as to decrease its operating cost. Although such measures have a detrimental outcome on near-term outcomes due to restructuring costs and other one-time items, also it positions the company to attain profitability in the longer run. Strategic financial performance is fundamentally regarding the identification of the potential strategies competent of maximizing an organization's market worth. It involves the allotment of limited capital resources amongst challenging opportunities. It
also includes the execution and monitoring of the selected strategy so as to attain agreed objectives.

The business situations and their dynamic impacts have brought forward the need to evolve multi-disciplinary concepts in the field of management. The dimensions are no longer restricted and intermingle to pose problems as well as help devise solutions. The strategist can no longer have a restricted approach to enterprise solutions. A comprehensive and main-dimensional approach may be necessitated to manage resources to secure a stable position of business in future. The economic resources especially funds are limited and can have alternative utilities. So, it becomes all the more important to manage them efficiently and effectively and only then an organization can function smoothly in competitive business environment.

- **Financial Managers role in Strategy and Implementation**

  Financial Management plays an important role in the strategic issues of any company or organization.

- **Criticality on Capital Resource Management**

  Securing capital wealth, administering fund flow, and managing the long-term assets allowance is primary in the post-recession industry situation. Many businesses around the globe counters challenge in securing wealth resources since banks and shareholders continue to be vigilant in investing funds in innovative ventures or projects. But, circumstances for transformed growth are appearing in local and international regions. Further businesses require being in a place to expand these opportunities swiftly and efficiently. Securing adequate capital resources from both internal and external sources will be a major success feature in opportunity growth. It is as well something
that necessitates the time and interest of the management team. To accomplish its tasks properly, Finance requires the support of all other functions in the business. Line managers in each section require being well-known with essential financial models.

➢ *Strategy of Wing-It*

Wing-It is the mainly a familiar mutual-fund strategy. Fundamentally, if your portfolio does not have a sketch or an arrangement, subsequently it is possible that you are utilizing the strategy of wing-it. But if you are adding funds to your portfolio now, how do you make a decision what to invest in? Are you a person who research for a new investment as you do not prefer the ones you previously have? A slight of this and a slight of that? If you previously have a sketch or arrangement, then adding up funds to the portfolio ought to be actually simple. Most professionals would concur so as to this strategy will have the slightest accomplishment as there is modest to no stability.

➢ *Strategy of Market-Timing*

Strategy of market timing means the capability to acquire into and out of sectors, assets or markets at the correct occasion. The capability to market time means that you will eternally acquire low and sell high. Unfortunately, little investors purchase low and sell high since investor behavior is typically determined by emotions as an alternative to logic. The truth is most investors are likely to do precisely the contrary – buy high and sell low. This directs most of them to deem that market timing does not work in practice. None can precisely envisage the future with any stability; though there are several market timing indicators.


> **Characteristics of Financial strategy**

Financial strategy as a contemporary discipline has incorporated the practices, methodologies and perspectives of strategic management and financial management. So, the salient features and characteristics contain the contributions of both these fields of study to promote sustenance and growth of enterprises. Various prominent features identified are as follows:

- Financial strategy relates to long-term management of funds. It incorporates management with a strategic perspective on finances, as to how they are to be accumulated, allocated, invested and reaped back in multiples. Financial strategy is an approach that takes a long-term new of financial performance of the business enterprise.

- It focuses on profitability and capital maximization to ease improved aggressive situation of the firm in future and to invest funds to create best returns over a period of time.

- It is result-oriented union of resources, particularly of financial and economic resources. They are directed towards the visionary pursuits and objectives of the organization. This field maneuvers the scarce capital resources to generate maximum benefits, and utilization is optimized.

- It takes into account an integrated and holistic view of the organization at present and decides its roadmap for future. While analyzing the inherent capabilities to make them go with existing as well as anticipated business dynamics, this field studies the organization in totality with the inclusion of facts related to various segments of the business organization. This approach is followed as the future implications of decisions will be borne by the organization as a whole.
Further, the long-term strategic perspectives are achieved through the integration of plans in the short-term. Strategic financial planning of flexible nature can be empowering.

- It establishes coherence between the organization’s long-term objectives with the financial prowess and capability to support such decisions in future. This can be useful in corporate restructuring decisions.

- It encourages development, productivity and sustainability of the institution in the long haul. It involves visualizing the futuristic image of the firm in the market and growth potential of the firm today. Financial strategy maximizes shareholders’ wealth through consistent growth and profitability.

- It is a growing and long-lasting method that connects regular revamping of strategies to attain strategic financial goals, particularly enhancing the worth of the firm.

- The concepts of financial strategy apply contemporary and traditional financial evaluation techniques to enhance strategic decision making.

- It incorporates an innovative, creative, multidimensional and lateral thinking oriented approach towards devising solutions to problems.

- It is an amalgamation of analytical financial techniques along with qualitative and quantitative judgment on factual information. A rational, logical and justified approach of strategist may help gain better foresight into business situations.
It is structured as well as flexible in nature. Some methodologies for analysis are structured, but decisions may be taken in a flexible manner, like exercising one out of a number of feasible options (especially in the case of capital budgeting).

There may be a number of solutions offered while analyzing the organization in context to financial strategy. The strategist is required to select the most appropriate solution out of the available feasible solutions, generally trading off risks and returns.

It anticipates repercussions of present decisions in the future. Financial strategy helps formulate appropriate strategies and facilitates constant monitoring of the action plan to match the long-term aspirations, both financial and non-financial.

It considers costs on a strategic basis. The benefits derived out of the investments in short-term and long-term must be satisfactory. This may entail sustainable quality of investments and capabilities as it focuses on availing lucrative opportunities in given business circumstances in the most effective and efficient manner possible.

It strives to cater to the interests of all the stakeholders. Financial strategy aims to provide them with consistent, stable and progressive benefits over time for being associated with the business enterprise. It may focus on wealth creation and capital appreciation through a strategic approach to dividend policy.

Thus, financial strategy is the field of study that is proactive in nature and adopts a strategic approach to efficient management of funds to help companies survive competition in business and sustain in the long run. It is a multi-faceted field and it can include a number of decisions in its scope.
4.3 Scope of Financial strategy

Financial strategy is of recent origin. Challenges have necessitated the requirement to adopt a multi-dimensional approach to the management of resources. The all-pervasive management function is becoming comprehensive to include various combinations of aspects spread across in the organization. Financial strategy has a wide scope and includes various management regulation contributions to afford for prosperity and provisions to reinforce the financial position of the firm. Broadly, the scope of financial strategy extends to five main areas:

- Strategic investment management decisions
- Strategic financing management decisions
- Strategic liquidity management decisions
- Strategic approach to shareholder’s wealth management and value of firm decisions
- Strategic profitability management

First, the strategic investment management involves the decisions related to the long-term benefits derived out of the capital invested today and its feasibility with the organization’s goals is ascertained. Capital budgeting techniques are available to analyze risk and return levels, using a number of methods. Strategic investments are made if the returns are adequate in the long run (considering many other factors).

Secondly, financial strategy deals with the strategic financing management decisions that take into account the amount of funds required in the long run. A firm cannot anytime raise any amount of funds as it has to maintain a balance between the costs to pay for raising these funds like interest payments for raising debt, or payment of dividends to shareholders,
etc. over the long run. Inapt decisions may lead to financial imbalances within the firm. For instance, the excessive debt may cause financial burden and if a company in future wishes to raise more funds, it will be seen as a risky firm. So, funds will be either inadequate or raised at additional costs if financial status is not sound.

Thirdly, *strategic liquidity management* decisions are important as a firm has to maintain cash reserves for future and contingencies. If the liquidity is not there, then a firm may face financial agony.

Fourthly, the *strategic value creation of the firm* enhances the market status of the firm. Consistently well-performing companies win the trust of existing as well as potential shareholders or investors. This increases the worth of the company’s shares in capital markets, which creates wealth and value of the firm in the long run.

Finally, a company cannot sustain in the future unless and until consistent adequate profits are planned and generated. The supply of income has to be pre-decided to attain profits in future. It can be closely related to investment decisions as the revenue generation will be from operations, investments, divestments, etc.

Effective decision making is crucial to the success of the company. These five main areas cannot be ignored and these are the ones out of which strategically advantageous plans can be formulated and implemented. Along with the above discussed five these areas, other interrelated areas in the purview of financial strategy are as follows:
Valuation of the firm

Financial strategy facilitates image building. The competent creation of financial value of the firm leads to wealth maximization. The share of a company holds greater value in the capital markets and so does the overall value of the organization. This is a success factor and should be handled with dexterity by the financial strategists.

Strategic risk management

Financial strategy attempts to bring feasible and acceptable trade-offs between market risk and return for both the business ventures and the shareholders. The companies intend to make provisions for futuristic risks faced by investors in the firm and anticipate expected returns. The strategists would depend on various portfolio tools, variance analysis and other techniques to foresee risk and make prior provisions for that. Many companies diversify their operations to counter a number of risks and attempt to keep the investors committed to the company. For instance, for market risks in capital markets, companies need to make provisions for expected dividends by the shareholders to consistently cater to their interest over a long period to build a good image. Also, the companies could look into expansion plans to grow in future.

Strategic investments analysis and capital budgeting

A business may face a number of risks from contingencies, economic downturns, inflationary trends, etc. To execute enhanced financially in the extended run, businesses invest their funds in a number of ventures which may be core area expansions or diversification. In order to commit funds of the company in any project, the financial strategist will weigh the return offerings of various projects available, at the real worth of money over a long period of
time. Techniques like capital budgeting under risk may be helpful. The investments in business units in a diversified firm may be assessed on the basis of adequate returns generated over a number of years in future, which may help survive uncertainties. Due caution is required when soaring levels of investments are made in high-end technological investments and R&D projects.

- **Corporate restructuring and financial aspects**

  Companies are required to foresee the need to grow and expand in order to build up their future profitability. At an opportune moment, the firm may have the feasible choices available to expand its operations or diversify them or at times even cut them down. At that stage, the firm needs to have appropriate levels of debt as well as equity in capital structure and adequate availability or capacity to raise funds. Strategic expansions, contractions, etc. need financial bolster for funding as well as analysis, as without it the optimal results out of the investments may not be achieved. Further, strategic financial decisions related to the evaluation of merger proposal, determination of swap ratios, valuation of firms merging or disintegrating, etc. will be required.

- **Strategic financial evaluation**

  The internal financial capabilities and forecast potential are generally ascertained through internal appraisal of the company. The major source of this strategic financial information is the analysis of financial statements. The details regarding cash flows and final financial statements of a number of years can be assimilated and rational deductions can be made out of them. Further, strategies for future financial need forecasting and better deployment of funds can be devised and executed like through long-range budgets.
**Strategic capital restructuring**

The companies can go for the analysis of financial data and formulate appropriate strategies related to the capital structure that is the composition of the funds raised through floating shares or debt and availability of reserves. A company can opt for strategic financing planning for incorporating and making available medium-term and long-term funds. The important aspects here are, managing the cost of capital so that over the years, these decisions do not become burdensome and hinder the growth. Hybrid financing options can be exercised and proper taxation management policies can be worked out, to keep the profits available to be distributed among shareholders.

**Strategic international financial management**

In the globalized world where borderless trading is inevitable, companies venture beyond geographic boundaries for availing lucrative benefits. In doing so, there are some constraints that need to be foreseen and evaluated well in time such as the fluctuations in exchange rates of currencies of various nations. The companies may be spread across geographical areas around the world and strategically the parity must be struck for the valuation of the firm. In such cases, the financial strategist can avail financial and economic benefits on the basis of inter-continental differentials like exchange rates, interest rates, purchasing price parity, etc.

**Strategic financial engineering and architecture**

Financial strategy helps devise innovative financial tools, techniques, and securities to combat the evolving dynamics of the business environment. Hybrid financial strategies, products, and services may be devised to attract investments in the organization by reducing risks and their proper utilization is also facilitated. Risk hedging instruments may also be devised.
- **Strategic market expansion planning**

  In the competitive arena, companies have a choice to either grow or perish. There is a pressure to perform better and further develop markets nationally or globally, to secure an advantageous edge in competition. For doing so, due to political, economical, geographical and cultural factors, firms may be required to enter into strategic alliances, consolidations, etc. This requires pre-planning of funds to meet the funding requirements of the decision and operational capabilities to meet customer and product demands.

- **Strategic compensation planning**

  Companies strive to be the top performers in their industry and, to do so; they need the best of the talent available to outdo the competition. The talent will come at a cost, i.e. salary and remuneration. As the business grows, the count of FTE’s raises which involves additional financial support to pay compensation to them for their services. The compensation packages for distinctively skilled and intelligent workforce may accelerate funds requirement for additional benefits and value-added packages. Financial strategy of the compensation plans for existing, potential and retiring workforce will also be required. This calls for strategic funds management.

- **Strategic innovation expenditure**

  Innovation is indispensable for business. Research and development are necessary to provide for differentiated products and services. It usually takes investment inputs over a long period of time to get breakthroughs in some industries. The influx of funding may crescendo over a number of years, especially in some innovation-oriented industries such as pharmaceutical, high-end technology, electronics, robotics, etc. The pay-back of research and
development investment is awaited till the novel product is commercialized. The investment becomes a consideration for future returns.

- **Other business challenges**

  The purview of financial strategy may extend to include contingencies or challenges emerging due to the business environment. For instance, recent policy changes in the world trade regime, which may increase costs due to environmental pressures like carbon credits or issues pertaining to intellectual property rights, etc. may be considered prior while managing financial resources as these will directly or indirectly impact the existence and financial status of the firms.

  The scope of financial strategy is expanding. With the increasing need to manage funds more effectively and efficiently, to generate optimum returns in the future, financial strategy, as an academic discipline as well as a practical technique in business, is gaining momentum. Recently, the business economic conditions have been challenging and strategists tried to safeguard the interests of their stakeholders by utilizing superior management techniques wherever possible. In such a business environment, sound management of resources is crucial. For this, foresight and a proactive approach are the facilitators that form an integral part of financial strategy.

4.4 Importance of Financial strategy

  The investors are now aware of the avenues available for investing their funds to get maximum returns. Organizations are striving to get optimum solutions to their funding needs at viable costs. Business enterprises need to demonstrate consistent good performance over a number of years to attract adequate investment as capital for future ventures. Besides this, there is the
companies’ attempt to increase shareholders’ wealth and value of their firm in the markets. These requirements make it imperative for the companies to sustain profitability over a long period of time. In a progressive business arena, it is essential for investors to experience growth, future security, liquidity, profitability and capital appreciation. In a nutshell, companies need to pursue the consistent and superior profitability and wealth maximization objectives to meet the shareholders’ and investors’ expectations. On a long-term perspective, strategic approach to finance management can be rewarding.

Financial strategy provides multi-dimensional thinking and apt strategy formulation to the finance strategists. It helps establish a reasonable compatibility of funds and resources with potential challenges in future. The field of financial strategy is gaining acceptability as it offers a number of benefits. The prominent factors due to which financial strategy is gaining importance are as follows:

- **Proactive planning and forecasting funding needs**

  Financial strategy focuses on pre-planning the funds and resources so that timely opportunities are availed. This extends to the financial assessment and evaluation of financial status of the organization. Proper planning and long-term budgetary control make available adequate funds for future endeavors of the firm. Further, sources are tapped to raise funds in consonance with capital structure in proper balance.

- **Optimal utilization of resources**

  Various tools and techniques facilitate better financial controls and reduce wastage. The return on investment helps analyze the productivity of financial decisions and a parameter to judge the real worth of returns over a
long period of time through a technique like net present value which discounts
the future cash flows to reveal the intrinsic worth of returns received over a
long period of time. So, investment and commitment of financial resources is
done in lucrative options while others may be discarded.

- **Strategic investment plans**

  Financial strategy advocates that the projects must generate expected
value to the firm that is more than the amount invested in the projects. The
plans are evaluated on the perspective of the time value of money; returns are
brought to the real value and analyzed for the feasibility of financial inputs.
This assures better profitability in the future.

- **Liquidity maintenance**

  Financial strategy provides for adequate funds, cash reserves
ascertained in advance and generation of required resources. Financial strategy
helps in providing a cushion against economic, natural or situational
contingencies. It forearms the firm against unforeseen difficult circumstances.

- **Stakeholder interest**

  It has been advocated as an objective of financial strategy to give due
regard to stakeholders’ returns on their qualitative or monetary investment
whether it is shareholders, creditors, employees, government or public at large.

- **Value of firm**

  Financial strategy optimally balances capital structure, takes account of
sensitivity of business environment to changes, caters to the interests of
stakeholders, follows idealistic yet innovative and visionary approach, etc.
Given all this and harmonious state of economy, a firm can potentially create sustainable value in the market and build a good brand image.

- **Perspective beyond working capital requirements**

  Financial strategy pushes the strategist to have a multi-dimensional perspective on the business and its future. It no longer stays restricted to catering to short-term fund needs. It facilitates foresight and concrete analysis of financial information.

- **Encourages consistency in profitability**

  The proactive approach follows the identification of problem areas well in time. This avoids the sudden negative impacts on returns. Financial strategy provides corrective analysis and solutions to identify problems that adversely affect profitability, facilitating appropriate strategies to defy financial distress situations.

- **Incorporates impacts of economic and business environment**

  Financial strategy foresees environmental changes and makes provisions well in advance to deal with the unpredictable business environment. It helps create buffers and reserves to counter difficult situations and promotes innovation, creativity, and prowess.

- **Promotes clarity on systems, requirements and goals**

  As the goals and expectations of the business leaders from business as a whole are clearly put in objectives, various segments and efforts of the workforce are channeled towards a pre-decided direction. This develops commitment, efficiency, and effectiveness in the organization.
• **Converging efforts and financial resources**

Well-directed financial resources and efforts bring productivity that leads to superior profitability and value of the firm.

• **Risk hedging**

Financial strategy provides for risk analysis and handling techniques. There can be various risks like business risks, exchange rate risks in currencies, the uncertainty of expected returns from projects, economic downturns, etc. Financial strategy provides techniques to understand environment and possible overtures to counter these challenges through foresight.

These factors are not comprehensive or exhaustive. There are many emergent benefits of financial strategy which may be qualitative as well as situational.

**4.5 Success factors and Financial strategy**

Financial strategy can be a catalyst for the superior financial status of the firms. A business firm aspires to build harmonious, long-term relationships with its investors, creditors and stakeholders. It also intends to establish itself as a socially responsible business entity. There are various factors that help businesses succeed in establishing themselves as successful organizations. Effective financial strategy provides endurance to firms to sustain business pressures. Financial strategy offers various success factors that may help a firm achieve optimum utilization of financial resources and improvise financial status of the firm. The various factors are enlisted below:
• **Principled economic approach**

This factor relates to generating superior revenues within the constriction of ethics and values of business without compromising on the quality of products and services. Sometimes, a business may pursue short-term profitability by compromising on quality, which negates sustainability and profitability. Long-term building of consistent profits along with appropriate quality can be achieved through strategic financial planning.

• **Strategic approach to intrinsic competencies and costs**

Financial strategy facilitates focusing on central capabilities and intrinsic competencies so that business becomes sustainable. It is further stressed that the costs be viewed in the long-term perspective and not to constrict costs to generating superior returns in short-term. It follows a wider perspective towards investments and return on investments, through a balanced approach.

• **Structured system approach with scope for flexibility**

Financial strategy follows a balanced approach towards the mechanisms of the organization. The methods and systems are structured, automated, documented, and still allow space for the flexibility required due to dynamic changes. This makes financial strategy dynamic in nature. To be static is to be subjecting to obsolescence.

• **Strategic approach to cost management**

Financial strategy follows a long-term perspective on managing costs. The short-term costs are perceived for receiving benefits in the long run. The long-term impacts of the costs must not be overlooked. It is tempting to cut
costs and compromise on quality. This generally puts the long-term image building in the market at stake. The long-term vision, perspective, and image should be kept in mind. Strategic cost-benefit analysis may be helpful in certain business conditions.

- **Positive responsiveness to dynamic environment**

  The business must be prepared for unexpected business changes. A proactive approach will facilitate positive responsiveness to the environment. Financial strategy facilitates superior evaluation of projects and funds management and provides for adequate resources to avail opportunities like corporate restructuring, technological prowess, product developments, market expansions, etc.

- **Survival and sustainability**

  Financial strategy puts the organization in a strong and capable financial position to survive competition, innovate, and sustain the market leadership position strategically.

- **Adaptability**

  Financial strategy advocates a constant environmental analysis and generates funds with a futuristic approach. When the changing dimensions can be identified well in time, then appropriate provisions can also be created proactively. So, constant analysis, evaluation and match of internal capabilities with external environs can be made. This would encourage better adaptability of the organization.
Financial control and prowess

Financial controls arrest wastage of financial resources directly and other organizational resources indirectly. This helps in investing resources in the most appropriate manner. The control measures build expertise in the utilization of resources. Control does not imply a deterioration of quality or capabilities; it checks wastage and wasteful expenditure of funds. In a nutshell, it is necessary to understand the strategic approach to funds management. The basis of success factors is the ethical approach of the companies towards business and stakeholders. The sustainability may rest on the idealism that the business leaders follow, compatible with evolution.

4.6 Constraints to Financial strategy

Financial strategy requires technical expertise, knowledge, analytical skill, wisdom, decisiveness, innovative approach, etc. to justify its academic capabilities. There are certain constraints that come into picture when strategists have to make crucial decisions with strategic impacts. Some major issues that pose constraints are discussed below.

- Closely linked to personal attributes of strategists

The attitude of the decision maker or strategist will determine the quality of decisions and how the vision for the organization is followed. Their incapability may affect the overall direction of the organization that can be detrimental. The preconceived biases must be dislodged.

- Capability to have a panoramic view on situations

The strategist as the decision maker must follow a multi-dimensional, multifaceted, innovative, Creative, and visionary approach. It takes a great
level of maturity and competence to imbibe this demanding approach. Any rigidity, bias, pre-conceived notions of the strategist on personal grounds, restrictive thinking, suppression and autocratic approach can defy the whole purpose of envisioning.

- **Technical know-how**

  The strategist is required to have mastery over finance methodologies, technical knowledge, inter-linkages of various issues, consequential impacts, etc. The ability to make accurate deductions is challenging and requires chiseled analytical skill. If the strategist falters to justify his competence, the purpose of financial strategy may be diluted.

- **Approach towards problems**

  If problems are not perceived properly, they may become insurmountable. A solution-oriented approach requires a great deal of practicality and optimism. This combination may not be readily available in the workforce.

- **Resource constraints**

  Due to sudden environmental pressures, resources may not be available to pursue the vision. There can be issues with vendors, distributors, personal rivalries, etc. which may impede the pursuit of a goal.

- **Conflict between owner’s and strategist’s vision**

  The owners participating in decision making may not agree with the strategist’s devised direction for the company. This may tug the organizational
resources and productive inputs in conflicting directions. This is counter-productive for the organization.

- **Inability to integrate**

  The strategist may become biased towards certain segments or notions. This may bring rigidity in planning and constrain the wider perspective. This may not provide proper integration of various segments, systems, and processes in the organization. The inability to connect with the organization as a whole may be impairing.

  Therefore, it is necessary to vest the decision making related to strategic moves in finance in capable and competent leaders. The dexterity of the strategist is crucial. Further, the way strategy is perceived and implemented also counts.

  The importance of financial strategy can be ascertained, after going through the following points:

- **Successful promotion**

  A Firm’s successful promotion is mainly depending upon well-organized financial management. If the sketch implemented, fails to supply ample funds to meet the necessities of fixed and working capital and predominantly the later, the firm cannot proceed its production effectively. As a result, sound financial preparation is fairly crucial for the victory of a business firm.
- **Smooth running**

  In view of the fact that investment is essential at all phase of the business such as promotion, incorporation, improvement, expansion and administration of operating expense, appropriate financial management becomes essential for the smooth administration of a business enterprise.

- **Decision making**

  Financial management offers a technical assessment of all information and statistics through diverse financial tools such as ratio analysis, Variance analysis, budgets etc., and such an investigation facilitates the organization to appraise the profitability of the sketch in the specified situations, As a result an appropriate result can be considered to lessen the risk.

- **Measure of Performance**

  Financial Management is believed as a measure of the performance of the company.

  The importance of Financial Management in a business enterprise can extremely be appreciated by the following words. "Financial Management is appropriately analyzed as a vital element of the overall administration slightly than as a personnel area of expertise concerned for the finance raising function. In addition to raising funds, financial management is directly apprehensive with production, marketing and other functions contained by an enterprise, at any time decisions are prepared in relation to the acquisition or distribution of assets".

  Thus, financial management has achieved a superior deal of significance in recent business.
- **Capital expenditure**

  Capital expenditures (CAPEX) are expenditures creating potential payback. A capital expenditure is incurred while a business spends funds either to purchase fixed assets or to add to the value of an existing fixed asset with its useful life widen further than the taxable year.

- **Usage**

  CAPEX is used by a business to purchase or promote physical assets such as equipment, property, or industrial buildings.

- **Financial innovation**

  There are quite a few interpretations of the phrase financial innovation. In common, it refers to the creating and advertising of new types of securities.

  Economic theory has a lot to state regarding what types of securities ought to exist, and why a few may not survive (why some markets should be 'incomplete') but modest to pronounce about why new types of securities ought to come into subsistence.

- **High-yield bond**

  In finance, a high-yield bond is a bond that is rated under investment grade. These bonds have a higher risk of non-payment or further unpleasant credit events, but in general provide higher yields than compared to superiority bonds in order to make them eye-catching to shareholders.

- **Innovation**

  Innovation is the making of improved or additional efficient products, processes, services, technologies, or ideas which are acknowledged by
markets, governments and the public. Innovation varies from discovery, innovation refers to the make use of a new idea or method, whereas invention refers more straightly to the making of the idea or method itself. Innovation differs from development in that innovation refers to the concept of doing a little special.

- **Business-to-business**

  Business-to-business explains exchange transactions between businesses, such as among a manufacturer and a wholesaler, or among a wholesaler and a retailer. Contrasting terms are business-to-consumer (B2C) and business-to-government (B2G). The volume of 828 (Business-to-Business) transactions is much higher than the volume of 320 transactions.

- **Dividend**

  Dividends are expenditures made by a company to its shareholder members. It’s the section of company’s profit shared to its stockholders. When a corporation earns a profit or surplus, that money can be put to two uses: it can either be re-invested in the business as retained earnings, or it could be distributed to shareholders.

- **Performance measurement**

  Measurement of performance is a technique for gathering and reporting information concerning the performance of a person, group or organizations. It can engage looking at process/strategies in place, as well as whether results are in line with what was planned or must have been achieved.
Feedback as a need for decision-making

Good presentation is the decisive factor whereby a business decides its ability to prevail.

Financial statement analysis

Financial statement is a controlled compilation of information according to rational and reliable accounting methods. Its principle is to communicate and comprehend a few financial characteristics of a business firm. It might show a position at an instant of time as in the case of a balance sheet, or might reveal a series of actions over a particular period of time, as in the case of an income statement.

4.7 Significance of Financial Statement

Income Statement

Income statement (also termed as profit and loss account statement) is generally considered to be the most useful of all financial statements. It explains what has happened to a company as a consequence of operations involving two balance sheet dates. For this intention, it matches the incomes and costs incurred in the course of producing revenues and illustrate the net profit earned or loss suffered through a specific period.

Balance Sheet

It is a statement of financial position of a business at a specified moment of time. It represents all assets possessed by the business at a particular instant of time and the claims (or equities) of the owners and
outsiders besides those assets at that moment. It is in a way snapshot of the economic circumstance of the business at that time.

- **Statement of retained earnings**

  The term retained earnings means the accumulated excess of earnings over losses and dividends. The balance shows by the income statement is transferred to the balance sheet through this statement, subsequent to constructing essential appropriations. It connects between the balance sheet and the income statement. It is primarily an exhibit of things that have caused the commencement of the periods retained earning’s balance to be altered into the one exposed in the end of the period retained earnings in the balance sheet.

  The statement is also termed as profit and loss appropriation account statement in the case of companies.

- **Financial position statement of changes**

  Balance sheet demonstrates the financial circumstance of the business at a particular instance of time, while the income statement reveals the results of operations of business over a period of instance. On the other hand, for a superior understanding of the affairs of the business, it is essential to identify the movement of working capital or cash in-out of the business. This information is accessible in the statement of changes in financial position of the business. The statement might highlight any of the following aspects relating to change in financial position of the business:

  - Change in the firm’s working capital
  - Change in the firm’s cash position
- Change in the firm’s total financial position

### Interpretation and Analysis of Financial Statements

Financial statements are employed in corporate business houses; includes a set of reports and schedules which accountant creates at the end of a fiscal year of time for a business enterprise. Financial statements are the ways with the aid of which the accounting system performs its core function of providing abridged information regarding the financial affairs of the business. These statements consist of Position Statement or Balance Sheet and Income Statement or Profit and Loss Account. As well to give a full view of the financial affairs of an enterprise, in accumulation to the above, the business may also prepare a Statement of Retained Earnings and a Cash Flow Statement. In India, each company has to submit its financial statements in the form and contents as set under Section 211 of the Companies Act 1956.

### 4.8 Objectives of Financial Statements Analysis

The financial statements are intended to provide an accurate financial position of a firm at a point in time and also operating results in a condensed form during the period under review. For reference Korn and Thomas, “An analysis of financial statements attempts to interpret or draw conclusions from the statements”. According to Hingorani and Ramanathan, “The objective of financial analysis is a detailed cause and effect study of the profitability and financial position”. Therefore, the analysis helps to understand the profitability performance including financial position of an enterprise. In words of Anthony, “The overall objective of a business is to earn a satisfactory return on the funds invested in it and consistent with maintaining a sound financial position”. The success of a venture depends on eventually upon potential developments and future may never be ‘analyses’ with accuracy. To quote
Garrison, “Without financial statement analysis, the tale that key relationships and trends have to tell may remain buried in a sea of statement detail”. He as well states that the purpose of financial statements analysis is to assist account users in forecasting the future by means of comparison, evaluation, and trend analysis.

Analysis of financial statements in a proper way provides a valuable insight into the financial condition and operations of business. It is therefore, imperative that financial statements such as balance sheet and profit and loss account, statement of retained earnings and sources and uses of funds are prepared to disclose useful overall summaries of the financial data accumulated by the firm. According to Salmonson, Hermanson and Edwards, “Financial statements are issued to communicate useful financial information to interested parties” in the terms of Myer, “The analysis and interpretation of financial statements of a business enterprise usually has as its objective, the formation of an opinion with respect to the financial condition of that enterprise.” As per Gestenberg, “Management can measure the effectiveness of its own policies and decisions determine the advisability of adopting new policies and procedures and document to owners the result of their managerial efforts”.

The subsequent groups have a straight interest in the financial statements of companies: Suppliers and potential suppliers of funds, i.e., shareholders, debenture holders, employees, customers, suppliers of goods and services on credit, tax authorities, etc. Also, there are groups which have an indirect interest in these statements: Financial analysts, advisors, stock exchanges, academicians, lawyers, regulatory authorities, trade associations, and labor unions.
Financial statement analysis is very much helpful in assessing the financial position and profitability of a concern. The major objectives of examining the financial statements are as follows:

- The relative study in regard to one firm with a different firm or one department with another department is possible by the analysis of financial statements.

- Analysis of past results in respects of earning and financial position of the venture is of immense help in forecasting the potential results. Hence, it helps in preparing budgets.

- It facilitates the measurement of financial firmness of the concern.

- The analysis would enable the present and the future earning capacity and profitability of the concern.

- The operational efficiency of the concern as a whole, as well as section wise, can be assessed. Therefore, the management is able to easily locate the areas of efficiency and inefficiency.

- The solvency of the company, both short-term and long-term, could be determined with the assist of financial statement examination which is favorable to trade creditors and debenture holders.

- The long-term liquidity position of funds can be assessed by the analysis of financial statements.
 Attributes of Financial Statements

Financial Statements developed for an enterprise ought to have the following attributes if they are to provide meaningfully the principle and purpose for which they are intended.

- **Relevance**

  The financial statements organized should be appropriate for the principle they are supposed to serve. While immaterial and puzzling disclosures must be avoided, not anything relevant and immaterial should be held back from the public. The accountant so compiles such statements must be clear about relevancy and materiality or otherwise of the range of information on the base of which these statements are prepared.

- **Accuracy and Freedom from preconception**

  Financial Statements must communicate a complete and accurate thought regarding the progress, position, and prospects of a venture. For this principle, they have to be precisely organized. Imprecision besides invoking legal consequences might also overwhelm the objectives for which the statements are meant. It may, however, be noted that absolute accuracy is not always possible, but this does not mean that rash and inaccurate data be consciously provided, The slightest one can expect is that those who prepare and present financial statements should not allow their personal prejudices to color the facts.

- **Comparability**

  Comparability enhances the utility of financial statements. Comparison with previous statements helps in assessing the performance and in localizing
the trends in the progress and position of the business enterprise. Comparisons with other alike concerns or the business reveal the strength of the enterprise vis-à-vis other firms and industry.

➢ Consistency

Financial statements for a definite period are exaggerated by the decision and bureaucratic choices exercised by the accountant. Opinions and procedures further than those engaged generally may cause the statement information to vary materially. Rules of accounting need that having prepared a selection of procedures, the accountant should strictly adhere them in successive periods unless the circumstances demand otherwise. Consistency has a straight bearing upon comparability. If inventories are valued on the diverse basis in different periods (LIFO to FIFO to Replacement Cost) the results disclosed, generate doubt and assessment become hard.

➢ Authenticity the financial statements

In order to be accepted as reliable must be reviewed and authenticated by an autonomous and competent individual, normally known as an auditor. Statements duly audited and certified by recognized and reputable auditors are received at their face value and are deemed to be more reliable. Unaudited statements give room to doubt and unreliability.

➢ Compliance with Law

Financial statements must meet the requirements of the law, if any, in the matter of form, contents, procedures, disclosures and methods. Non-compliance with legal provisions, in addition invoking penalties, impairs the assurance of the public investors. Companies in India are required to present
their financial statements according to the provisions of Section 211 of the Companies Act, 1956.

- **Analytical Presentation**

  The financial statements must be prepared in a classified structure so that an enhanced and significant examination can be made. Appropriate organization assists in tracing and understanding in causes of the results as exposed in these statements. Thorough and classified information helps to disclose inefficient performance and extravagant activities. Such categorization helps in the speedier examination of these documents.

- **Promptness**

  The preparation of financial testimonial is to some extent complicated, but an unwarranted wait in their preparation would decrease the implication and efficacy of these statements. They should be prepared as soon as possible, after the end of the period for which they are meant. Undue delay, the time lag between the end of the period and the preparation of these statements, may present difficulty in training the causes of the results as disclosed in the statements. Such waits and the delayed action thereon may do more harm than good to the enterprise.

- **Generally Accepted Principles**

  Since the financial statements are meant for the use of a wider clientele, they must have broadly suitability and understandability. This suitability and understandability can come only when these statements are prepared in agreement through the “generally established accounting principles”. This also increases the reliability of these statements and ads to the confidence of the users.
Presenting Financial Statements Recent Trends

Each company in India has to provide its financial statements in the form and contents as set under Section 211 of the Companies Act, 1956. In view of the same, complications of statutory forms in the Companies Act, now-a-days it is general practice to put in the profit and loss account and balance sheet drawn in statutory forms, a few voluntary supplementary information in an easy manner as would be simply understood by a layman.

This voluntary information may include; the following:

Summarized profit and loss account and balance sheet Now-a-days, companies are disregarding the preparation of conventional two-sided balance sheet, profit and loss account and are following columnar forms of the balance sheet, profit and loss account which are an easy way of arrangement of information.

Provision of significant accounting ratios

Accounting ratios illustrate the interrelationship which exists amongst various accounting data. Balance sheet is authenticated by the significant ratios of the current year and of the last two years.

Accounting policies disclosure

Currently, progressive companies unveil accounting policies in their published accounts on the basis of which they have prepared their financial statements. This is done with a view to giving a better understanding of the financial statements to the public.


- **Impact of price level changes**

  Since prices go on altering everyday financial statements based on historical costs do not reflect the effect of price level changes on the financial position and profitability of the company. In order to accommodate the effect of price stage changes in the financial statements, recent days many companies have started showing these effects on financial statements in a supplementary statement in accumulation to the conventional statements prepared on a historical basis.

- **Rounding off of figures**

  The Sachchar Committee has suggested the companies must be provided the option to round off the figures of financial statements to the nearest thousand and/or hundred or ten rupees. This suggestion has been accepted and companies are now-a-days utilizes the rounding off of figures.

- **Use of charts, graphs, and diagrams**

  Many Businesses integrate charts, graphs, and diagrams in their published accounts. It is identified as a graphic method of presentation of information. It attracts the interest of the users further swiftly and effectively. Of late, graphs and diagrams have been fetching much admired since they are measured to be the mainly efficient media for disclosing trends and making comparisons above fairly long periods in a short gap. This method of presenting information is able to effectively depict production costs, fluctuations in output and sales, components of cost of production and income, the exercise of divisible profits as taxes, dividends, other appropriations and retained profits etc.
Use of Schedules

In order to make the balance sheet and profit and loss account as compact as possible, separate schedules for diverse heads (e.g. share capital, reserves and surplus, secured loans, unsecured loans, current liabilities and provisions, fixed assets, investments, current assets, loans and advances, miscellaneous expenditure, etc.) are arranged and details about these heads as prescribed in the Companies Act are given in these schedules. This is done to make the balance sheet and profit and loss account manageable within limited space. These schedules are properly numbered and position of these is given in the balance sheet and profit and loss account.

Highlights

Highlights are typically revealed at the commencement of the annual report as a result that the users might arrive across the significant facts of the company straight away as he/she opens the report. It might generally cover information regarding sales, production, and profit before and after tax, capital projects, working capital, fixed assets, share capital, imperative landmarks of the year, etc.

Uses of Financial Statements

Financial statements are general purpose statements and blueprints of the financial affairs. These statements play a pivotal role in providing the information concerning the financial position of a firm and the results of its operations to varied interested groups. The information so obtained is useful for all external and internal stakeholders for decision making. In this context, it is appropriate to quote Bierman and Drebin, “Financial statements are prepared primarily for decision making. The statements do not end in them, but must be useful in decision-making context”. In the words of Shuckett and
Mock, “Financial statements may reveal shortcomings in control or indicate major areas for changes in corporate policy”. According to American Institute of Certified Public Accountants (AICPA), “Financial statements are constructed with a view to presenting a periodical review or report on progress by the management and deal with the position of investment in the business and the results achieved during the period under review”. For Reference, Vidyadhara Reddy and Shankaraiah, “The most important function of financial statement is to enable the people to understand how efficiently the capital of the business is utilized, how well credit standards are observed and how financial condition has improved”.

According to Ravi, Thilakram, and Ramsubramanian, “Over the years, the utility of financial statements has been on the increase and this may be chiefly attributed to large scale production, Government regulations, Income-tax legislation, large scale investment by the general public, increasing investment by the banking sector and the financial institutions”. Any published financial statements of a business enterprise are basically useful for two users for the external user’s investors, creditors, and lenders. The other is to internal users they are the eyes in as much as they reveal the strength and weaknesses and also trends in the financial of the firm in the light of which the management can take appropriate steps to settle matters right. Thus, the financial statements are useful to varied parties interacting with business firm, such as, owners of the enterprise, they reveal its progress as evidenced by earnings and current financial conditions to prospective investors, they act as a mirror reflecting potential investment opportunity, to the creditors and bankers, these statements act as a magic eye highlighting the credit worthiness, i.e., assurance whether the company will honor the obligations as and when they mature, to the shareholders and debenture holders, financial statements analysis is their means of reinforcing judgments or of forming new
judgments regarding the capital investment they have undertaken: to the economist, the financial statements judge the extent to which current financial environment has affected the business activity and its financial position, to the financial analyst and researcher, to peep through these statements into the financial policies followed by the management and tender constructive suggestions to overcome the financial malady if diagnosed and to the government authorities, to assess the revenue through various taxes.

Analysis of financial statements reveals a business enterprise’s way of life, its health, its future prospects and its commitment towards the society around it. In a nutshell, financial statements and their analysis are of varying importance and cater to the different needs of groups with diverse interests.

**Approaches of Ratio Analysis**

The various approaches of ratio analysis are,

- **Interpretation of individual Ratio**

  Individual ratio, by itself, might have the significance of its own. For example, a relentless drop in the net profit to sales ratio might indicate inefficiency of waste in the organization. Normally they are to be studied with reference to certain standards. On the other hand, these standards are typically approximations; the conclusions resulting from deviations of actual ratios from them might be misleading. Therefore, this approach is to be clubbed with others.

- **Interpretation by referring to a collection of ratios**

  At times, while studied individually, it might be hard to figure out the implication of certain ratios fully. In such instances, the investigation could be
made additional significant by computing some of the extra connected ratios. An alteration in one ratio might have significance only when viewed in relation to other ratios. For instance, the importance of the Profit Ratio could be made clear by calculating other ratios similar to return on capital employed, interest coverage ratio, etc.

- **Interpretation of ratios by trend**

  Under this technique, a single ratio or a group of connected ratios are computed and evaluated over time. The significant trends – increasing, decreasing or constant – are measured for the accomplishment of conclusions. Sometimes the mean of the ratios calculated for a number of years are used for carrying out the analysis.

- **Interpretation by inter-firm comparisons**

  From this approach, the ratios of one company are compared with the ratios of other company in the similar industry. Such inter-firm comparisons may be noteworthy as some of the other firms considered for comparison might be experiencing the similar or alike financial problems. In general, selected significant ratios are computed and published by trade associations or credit rating or financial institutions in the way of tables. Individual firms for preparing the analysis may use such tables.

  A Full-fledged examination of the financial and economic position of any business, though, needs the application of all the 4 approaches. This is necessary for generating constructive information that will make clear the intrinsic meaning of any ratio.


- **Uses of Ratio Analysis**

  The uses of ratio analysis are,

  - *Simplification of collection of accounting data*

    Ratios allow the gathering of accounting data to be summarized and simplified, in addition, they supply the means of showing the interrelationship that survives between a range of segments of business, as exposed through accounting statements, and thereby avoid any distortions that might result from the investigation of absolute figures,

  - *An invaluable support to management*

    Ratio analysis assists management in the discharge of its basic functions such as planning, forecasting and control. The trend ratios might be useful for predicting likely events in the upcoming. The plans prepared can be ‘signposted’ by accounting ratios and thereby develop into an integral part of the standard costing and budgetary control systems.

  - *Facilitates enhanced coordination and control*

    Ideal ratios are able to be established and the relationship between primary ratios might be used to establish the desirable coordination. Ratios might also be used for control of performance as well as control of costs. They are an efficient means of communication and play an imperative role in informing the position of and progress made by the business unease to the owners or other parties.

  - *A tool to evaluate important characteristics of business*
Ratio analysis is an efficient instrument to assess important uniqueness of business like liquidity, solvency, and profitability. A study on these aspects might enable to depict conclusions concerning the financial requirements and capabilities of business concerns.

- **An efficient tool of analysis for intra-firm and inter-firm comparisons**

Ratio might also be used as measures of efficiency. It is the key tool of analysis for intra-firm and inter-firm comparisons. By comparing the ratios of different firms one might discover the factors associated with successful and unsuccessful firms or strong and weak firms or overvalued and undervalued firms.

- **Classification of Ratios**

Financial Ratios may be classified in various ways, one way of classifying:

- **Balance Sheet Ratios**

Balance sheet ratios are the ratios which deal with the relationship between two figures or group of figures visible in the balance sheet, for instance, current ratio and debt-equity ratio.

- **Profit and Loss Account Ratios**

Profit and loss account ratios deal with the relationship between two figures appearing in the profit and loss account, for instance, profit margin ratio and operating ratio.

- **Combined Ratios**
Combined ratios deal with the relationship between two figures or groups of figures one appearing in profit and loss account and the other in the balance sheet, for example, net profit to net worth ratio, sales to working capital ratio.

The above classification, however, is rather crude. Since it implies that analysis of the income statement or the balance sheet can be done in isolation. Herbert has divided financial ratios into the following four categories.

- **Liquidity Ratios**

  They are designed to measure a company’s capability to meet its growing short-term obligations.

- **Profitability Ratios**

  They measure management’s overall efficiency as shown by the returns generated on sales and assets.

- **Activity Ratios**

  They measure how effectively the company is using its assets and liabilities.

- **Leverage Ratios**

  They measure the extent to which a company has been financed by debt. Ratios do not immediately spotlight the vulnerable areas. They cannot replace business efficiency and decision-making and then do not also provide a mechanical solution to business problems. Helfert rightly remarks, “Ratios are not ending in themselves, slightly, on a discriminating basis they may help
answer significant questions”. Therefore, ratio analysis enables the user to have a clear perception of the financial statements than by looking at the absolute data alone.

4.9 Conclusion

Financial strategy is at its nascent stage as a field of management study. The evolution in finance with a strategic perspective has brought about dimensions for strategists and finance professionals to bring positive transformation in the organization and the way the future is perceived.