

Banking and Accounting Issues

Chapter 9

Overview of Financial Performance Concept in Organisations

Horsfall, Kaine Anwuli

Department of Accounting, Faculty of Business Studies

Ignatius Ajuru University of Education, Port Harcourt, Rivers State, Nigeria

kainesjoy@yahoo.com

Concepts of Financial Performance

Performance is the function of the ability of an organization to gain and manage the resources in several different ways to develop competitive advantage (Chen & Wong, 2004). There are two kinds of performance, financial performance and non-financial performance. Financial performance emphasizes on variables related directly to financial report. Company's performance is evaluated in three dimensions. The first dimension is company's productivity, or processing inputs into outputs efficiently. The second is profitability dimension, or the level of which company's earnings are bigger than its costs. The third dimension is market premium, or the level of which company's market value is exceeding its book value (Walker, 2001). Performance is a difficult concept, in terms of both definition and measurement. It has been defined as the result of activity, and the appropriate measure selected to assess corporate performance is considered to depend on the type of organization to be evaluated, and the objectives to be achieved through that evaluation.

Financial performance is a slanted gauge of how efficient a corporation can use resources from its prime means of business and spawn revenue. It's also, a gauge of the outcome of a corporation's policies and monetary terms of its operation. There are several ratios how to measure the company performance. Spira (2013) mentioned accounting-based performance using three indicators: return on assets (ROA), the return on total equity (ROE) and return on investment (ROI). These are widely used to assess the performance of firms. Even though more sophisticated methods such as IRR, CFROI and DCF modelling have come along; ROE has proven as a good technique. It focuses on return to the shareholders of the company but on the other hand it can obscure a lot of potential problems. Companies can use financial strategies in order to artificially maintain healthy ROE and thus hide deteriorating performance in business fundamentals. On the other hand, ROA avoids the potential distortions created by misleading financial strategies.

Another ratio used to represent firm financial performance is so called Tobin's Q ratio. It is calculated as a market value of the company divided by the replacement value of the firm's assets. In this study, the relationship between various Audit Committee characteristics and the hospitality industry performance is represented by ROE, and Tobin's Q

Researchers in the economics field have offered a variety of models for analyzing financial performance. However, little consensus has emerged on what constitutes a valid set of performance criteria. For instance, researchers have suggested that studies on financial performance should include multiple criteria analysis. This multidimensional view of performance implies that different models or patterns of relationship between corporate

Banking and Accounting Issues

performance and its determinants will emerge to demonstrate the various sets of relationships between dependent and independent variables in the estimated models.

Financial performance have been measured using various standards including gross profit, net profit, return on equity and return on assets among other measures. For the purpose of this study, net profit, Return on Asset and Return on Equity shall form the proxies of the study.

(i) Net Profit

Net Profit is the total amount that a business earns after all tax deductions have taken place. It is used as an indicator to determine how much business really earns and how much it can utilise for its day to day activities. Net Profit is also seen as a measure of a company's profitability after all its expenses have been deducted and can fully utilise by the company to conduct its business.

Net profit of a firm is what comes after operating expenses and all other charges including taxes, interest, depreciation and amortization have been deducted from total revenue. Also called Profit after Tax (PAT). It also entails the total income generated from sales, and different transactions after-tax (Wilkinson, 2013). Moreover, as an alternative to gauging the accomplishment of the corporation in attainment of profit, more profitable industries in diverse sectors also guide their performance against its rivals within the industry average.

Net Profit/Profit after-tax is the earnings of a business after all income taxes have been deducted. This amount is the final, residual amount of profit generated by an organization. The profit after-tax figure is considered the best measure of the ability of an entity to generate a return, since it incorporates both operating income and income from other sources, such as interest income. The profit after-tax margin is closely watched by investors to see if the income-generating ability of a firm is changing over time. If so, this could be considered a valuation indicator that may result in a change in the stock price.

In the business world, profitability refers to the extent to which an organization has added value in its line of activities. Profitability is most often used to assess the ability of an organization to continue in business. The main issue in evaluating the profitability of an organization is its profit performance. The term Profit has several definitions; an investor views it as a measure of return on his money. Economists look at it as a reward for entrepreneurship for taking a risk. An accountant thinks that profit is the excess of income/revenue over expense incurred in producing that revenue. Lagerstrom (2000) views profit as a measure that is helpful to both the managers and those who judge the performance of the managers. It, therefore, provides managers with the recent and easily comprehensible signal of how well they are performing, and it gives others the basis of judgments over the performance of the managers. Van Horne (2002) assert that tests of profitability centre on measuring the adequacy of income by comparing it with one or more primary activities or factors that are measured in the financial statement. According to Iyiegbuniwe (1996), profit is a measure of the productivity of economic activities, a function of the market price of the goods and services, and the operating efficiency in terms of minimum input costs of business enterprises. As a measure of performance, profit is universal and fundamental to economic activity, here in this study; profitability is measured in terms of profit margin.

(ii) Return on Assets (ROA)

Banking and Accounting Issues

Return on Assets (ROA) determines an organization's efficiency in the ability to make use of its assets. Return on Assets (ROA) is described to be the sum of a company's fixed assets and current assets as recorded in the company's statement of financial position. It is also, described as the sum of all cash, investments, PPE (property, plant and equipment), equipment, receivables, intangibles, and any other piece of value a business entity owns.

The return on assets ratio evaluates the financial performance of an organization in terms of its investment in total assets or net assets. The fund employed in net assets is known as capital employed. Net assets equal net fixed assets plus current assets minus current liability, excluding bank loans. Alternatively, capital employed is equal to net worth plus total debt (Pandy 2004). The formula for calculating it is:

$$\text{ROA} = \frac{\text{Net Profit after Tax + Interest}}{\text{Total Assets}}$$

The total assets have been financed from funds supplied by creditors and owners. In measuring the return on assets, the intention is to judge the effectiveness of using the total funds supplied. The return on assets is a useful measure of the profitability of all financial resources invested in the firm's assets. It evaluates the use of total funds without any regard to the sources of funds (Pandy 1979 as cited by Nwanyanwu 2013).

Many analysts consider the return on total assets ratio to be a better measure of management's ability to effectively utilize assets independent of how the assets were financed. Under the return on assets, also referred to as return on total investment ratio, investment is the number of resources provided by both owners and creditors (Libby et al., 2001).

(iii) Return on Equity (ROE)

Ross (1996) noted that return on equity is a measure of how the shareholder's money fared during the year. They further assert that ROE is, in an accounting view, the right bottom-line measure of performance. ROE is a measure of profit on investment in equity. Helfert (1991) calls this ratio, return on net worth, and states that it is the most common ratio used for measuring the return on the owners' investment. The ratio of net profit after taxes to common equity measures the rate of return on the stockholder's investment. Return on equity (also called return on owners' investment) is a fundamental test of profitability. It relates income to the investment that was made by the owners to earn income. It reflects the simple fact that investors expect to earn more money if they invest more money. It provides the most comprehensive framework for evaluating company performance. Return on equity measures how much the firm earned for each naira of stockholder's investment. In the long run, firms with higher ROE are expected to have higher stock prices than a firm with lower ROE, all other things being equal. Managers, analysts, and creditors use this ratio to assess the effectiveness of the company's overall business strategy – its operating, investment, and financing strategies (Libby et al., 2001). Thus, Return on equity (ROE) can be defined as the amount of net income returned as a percentage of shareholders' equity. It is one of the all-time favourites and perhaps most widely used overall measure of corporate financial performance. ROE is popular among investors because it links the income statement (net profit/loss) to the balance sheet (shareholders' equity). The fact that ROE represents the end result of structured financial ratio analysis, called Du Pont analysis, also contributes towards its popularity among analysts, financial managers, and shareholders alike (Mboroto, 2012).

Return on equity is expressed mathematically thus:

Banking and Accounting Issues

$$ROE = \frac{\text{Net Profit}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Assets}} \times \frac{\text{Assets}}{\text{Equity}}$$

The ratio tells us the earning power on shareholders' book investment, and it's frequently used in comparing two or more firms in an industry (Van Horne, 2002). The ordinary shareholders' equity is total shareholders' equity (net worth) less the preference shareholders equity, or it can be found out as paid-up ordinary share capital plus share premium, reserves, and surplus less accumulated losses. This ratio indicates how well the firm has used the resources of the owners. This ratio is one of the most critical relationships in ratio analysis. The earning of a satisfactory return is the most desirable objective of a business. The ratio of net profit to owners' equity reflects the extent to which this objective has been accomplished. This ratio is thus, of great interest to present as well as prospective shareholders and also of great concern to management, which has the responsibility of maximizing the owners' welfare (Pandey, 1979).

ROE = (Net profit after tax/sales) * (Sales/Net assets)* (Net assets/Total equity). The above equation is the traditional Du Pont identity. It shows that ROE depends on operating efficiency (profit margin), asset use efficiency, and financial leverage (Ross, 1996). The Du Pont system is a financial analysis and planning tool, which uses basic accounting relationships. It is designed to provide an understanding of the factors that drive the ROE of a company. ROE can be progressively decomposed to the specific income statement and balance sheet items. A flow chart may represent the decomposition of ROE. Management can use such a flowchart to identify nations where improvement can best be achieved if ROE is unsatisfactory (Ross, 1996). According to Banker (1993), the Du Pont formula has long been used to measure the financial performance of companies. They think that due to how the profitability ratio is constructed, it provides only a gross aggregate measure and does not easily capture the impact that the micro-attributes of the operations of companies have on profitability. In answer to this problem, the American Productivity Center (APC) formally disaggregates changes in a company's profitability into two components capturing changes in its productivity and its price recovery ability.

Incorporate finance; the return on equity is a measure of the profitability of a business in relation to the equity, also known as net assets or assets minus liabilities. ROE is a measure of how well a company uses investment to generate earnings growth. This is a monetary ratio which indicates the amount of value earned by an organization as against the combined sum of equity invested (Mboroto 2012). Return on equity (ROE) reveals the return investors expect to earn on their investments.

However, for different reasons, ROE could be a misleading measure of corporate financial performance (Mboroto 2012). First, earnings can be manipulated within the legal framework via changes in accounting policy. Second, ROE increases with more financial leverage, as long as the returns earned on the borrowed funds exceed the cost of the borrowings. An increase in leverage beyond a certain level may translate into an increase into the firm's systematic risk or beta. Third, ROE is also susceptible to inflation; inflation had a negative relationship with the profit margin which will, in turn, reduce ROE and expected growth (Mboroto 2012).

REFERENCES

Banking and Accounting Issues

Banker, M. (1993). Corporate performance management. *Measuring Business Excellence*, 7(2), 15-21.

Chen, K. C., & Wong, S. (2004). The stock market valuation of research and development expenditures. *Journal of Finance* 56(6), 2431-2456.

Helfert, R. U. (1991). The Impact of Capital structure on corporate profitability in Nigeria. *Accountancy Review*, 3(1), 21-38.

Iyiegbuniwe, H. (1996). Corporate governance and firm cash holdings in the U.S. *Journal of Financial Economics*, 87, 535-555.

Lagerstrom, E. (2000). The intellectual capital and corporate performance in Indian pharmaceutical industry. *Journal of Intellectual Capital*, 9(4), 684-704

Libby, U., Libby, S., & Short, G. (2001). Human resources accounting: Measuring the value for human assets and the need for information management. *European Journal of Accounting, Auditing and Finance Research*, 3(7), 72-90.

Mboroto, S.N., (2012). *The effect of mergers and acquisitions on the financial performance of petroleum firms in Kenya*. Doctoral dissertation, University of Nairobi Press.

Nwanyanwu, L. A. (2013). Financial reporting and organizational liquidity in Nigeria: the accounting bases perspective. *Research Journal of Finance and Accounting*, 4(16), 79-89.

Ross, E. (1996). *The measurement and management of intellectual capital*. New York, NY: International Federation of Accountants (IFAC).

Spira, L. F. (2013). Ceremonies of governance: Perspectives on the role of the audit committee. *Journal of Management and Governance*, 3, 231-260.

Walker, D. (2001). Exploring the human capital contribution to productivity, profitability and the market evaluation of the firm. *Journal of Economics and Sustainable Development*, 23(2), 34-59.