

**Understanding financial statements of a business – Part 1**

Profitability and return on investment – the ROI

**Introduction**

Operating business is like driving a motor vehicle. Before driving off a car the driver needs to know the amount of fuel and adequacy of engine oil as well as conditions of the car braking system. After driving a distance, the driver checks again the fuel level, how far the distance been travelled and the level of lubrication and general condition of the car to complete the journey.

So when the owner or manager operates a business, he or she has to know the amount of stocks and cash available, the amount of sales revenue and expenses incurred as well as any money owing or not collected.

Operating a business without financial statements to provide the information go the owner or manager, is like driving a car without its dashboard, driving without knowing the condition of the car.

**Other purposes and users of financial statements**

Besides the owner and its managers, there are other parties who need to understand the business and its financial statements. A car has passengers, who do not drive but have to take risk on the driver. A bad or poorly prepared driver is a risk to all passengers, and some passengers may not want to be in the car.

Likewise in a business there are other people involved who are not the owners and managers. Like passengers in the car they are suppliers, bankers who lend money as well as customers who have paid deposits for their goods. These parties would want to understand the business and feel safe enough to be in the business like any passenger in a car. These suppliers, bankers and customers need to be comfortable or convinced that the business is also safe and trustworthy for any money it is obliged to pay.

**Financial statements**

*Historical financial statements*

Financial statements provide information to drive a business. Financial statements that are prepared for an operational period earlier are based on historical financial information. The historical financial statements are usually audited by an external audit firm to ensure that they reflect a true and fair view of the business.

The historical financial statements provide the owners of the business or its shareholders and lending bankers with a view of the profitability and financial condition of the business. This view will then let the owners and bankers decide if the business is doing well and the level of risk it is facing, and make decisions whether the business should continue or be terminated.

These historical financial statements are also regularly used by managers of the business like the CEO and the management team to decide if business strategies are working and whether financial resources are adequate for business operations. From these the management then make decisions on changes in business policies and tactics to ensure achieving the results it wanted. For management purposes these historical financial statements are prepared more frequently e.g. at the end of each month and may not be audited for public disclosure.

Without these historical financial statements the management would be like driving a car without a dash board and business owners and investors would be taking investment risk without understanding the business condition.

*Forecast financial statements*

Unlike historical financial statements, forecast financial statements are estimated outcome of the business if certain resources, policies and actions are followed at the end of a future period. The estimated results and financial position would provide both the business owner and bankers an idea of the likely achievements for that period, and make judgment whether the estimated outcome is satisfactory or need to be improved.

Management of the business too would find this as the basis for making changes in business plans and resource requirements if the forecast outcome is not satisfactory. Once these forecasts are agreed upon, they then become formal budgets for the company to achieve in the coming period or financial year.

**Profitability**

A commercial business is operated for a profit and it must be attractive enough to draw capital and financial support from investors, banks and creditors. A business that does not show ability to achieve sufficient profitability indicates to its owners and investors that it may not be economic as an investment.

When such a judgement is arrived at by the owners and investors, future capital requirements or financial support become unlikely and the company faces increase risk of loss of financial access. If business owners and investors are to feel that way, loans and credit support from suppliers will only dwindle away. This leaves a company vulnerable to a cash flow crisis and potential collapse.

*Business profitability*

A company is organized to operate a business such as marketing and selling landed properties, manufacture and selling apparels or operate a hotel – cum restaurant. In general terms a high risk business would have a higher profitability than a lower risk one. Different types of businesses would have different degree of risk. As an example a construction company has considerably more risk than a business distributing staple consumer food products like sugar and rice.

The gross profit margin is the difference between the selling price and the costs of the product or service sold. This gross margin generally reflects the principle of risk and reward for a business activity. For illustrative purpose, a simple example is provided here –

|  |  |  |  |
| --- | --- | --- | --- |
|  | A Co. | B Co. | C Co. |
| High risk business | Low risk business | High risk business |
| Sales income | 100 000 | 100 000 | 100 000 |
| Cost of goods sold | - 60 000 | - 85 000 | - 85 000 |
| Gross profit | 40 000 | 15 000 | 15 000 |
| Gross profit margin | 40% | 15% | 15% |

The observation above shows that A Co. and B Co. would be considered as normal risk – pricing practice. C Co. illustrates one that might be deemed as less satisfactory since it is higher risk but carrying a low gross margin. The business owner and its management might want to review this situation unless it considers this high risk low margin situation as healthy. Please note that operating expenses have not yet been deducted from the gross profit to arrive at the net profit as illustrated below.

*Company profitability*

Company profits are derived from various business activities and projects, and after deducting operating expenses. Operating expenses are those costs associated with running the company and not factory product costs or direct project costs. Operating expenses are those incurred in running and administering the company such include accounting, office salaries, advertising, office rental, sales delivery costs and customer service expenses. The net profit of a company is determined after deducting all these operating expenses.

|  |  |  |  |
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| Sales income | 100 000 | 100 000 | 100 000 |
| Cost of goods sold | - 60 000 | - 85 000 | - 85 000 |
| Gross profit | 40 000 | 15 000 | 15 000 |
| Operating expenses | 10 000 | 10 000 | 10 000 |
| Net profit before tax | 30 000 | 5 000 | 5 000 |
| Net profit margin | 30% | 5% | 5% |

It can be observed from the above that a business with a higher margin is a more successful one. But on another hand it can also be said that the business with a small net profit margin (also called net sales margin) is a riskier business since it can very easily slip into a loss.

B Co. has a smaller net margin like C Co. However C Co. is a higher risk business. If business conditions become difficult or competitive, a higher risk business would face higher costs and or with sharper reduction in selling prices or sales volume. The question that is asked is whether C Co. can sustain as well as B Co. given it has a much higher risk but at the same net profit margin.

*Non - operating income*

There are times when trading conditions become difficult and yet there is pressure to show progress and profitability. Business managers, rather than owners, would always try to improve profit results from all possible avenues. This then leads to other income from non-operating areas. Such other incomes commonly include profit from sale of land and fixed assets, gains from financial derivatives and foreign currency positions as well as dividends and profits from associated companies. These incomes do not arise from core business activities for which the company has been set up for. While they are rightfully income of the company, these are often once – off items and non - recurring. Even if they do, the contribution is not expected to be significant, say 5% to 10%. Where the other income is significant, say 40%, then the true results of the business (not company) must be disturbing for that year.

|  |  |  |
| --- | --- | --- |
|  | X Ltd. | Y Ltd. |
| Sales income | 500000 | 500000 |
| Cost of goods sold | - 420000 | - 400000 |
| Gross profit | 80000 | 100000 |
| Other income | 50000 | NA |
| Operating expenses | -70000 | -70000 |
| Net profit before tax | 60000 | 30000 |
| Net profit margin | 12% | 6% |

The above illustration shows the kind of distortion to the final profit results if one ignores the other income of $50000 in the case of X Ltd. The true net operating margin is really 2% instead of 12%.

*Return on investment*

When a business is set up, the business owner would have high hopes of attractive returns. If the return on investment subsequently shows that the profitability is not attractive enough, the business might just be closed, even if it is not yet losing money. The issue is a satisfactory return on investment – or the ROI.

The ROI is defined differently from different perspectives. The owner of a business would see the ROI in terms of what he or she gets back from the money invested into the business. The money he or she invested is commonly spoken of as capital or as equity if it is capital and retained profits. In this instance the business owner or investors could have spoken of return on equity instead i.e. the ROE. So the ROE is an indicator of return i.e. the ROI from the business owner’s or shareholders’ perspective.

Other people, such the lending bank and the management of the company, would look at the total funds provided to the business and how they are used to generate profit, and whether that profit is acceptable return. Obviously it is the management (not necessarily the business owner) of the company that uses the money to generate a return from operating the business.

Since the funds for the business is made up of equity as well as funds from banks and suppliers credit, it would be practical to see the returns from the use of all these funds, to see if the return is satisfactory to make everyone happier. This leads to the view of the ROI as a return from the use of these funds, and this is commonly referred to as return on assets – the ROA. The following diagram illustrates the ROE and ROA as measures of return on investment.

Total

Assets

100m

Sales

COGS

OPEX

EQUITY Capital

+

Profit

60m

Net profit 4.8m

Loans

+

Credit

The above illustration indicates that the ROI differs from different perspectives.

From the perspective of the business owner or shareholders, the ROI is the ROE i.e. $4.8m against capital and retained profits of $60m. That leaves a return of 8%. The ensuing question for the business owner and shareholders is whether this 8% will keep them interested in the business, given there are also other investment alternatives of higher returns or lower risks.

The management of the business will be under intense focus in this illustration. The result of $4.8m is from the use of total assets of $100m, regardless of the money coming from shareholders or suppliers or banks. Therefore this provides a view to the efficiency of the business and how its assets are managed to generate the return. This is the ROA – the return on assets. Poor management efficiency shows up in a low ROA of 4.8%.

This ROA will be further scrutinised and compared with the cost of money raised for the company. Money raised for the company comes from a combination of loans from banks as well as capital and retained profits of the shareholders. Since money borrowed from banks carry an interest rate, the ROA should logically exceed the cost of loans. If the ROA is less than the cost of loans, then the business assets have been poorly managed.

However the total assets of the company also draw funds from the shareholders and a financial compensation is expected. This is the return expected by shareholders or the business owner when they all decided to put their money into the company. Therefore the ROA must also be greater than the ROE, explained earlier.

Equity 60M

15%

Total

Assets

100m

This leads to the recognition of the cost of capital of the

company. The diagram shows the funding structure and its

components of financing as well as the costs.

Loans 40M

10%

The cost of capital here is then made up of –

1. Cost of loans 10% x $40m = $4m
2. Cost of equity 15% x $60m = $9m

Total cost of capital $13m or $13m/ $100m i.e. 13%

If the cost of capital is 13% and the ROA of 4.8% then this cannot be said as a satisfactory performance. Certainly it would encourage bankers to look away, if not the business owner.

**Summary on profitability and the ROI**

The profitability of a business and the company should be distinguished for a better understanding of the company’s success. A company is set up to engage in a business undertaking which carries risks and rewards. That business itself and its activities should be subject to an assessment as to whether it is rewarding at all for the past year to justify capital investment and continuing risks.

A high risk business should be compensated by a higher gross margin and any other way would appear to be a bad mispricing. Competition, changes in economic conditions and operational issues every day are risk concerns and attractive rewards have to be present to motivate risk taking.

A low net operating margin highlights the serious risk of incurring a loss at some slight changes in pricing, costs and economic volatility. Acceptance of a low net margin for a disproportionately higher risk reflects the presence of a weak business environment and that itself is a warning of some sort to the banker, business owner, investors, management and suppliers to the company.

The return on investment is the motivation for capital investment and a poor ROE would triggers off concerns over poor investment and rising risk of falling financial support from shareholders and business’ owner. If the owners of the business are not inclined to support a company with low ROE especially during down times, the danger would increase for the banks and suppliers on credit terms. All these can then lead to withdrawal of bank lines and reduced credit terms.

The ROA is a proxy of management quality or management performance. Assets of a company are for business activities. These assets are funded with a cost of capital. Unless the ROA exceeds the cost of capital, it may signal presence of non - performing assets or poor management and leadership. Once this has been observed, senior management and directors of the company would have to kick into action to arrest the weak situation from deteriorating.

Perhaps the low ROA is temporary, but nonetheless it is a danger signal to start the risk management process. We do not react and take action only when a business loss happens …. Perhaps we should take action even before losses happen.

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To be continued ……

**Understanding financial statements of a business – Part 2**

Financial condition of the business and its risks