Proactive analysis of Financial Statements

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Abstract— **Proactive analysis of financial statements means estimating the future position and initiating change and influencing environment to attain desired place. This technique allows teams to discover possible problems, or ways the launch could fail, while there is still time to make adjustments. This paper explores the topic of understanding proactive analysis of financial statements. It also discuss about the reasons and essentials of proactive analysis of financial statements. Then, it details about the benefits and limitations of proactive analysis of financial statements. Lastly it is concluded that proactive analysis of financial statements is very useful as it helps in understanding the risk and profitability of a firm, business, sub-business or project through analysis of reported and projected financial information, by using different accounting tools and techniques.**

Index Terms— Financial ratios, Financial statements, Proactive analysis, Projections

I. INTRODUCTION

Financial statement analysis is an evaluative method of determining the past, current and projected performance of a company. Several techniques are commonly used as part of financial statement analysis including horizontal analysis, which compares two or more years of financial data in both dollar and percentage form; vertical analysis, where each category of accounts on the balance sheet is shown as a percentage of the total account; and ratio analysis, which calculates statistical relationships between data.

Financial statement analysis (or financial analysis) is the process of understanding the risk and profitability of a firm (business, sub-business or project) through analysis of reported financial information, by using different accounting tools and techniques.

Financial statement analysis consists of Reformulating reported financial statements, Analysis and adjustments of measurement errors, and financial ratio analysis on the basis of reformulated and adjusted financial statements.

Manuscript received Aug 22, 2014

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The first two steps are often dropped in practice, meaning that financial ratios are just calculated on the basis of the reported numbers, perhaps with some adjustments. Financial statement analysis is the foundation for evaluating and pricing credit risk and for doing fundamental company valuation

II. PROACTIVE PERSONALITY

Bateman and Crant (1993) developed the proactive personality concept, defining it as a relatively stable tendency to effect environmental change that differentiates people based on the extent to which they take action to influence their environments. Individuals withaprototypical proactive personality identify opport unities and act on them, show initiative, take action, an d persevere until meaningful change occurs (Crant, 20 00). In contrast,people who are not proactive exhibit th e opposite patterns:
they fail to identify, let alone seize, opportunities to change things. Less proactive individuals are passive and reactive, preferring to adapt to circumstances rather than change them (Cant, 2000). As work becomes more dynamic and decentralized, proactive behavior and initiative become even more critical determinants of organizational success. For example, as new forms of management are introduced that minimize the surveillance function, companies will increasingly rely on employees' personal initiative to identify and solve problems. Crant (2000) defined proactive behavior as taking initiative in improving current circumstances or creating new ones; it involves challenging the status quo rather than passively adapting to present conditions. Employees can engage in proactive activities as part of their in-role behavior in which they fulfill basic job requirements (Crant, 2000). For example, sales agents might proactively seek feedback on their techniques for closing a sale with an ultimate goal of improving job performance. Extra-role behaviors can also be proactive, such as efforts to redefine one's role in the organization. For example, employees might engage in career management activities by identifying and acting on opportunities to change the scope of their jobs or move to more desirable divisions of the business. Crant (1995) demonstrated that proactive personality accounted for incremental variance in the job performance of real estate agents after controlling for both extraversion and conscientiousness. Proactive personality refers to individuals' disposition toward

engaging in active role orientations, such as initiating change and influencing their environment. Proactive people are relatively unconstrained by situational forces, and they identify opportunities, act on them, show initiative, and persevere until meaningful change occurs. The key differentiating feature of proactive personality and behavior is an active rather than passive approach toward work Proactive analysis of financial statements means estimating the future position and initiating change and influencing environment to attain desired place. This technique allows teams to discover possible problems, or ways the launch could fail, while there is still time to make adjustments

III. PROACTIVE VS. REACTIVE

Proactive is being ahead of what might happen. In behavior proactive means anticipatory, change-oriented and self-initiated behavior. This can be at a work place or anywhere in life. Proactive behavior is acting in advance of a future situation, rather than just reacting. Proactive is described to a person who takes responsibility for his or her life rather than looking elsewhere to make up their mind. Over the last decades, researchers have identified proactive behaviour as a very important determinant of success in one's life. Of course, reactive is exactly the opposite. It's waiting for things to happen and then trying to do something about them after the fact. A reactive person is unable or unwilling to confront certain situations. The problem with this kind of behavior is that things never get to be resolved. Unlike the proactive person that anticipates the problem, the reactive person is usually stuck, and not prepared. Proactive business owners have a significant competitive advantage. They are flexible, adaptable and focused on continually improving their customer service, productivity, efficiency and workplace environments. Reactive owners, on the other hand, never maximize the potential of their businesses because they postpone change until it's absolutely necessary and perhaps too late.

A. Reactive organizations

Reactive organizations don't change until situations force them to act. For example, an emerging new competitor might spur a company to remain competitive and find ways to improve its performance. Or a company might wait for an economic crisis before it researches ways to increase productivity and cut costs. By waiting for extenuating circumstances and by failing to anticipate major developments, reactive organizations put themselves at risk: Sooner or later, aggressive competitors overtake slow-moving companies.

B. Disadvantages

A reactive business might ignore danger signs and allow serious problems to develop. For example, if a factory waits until third-party inspectors call attention to its poor equipment maintenance, problems that could have been easily fixed early on might now require extensive repairs. A reactive organization might miss opportunities if it only improves itself as situations demand. Suppose a company waits until revenues are low to find new customers. Had it expanded its customer base earlier, the company could have kept revenues high instead of putting itself in a precarious financial situation.

C. Proactive organizations

Proactive organizations continually analyze the business environment for signs of impending change so they can improve their performance. For example, a manufacturer might hire a market-research firm to analyze its target consumers and forecast shifts in consumer demand. The proactive manufacturer can use the data to optimize its product line long before its reactive competitors recognize they are behind the times. At the same time, the manufacturer might institute a self-evaluation program to analyze its productivity, efficiency, worker morale and other areas that bear improving.

D. Advantages

Proactive organizations are a step ahead of the game. Rather than wait for circumstances to dictate their actions, they change long before risks materialize. Competitors find it difficult to keep up because proactive organizations undergo continuous self-improvement even during good times, when other organizations might rest on their laurels. Proactive organizations are also cost-effective. By honing their performance to increase productivity and efficiency and by dealing with small problems before they develop into bigger problems, they save money that can be used to lower their prices, further increasing their competitiveness.

IV. REASONS TO DO PROACTIVE ANALYSIS

First and foremost important reason is that Reactive analysis are too late. Reactive analysis is done after the occurrence of a change or event. This is reacting to consequences of such changes or events. Reactive analysis is late and business may have wasted time. Secondly, Being Reactive may be very costly. Reactive analysis is done after the occurrence of events so business may have wasted resources in reacting and mitigating losses. Thirdly there is Need to slow down in order to go fast. Business need to plan before reacting or initiating changes. Proper planning ensures fulfillment of all objectives and minimization of wastage. Fourth and important reasons that business environment is dynamic in nature. The accounting, taxation or legal requirements keeps on changing so continuous proactive analysis is important. Fifth reason

is that it helps in making policies so management can make proper plans to face contingencies after having proactive approach e.g. Provision for bad debts. Sixth reason is to ensure sufficient resources for future. Proactive analysis ensures sufficient resources to meet the needs of future and facing changes of environment. Lastly it is required when the organization has almost come to an important choice but still before the big decision. When an important decision is taken by management proactive analysis is needed because large projects involve huge investment over a longer period of time.

V. ESSENTIALS

Firstly, a capable team is required to do the proactive analysis. A team with ability to do proactive analysis. Secondly, team should have ability to predict future. The team should have capability to predict future changes in environment in order to ensure proper planning. Third essential Understands of the key drivers of financial results for the business. Because understanding of key drivers that affect the financial statements is important in order to ensure achievement of desired results. Forth essential is past information. Past information acts as basis for future plans and helps in predicting likely future changes or events. Fifth essential is sufficient resources to achieve goals. There need to be sufficient resources in terms funds and time to do proactive analysis. Sixth requirement is doing Timely analysis. Proactive remains proactive if it is done timely and ahead of changes. So it should be done in time and should not convert into post analysis. Lastly Continuous monitoring is required, because Proactive analysis is effective if continuous monitoring is done regarding continuous changes of dynamic environment.

VI. PROACTIVE ANALYSIS OF FINANCIAL STATEMENTS

Unless it is a religious or charitable organization, the primary reason for starting a business is to make money. The drive to be own boss might have caused people to quit being an employee and start their own business, but the quest for income is what keeps it going. When a business plan is developed, financial projections and cash flow analysis are among the most critical elements. A newly started up business do experience at least a short period during which expenses exceed revenue. Without plans for adequate cash reserves, borrowing capacity, or other means of meeting those expenses, a cash shortfall can cause the early demise of new business. It doesn't matter that the idea behind the business is fundamentally sound; without adequate capital, it can fail.

The timing of revenues and expenses are critical to all businesses, whether new or established. Even if revenues exceed expenses, the actual receipt of cash has to occur in time to meet expenses as they become due. Assessing business expenses, both recurring (e.g., rent, wages, payments to vendors) and nonrecurring (e.g., unexpected repairs) is vital. One way to do this type of planning is to check the discussion of cash flow. This gives a good idea of the type of analysis needed to prepare for this portion of business plan.

The type of financial information that is going to be needed to prepare this analysis will depend on whether the business is an established enterprise or is just starting out. For writing a plan for a new business, survey of assets and borrowing ability is required. However, since business probably has few assets and no prior financial history, business plan rely almost entirely on financial projections.

Financial Projections section is developed after analyzing the market and clear objectives are set. Then business can allocate resources efficiently. The following is a list of the critical financial statements to include in a business plan packet.

A. Historical financial data

For an established business, supply of historical data related to company's performance is required. Most creditors request data for the last three to five years, depending on the length of time business is in existence.

The historical financial data to include are company's income statements, balance sheets, and cash flow statements for each year you have been in business (usually for up to three to five years). Often, creditors are also interested in any collateral that could be used to ensure loan, regardless of the stage of business.

B. Prospective financial data

All businesses, whether startup or growing, will be required to supply prospective financial data. Most of the time, creditor's wants to see what company would be able to do within the next five years. Each year's documents include forecasted income statements, balance sheets, cash flow statements, and capital expenditure budgets. For the first year, monthly or quarterly projections could be supplied. After that, it could be stretched to quarterly and/or yearly projections for years two through five.

VII. PROJECTIONS

Projections should match funding requests; creditors will be on the lookout for inconsistencies. If there are any assumptions in projections, they should be summarized to tell what have been assumed. This way, the reader is not being left guessing.

Finally, it includes a short analysis of financial information. It includes a ratio and trend analysis for all financial statements (both historical and prospective). Graphs of trend analysis (especially if they are positive) could be added.

The financial projections are the most formalistic and stylized documents that are prepared. Formalistic mean to project, in a mathematically correct fashion, the anticipated monetary results of business operations. Stylized mean that the format of financial documents will be dictated in large part by accounting conventions and the specific requirements of audience.

Startup businesses, or business expansions, frequently involve a startup budget that is different in character from the operating budget of an ongoing business. These startup costs will be rolled into profit and loss projections.

The following list sets forth the major elements of the financial portion of a business plan. The first two items are applicable to any business. The third discusses the types of information that an existing or ongoing business needs to provide, while the fourth discusses the special financial planning issues that a new business must address.

The last item presents a number of calculations that can be used to diagnose a business's financial condition. These are projected profit and loss statement, projected cash flow, Historical financial information, Startup business financial information and financial ratios.

In some cases, the financial portions of a plan are prepared to conform to generally accepted accounting principles. If the financial material was created in conformity with GAAP, that fact should be noted at the appropriate location within the plan. The same is true if the financial statements have been audited.

A. Projecting Financial Results from Operations

A projected profit and loss statement is a financial document that reflects the amount of profit or loss expected from business to generate in future periods. This is an essential document that should be put together. It will be a useful tracking tool for objectively determining whether a business is likely to make a profit and be successful or generate losses and eventually fail.

The projected profit and loss statement will list revenues from sales or services provided, cost for goods or services provided, operating expenses such as wages, rent, advertising, and net income or loss.

A projected profit and loss statement includes best estimates of future results rather than historical information. If there are trends, it's reasonable to take them into account. But Past performance is no guarantee of future results.

Depending on whether a projected profit and loss statement is prepared for an existing business or a startup enterprise, there arises some difficulty coming up with reliable estimates. For instance, for an existing business, it’s easier to make projections because historical financial information helps to forecast what a business might do in the future. On the other hand, for a startup business, some outside research is required.

Local library, chamber of commerce, and other industry associations can be used for information on demographics such as population, average age, and median income of the target market business is hoping to attract. This helps to determine whether there is a market for company’s product or service and also give an idea of any future growth trends. Dun & Bradstreet and other financial information purveyors can provide information regarding industry averages.

B. Projected cash flow statement

The projected cash flow is very important to most lenders because it provides an indication of whether business will have enough cash to pay its suppliers, vendors, and other creditors on time. This information also functions as a planning tool. If cash flow estimates show that business will occasionally not have enough money to pay its bills, it needs to arrange in advance for other sources of funds to get through cash flow crunches.

Cash flow is determined by taking inflows of cash (cash you're receiving) and subtracting outflows of cash (cash you're paying out). While preparing a cash flow budget worksheet for an existing business; historical information can be used as base. For a startup business, estimates of cash sources can be based on the revenues and expenses listed in the projected profit and loss statements. Review of projected profit and loss statement section is required to complete a projected profit and loss statement before completing the cash flow budget worksheet.

VIII. USING FINANCIAL RATIOS

Financial ratios provide audience with an objective basis for comparing the performance of a business with other businesses in the same industry. In addition, financial ratios also provide a company with the tools necessary to assess whether certain operations of business need fine-tuning. The following list explains how each of the financial ratios is calculated and what it reveals about a business's financial health. The list includes those financial ratios that should be included in a business plan. They provide a clear picture of business’s ability to generate a profit, pay bills on a timely basis, and utilize assets efficiently.

A. Current ratio = current assets / current liabilities

This ratio is the most commonly used measure of short-term solvency. It indicates the amount of current assets, such as cash, accounts receivable, and inventory that can be converted into cash to pay your short-term liabilities.

B. Quick Ratio = (Cash + Stocks &; Bonds Held for Investment + Accounts Receivable) / Current Liabilities

This ratio is a variation of the Current Ratio. It looks at current assets, but only those that can be quickly converted into cash to meet short-term liabilities. Many lenders are interested in this ratio because it does not include inventory, which may or may not be easily converted into cash.

C. Profit Margin Ratio = (Net Income + Interest Expense for the Period) / Revenues

This ratio provides a good indication of a business's ability to manage operating expenses at a given amount of revenues. For example, if profit margin has been diminishing over consecutive periods and revenues have remained the same, company has to take a close look at its operating expenses to see if it can cut overhead costs without affecting sales.

D. **Average Collection Days to Receivable Ratio= Annualized Accounts Receivable / Annual Net Credit Sales**

This ratio represents the average length of time it takes for business to convert credit sales into cash. It is calculated by multiplying your current account receivables by the number of days in the year. The result, annualized account receivables, is divided by your total annual credit sales. The resulting ratio shows the average number of days it takes to collect on receivables. A ratio that is high by industry standards will generally indicate that business needs to improve its credit policies and collection procedures.

E. Debt ratio = total debt / total assets

This ratio indicates the amount of debt a business has taken on relative to the total assets it owns. A high debt ratio indicates that creditors have financed a substantial portion of a business. This is often a red flag to potential lenders since it increases the possibility of bankruptcy if company’s net sales are not enough to meet its monthly debt and interest payments.

F. Return on Total Assets = Net Income / Total Operating Assets

This ratio indicates the rate of return being generated by the assets of a business. In some cases, consecutive periods of diminishing ratios may indicate a poor utilization of a plant and operating equipment. On the other hand, one or two periods of a lower ratio may not be cause for concern. In many instances, businesses gearing up for future growth invest in operating assets that do not immediately begin generating additional sales.

IX. APPENDIX

The appendix is the repository for those items that aren't part of the plan itself, but that are helpful or useful to someone reading the plan. It contains the material that supports and explains the conclusions and assumptions contained within the plan. If a reader is likely to seek further information regarding some portion of the plan, appropriate material should be included in the appendix. That way, company avoid having to dig through the material you accumulated while preparing the plan if a question arises as to the information presented within the body of the plan.
The appendix also houses, for example, sample marketing material. If company plans to run magazine ads, copies of the ads could be included in the appendix. Consider material for inclusion only if it adds to or clarifies the rest of the plan. For a startup it includes resumes of key employees if company relies on their skill and experience.

BENEFITS

1. It can identify potential problems that otherwise would not have surfaced until they caused major damage. Proactive analysis helps in forecasting the future events in advance and prepares future plans. The proactive approach is a deep analysis and identifies maximum potential problems.
2. Proactive analysis helps in facing the dynamic nature of environment by preparing contingency plans.
3. Proactive analysis helps in reducing the causes of failure by forecasting and preparing plans thus it reduces probability of failure.
4. It involves less cost but high returns in terms of pay offs. It helps in reducing probability of failure or losses.
5. Proactive analysis helps in ascertaining likely future requirements of the business projects and ensures availability of resources.
6. It helps in streamlining the direction of business by working to create and define those projects. It can also change the dynamics of the decision-making

LIMITATIONS

Firstly it is very costly affair. Proactive analysis involves investment of funds and a special team. So it increases the cost of business. Secondly, being proactive involves time investment because Proactive analysis is not a onetime analysis it has to be done continuously so it involves investment of time of business. Thirdly an efficient and effective proactive analysis depends upon the capability of the team. It will be of no use if team is incapable of projecting financial statements or predicting likely changes. Fourthly it Projects only part of future. The projections are different from the actual results of financial statements.

So it helps in predicting only part of future but is not capable to forecast all the changes and events. Fifthly it cannot identify all and rare opportunities/ threats. It cannot identify all the possible reasons and causes of failure. It is not able to predict the rare opportunities or threats of future e.g., natural disasters etc.

CONCLUSION

Proactive analysis of financial statements means estimating the future position and initiating change and influencing environment to attain desired place. This technique allows teams to discover possible problems, or ways the launch could fail, while there is still time to make adjustments Proactive is being ahead of what might happen. In behavior proactive means anticipatory, change-oriented and self-initiated behavior. This can be at a work place or anywhere in life. Proactive behavior is acting in advance of a future situation, rather than just reacting. Proactive is described to a person who takes responsibility for his or her life rather than looking elsewhere to make up their mind. Over the last decades, researchers have identified proactive behaviour as a very important determinant of success in one's life. It can be done by choosing something a company really wants to see succeed, and imagine a world in which it failed. Then, come up with all the ways it could have prevented that from happening in advance. This process should help provide clarity on exactly what a company need to do next

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