FINANCIAL PERFORMANCE MEASURES

Image from Pixabay

How to measure company financial performance?

Financial performance measures are used to monitor the inflows (revenue) and outflows (costs) and the overall management of money in the business. These measures focus on information available from the Statement of profit or loss and Statement of financial position of a business. Financial measures can be used to record the performance of cost centres, profit centres and investment centres within a responsibility accounting system but they can also be used to assess the overall performance of the organisation. For example, if cost reduction or cost control is identified as a critical success factor, cost based performance measures might be an appropriate performance indicator to be used. Cost based performance measures can be calculated as a simple cost per unit of output. The organisation will have to determine its policy for establishing cost per unit for performance measurement purposes. The chosen method should then be applied consistently.

Measuring profitability

The primary objective of a profit seeking company is to maximise profitability. A business needs to make a profit to be able to provide a return to any investors and to be able to grow the business by reinvestment.

Three profitability ratios are often used to monitor the achievement of this objective:

- **Return on equity (ROE) = operating profit ÷ (non-current liabilities + total equity) %**

- **Return on sales (ROS) = operating profit ÷ revenue %**

- **Gross margin = gross profit ÷ revenue %**

NOTE: Operating profit is profit before interest and tax and after nonproduction overheads have been charged.

Return on equity (ROE)

This is a key measure of profitability as an investor will want to know the likely return from any investment made. ROE is the operating profit as a percentage of capital employed. It provides a measure of how much profit is generated from each 1 euro of capital employed in the business. Operating profit (profit before interest) is being compared to long term debt (non-current liabilities) plus the equity invested in the business. Operating profit represents what is available to pay interest due to debt and dividends to shareholders so the figures used are comparing like for like.

A high ROE is desirable. An increase in ROE could be achieved by:

- Increasing profit, e.g. through an increase in sales price or through better control of costs.

- Reducing capital employed, e.g. through the repayment of long-term debt.

Return on sales (operating margin)

This is the operating profit as a percentage of revenue. A high return is desirable. It indicates that either sales prices and or volumes are high or that costs are being kept well under control.

Gross margin

The gross margin focuses on the trading activity of a business as it is the gross profit (revenue less cost of sales) as a percentage of revenue. A high gross margin is desirable. It indicates that either sales prices and or volumes are high or that production costs are being kept well under control.

Measuring liquidity

A business can be profitable but at the same time encounter cash flow problems. Cash at the bank and profit are not the same thing. There are two liquidity ratios that are used to give an indication of a company's ability to manage and meet short term financial obligations.

Current ratio

This is the current assets divided by the current liabilities.

$$\text{Current ratio} = \frac{Current\ assets}{Current\ liabilities}$$

The ratio measures the company's ability to meet its short-term liabilities due within one year with the current assets than should be converted into cash within one year. A ratio in excess of 1 is desirable but the expected ratio varies depending on the type of industry. A decrease in the ratio year on year or a figure that is below the industry average could indicate that a company has liquidity problems. The company should take steps to improve liquidity, e.g. by paying payables as they fall due or by better management of receivables in order to convert the money owed into cash more efficiently.

Equally a high ratio could indicate that any surplus cash is not being made efficient use of. Cash does not provide a return so it should be reinvested in the business.

Acid test (Quick ratio)

This is a similar to the current ratio but inventory is removed from the current assets due to itspoor liqui dity (time taken to convert into cash) in the short term.

$$\text{Quick ratio} = \frac{Current\ assets - inventory}{Current\ liabilities}$$

Image from Pixabay

Measuring activity

Activity ratios look at how well a business manages to convert statement of financial position items into cash. They are used to investigate how efficiently current assets are managed.

Asset turnover

$$Asset\ turnover = Revenue\ \div Capital$$

The asset turnover measures how much revenue is generated from each 1 euro of capital employed in the business. A high asset turnover is desirable. An increase in the asset turnover could be achieved by:

• Increasing revenue, e.g. through the launch of new products or a successful advertising campaign.

• Reducing capital employed, e.g. through the repayment of long-term debt.

Inventory days

$$Inventory\ days = Inventory\ \div Cost\ of\ sales\ \times\ 365$$

This indicates the average number of days that inventory items are held for before they are sold. Cost of sales is used in this calculation as opening inventory plus purchases less closing inventory equals the

inventory being held. Sometimes a business might want to look at a specific line of inventory so more detailed information will be required.

An increase in the inventory holding period could indicate that the company is having problems selling its products and could also indicate that there is an increased level of obsolete inventory. The company should take steps to increase inventory turnover, e.g. by removing any slow moving or unpopular items of inventory and by getting rid of any obsolete inventory.

A decrease in the inventory holding period could be desirable as the company's ability to turn over inventory has improved, and the company does not have excess cash tied up in inventory. However, any reductions should be reviewed further as the company may be struggling to manage its liquidity and may not have the cash available to hold the optimum level of inventory.

Receivable days

$$Receivable\ days = Receivables\ \div Credit\ sales\ \times\ 365$$

This is the average period it takes for a company's receivables to pay what they owe. Sometimes the breakdown of revenue into cash and credit sales is not available, in which case revenue is used in place of credit sales and it is assumed that all sales are on credit. An increase in the receivable days indicates that the company is struggling to manage its debts.

Possible steps to reduce the ratio include:

• Credit checks on customers to ensure that they will pay on time

• Improved credit control, e.g. invoicing on time, chasing up debts.

A decrease in the receivable days may indicate that the company has improved its management of receivables. However, receivables days well below the industry average may make the company uncompetitive and profitability could be impacted as a result.

Payable days

$$Payable\ days = Payables\ \div Credit\ purchases\ \times\ 365$$

This is the average period it takes for a company to pay suppliers for purchases.

If the value of credit purchases is not available then cost of sales can be used in its place.

An increase in the company's payable days could indicate that the company is struggling to pay its debts as they fall due. However, it could simply indicate that the company is taking better advantage of any credit period offered to them. A decrease in the company's payable days could indicate that the company’s ability to pay for its purchases on time is improving. However, the company should not pay for its purchases too early since supplier credit is a useful source of finance.

Measuring risk

In addition to managing profitability, liquidity and activity it is also important for a company to manage its risk. How 'geared' a business is can be calculated to assess financial risk. Gearing indicates how well a business will be able to meet its long-term debts.

Capital gearing (leverage)

This ratio calculates the relationship between borrowed capital (debt) and owner's capital (equity):

Capital gearing = non-current liabilities (debt) ÷ ordinary shareholders funds(equity) %

Or

Capital gearing = non-current liabilities (debt) ÷ (non-current liabilities + ordinary shareholders funds (debt + equity)) %

The level of gearing indicates how much a business relies on long term debt finance. The higher the percentage the higher the level of risk as any debt finance must be paid back through interest and capital repayments. There is a legal obligation to make these payments. Repayment of equity finance is through dividends and there is no legal obligation to make these payments to shareholders.

There is no 'correct' level of gearing but if debt exceeds equity then gearing is too high.

Interest cover (income gearing)

$$Interest\ cover = Operating\ profit\ \div Finance\ cost$$

This shows how many times the finance cost (interest payments) could be paid out of the operating profit. The higher the figure the better. A decrease in the interest cover indicates that the company is facing an increased risk of not being able to meet its finance payments as they fall due. The ratio could be improved by taking steps to increase the profit, e.g. through better management of costs, or by reducing finance costs through reducing the level of debt.

Problems with using only financial performance indicators

All of the ratios reviewed so far have concentrated on the financial performance of the business. Many of these ratios, e.g. ROE, gross margin, may be used to assess the performance of a division and of the manager in charge of that division. Achievement of these target ratios (financial performance indicators) may be linked to a reward system in order to motivate managers to improve financial performance.