Analyzing financial information to make viable management decisions

What is Financial Information?

Financial information is anything related to the business's economic activities and performance. This information is from financial statements or reports that cover a specific aspect of a business's or individual's finances, such as cash flow and profitability.

Financial information shows a business's or individual's past performance, current performance, or expected future performance.

Effectively interpreting and leveraging financial data is paramount for informed decision-making, as it empowers managers to allocate resources efficiently, mitigate risks, and drive sustainable growth, ultimately ensuring an organization's long-term viability and success.

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Significant users of financial information

1. Investors.
   Investors use this information to decide whether to continue investing in the business or pull out based on the performance.

2. Lenders
   Lenders use this information to gauge a company's ability to pay debt or what interest rate to use.
3. Investment analysts.
   The analysts use this information to keep an update on a company's performance. Based on their analysis, they can recommend a company to their clients.
4. Customers
   Customers use financial information to determine whether they want a long-term relationship with a company.
5. Competitors
   To remain competitive and have a competitive edge, a competitor will want to know the financial status of its peers. They could also use this knowledge to determine if they need to change strategy.
6. Government institutions
   Governments use the financial information to determine if a company has paid its appropriate tax.
7. Company's management.
   The company's management prepares the company's financial information and uses it to measure its progress and growth. They also use this information to make decisions about the business.

Uses of financial information

Different types of financial information are used for various management purposes;

1. **Investment decisions:** Businesses can use financial information to determine if they have the necessary funds and solid financial standing to invest in new areas.
   Investors need to know and understand the cash flow, income, price, earnings, dividend per share, and other relevant financial statements to avoid irrationality in investment decision-making.
   Investors can also use information from financial statements to make decisions about the value and creditworthiness of a company.
   Investment decisions are crucial, and one must take caution because hard-earned resources are involved. Informed investment decision-making is essential to minimize risks associated with the loss of value of the money invested.

2. **Credit decisions:** Banks and lenders can use a business's financial information to determine if a company or individual is healthy enough to receive a loan. Financial information extends, restricts, or terminates an existing loan.

3. **Tax decisions:** Financial information can be used by tax authorities to determine how much a business needs to pay. One can use these statements to determine if an organization owes tax to the government or if the tax authority needs to issue a refund.

4. **Operational decisions:** Businesses can adjust their processes and staff based on information derived from financial data. They can use the information to measure their operation's effectiveness and make changes.

5. **Product or service decisions:** Analyzing financial information can be used to decide whether they need to change a product or service or the pricing to remain profitable.

Examples of financial information

Financial statements are the audited annual accounts of an organization. The audited accounts can include:

a) Balance sheet
b) Profit and loss account
c) Cash flow statement

1. Balance sheets
   It is also called a statement of financial position. It provides a snapshot of what a company owns and owes and the amount shareholders invest.
   The components of a balance sheet are:
   - Assets
     Assets are resources that a company owns, and that hold value. Assets are categorized into short-term assets and long-term assets.
     Examples of short-term assets are:
       - Accounts receivables: This refers to money that customers owe the company
       - Marketable securities: These are equity and debt securities for a liquid market.
       - Liquid assets: Cash and cash equivalents are the most liquid assets. They can include treasury bills, short-term certificates of deposit, and hard currency.
       - Inventory: Refers to any goods available for sale, valued at the lower cost or market price.
       - Prepaid expenses: This represents the value already paid for, such as insurance, advertising contracts, or rent.

Examples of long-term assets are:

  - Intangible assets: This includes non-physical assets such as intellectual property and goodwill.
  - Fixed assets: These refer to buildings, equipment, buildings, land, machinery, and other durable, capital-intensive assets.
  - Investments: These are securities that someone cannot liquidate in the next year

- Liabilities

  Liability refers to money a company owes to outside parties. It can be bills the company must pay suppliers, interest on bonds issued to creditors, rent, utilities, and salaries.

  There are two types of liabilities.

  - Long-term liability: This can be
    - Pension fund liability. It is money an organization must pay its employees after they retire.
    - Deferred tax liability: This is the tax that a company will not pay for another year.
    - Long-term debt: This could be interest and principal on bonds issued.
  - Current liability: These are in the following categories:
    - Accounts payable: These are debt obligations on invoices processed as part of the operation of a business that is often due within 30 days of receipt.
    - Premiums: Earned and Unearned. These are prepayments received by a company upfront.
    - Wages payable: These refer to salaries, wages, and benefits to employees, often for the most recent pay period.
    - Dividends payable: These are dividends that have been authorized for payment but have not been issued.
    - Customer prepayments: The customer receives money before the service or the product is delivered or provided.

- Shareholder Equity

It is money owned by the owners of the business or its shareholders. It can also be defined as the total assets of a company minus its liabilities or the debt it owes to non-shareholders.

Examples of shareholder equity:

  - Treasury stock: This is the stock a company has repurchased.

- Retained earnings: Earnings a company reinvests in the business or uses to pay off its debts.

2. Profit and loss statements
   A profit and loss statement refers to a financial statement that summarizes the company's proceeds, revenues, and expenses incurred during an accounting period. It provides a thorough look at a company's economic performance.
   The statements are prepared using the following accounting methods.
   - Cash method: This is when cash goes in(received) and out (paid) of the business.
   - Accrual method: This method records revenue when it is earned. It includes money that it expects to receive in the future.

3. Cash flow statements

   A cash flow statement provides a detailed picture of what happened to a business's cash during a period known as the accounting period. The report also shows how well a company generates money to pay its obligations, fund operating expenses, and fund investments.

   Using this statement, investors better understand how a company operates, where its money comes from, and how it is spent. The cash flow statement also provides information on whether a company has a firm foundation.

   There are three categories of cash flow statements:

1) Operating activities. This is the primary revenue of the company. It is derived from:
   - Sales of goods and services
   - Salary and wage payments to employees
   - Rent payments
   - Income tax payments
   - Interest payments
2) Investing activities: Includes cash flow from purchasing or selling the company's assets, such as real estate or vehicles. It also refers to loans made to vendors or received from customers.
3) Financing activities: Refers to cash from investors and banks, money paid to shareholders. It could include dividends or repayment of principal loans made by a company.

Image source: online.hbs.edu

Benefits of using financial information in an organization

a) Easier decision making
Institutions can use financial information to decide about the current condition, the plans, and areas where improvement is necessary. Investors also use this information to make investment decisions.

b) More accountability
The management is accountable to an organization's stakeholders because the information about the company's performance in the financial statement is known to the public, who may be interested in the company. The management must provide clear and transparent information supported by financial reports.

c) Better transparency
Proper accountability derived from good financial records leads to transparency, which is necessary for gaining the trust and confidence of investors, lenders, and other stakeholders.

d) Risk management
Investor's main aim is to try and minimize risk and maximize return on their investment in any company. Authentic company financial information helps investors manage that risk. The management can make investment decisions only after considering the investment risk for the business. These financial reports help in providing those insights.

e) Performance improvement – Analysis, transparency, and accountability help improve the company's performance and support in increasing profitability, liquidity, and the business's overall health.

Limitations of using financial information

I. The information is sensitive and risky to handle. Financial statements are subject to fraud due to manipulation by the management.
II. Historical costs. Sometimes, companies do not update financial information in time, which may be misleading. Making management decisions based on outdated data may lead to wrong conclusions. For example, a person who defaulted on a loan payment may be denied a loan in the future. Institutions may also increase a borrower's interest rate based on historical information.
III. Inflation. Information on assets and liabilities captured in financial statements does not consider inflation. If inflation is high, the information on the report will have a lower value.
IV. Intangible assets. It includes the company's reputation and brand value. These are neither recorded on the financial statements nor recorded in the sales.
V. Future predictions and assumptions. Financial statements provide historical information. This information is used to predict future sales. This prediction is prone to many assumptions and may not reflect the correct position in the future.

References:

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