Assessing Financial Health (Part-B)[1]

In Part-A of the analysis, we have looked into the financial statement of a company and examined the financial health of the firm through various ratios. Our analysis was aimed to find out how efficient the firm was in using the assets (turnover ratios) and capital (profitability ratios) and how efficient the firm was managing long-term and short-term solvency (debt to total assets and current ratios). In this Part-B, we will be comparing the financial statement and ratios of the firm with a close competitor or best company in the industry (or alternatively with the industry average) to understand strong and weak areas of the firm. Such an analysis is expected to benefit the firm to develop appropriate strategy and deploy resources to improve the financial health. We will be referring the company you have analyzed earlier as "the company" and the competitor company as "the competitor" (or "the industry" in case we use industry ratios) for this Part-B. The financial statement of the industry (or competitor) in summarized form is given in Exhibit 3 and Exhibit 4.

(1) Before we proceed further, complete the following table, which consists of few ratios which you have computed for the company in Part A or compute again and enter the values. Also compute and enter the ratios of the competitor (or the industry) in the same table (column 3). Use the data presented in Exhibit 3 and Exhibit 4.

	Company	Competitor or Industry
Return on Equity (PBT/Shareholders Fund)		
ROCE (PBIT/(Total Assets-Current Liabilities)		
Total Debt to Shareholders' Fund		
Assets Turnover Ratio (Sales/Total Assets-CL)		
PBIT margin (PBIT/Sales)		
Fixed Assets Turnover Ratio (Sales/Fixed Assets)		
Current Assets Turnover Ratio (Sales/Current Assets)		
Raw Material to Sales		
Conversion Cost to Sales		
Selling and Distribution to Sales		

[1] This case study is prepared by Prof. M S Narasimhan, Indian Institute of Management Bangalore based on the article Narasimhan, M. S. and Balasubramanian, G., "Quality of Earnings: An Accounting Model for Analysing Corporate Performance", *Management Review (IIMB)*, Vol. 12, No. 4, December, 2000, Pp. 35-42. Please refer the article for additional input on the topic.

How my returns are comparable with my industry (or competitor)?

(2) The company has earned a Return on Equity of __________ % and it is higher/lower than the Return on owners' equity of ________ % of the industry (or competitor).

If a firm reports a Return on Owners' Equity, which is higher than its competitor(s) or industry average, the management should be proud about it. On the other hand, if the Return on Owners' Equity reported by the firm is less than its competitor(s) or industry average, the management should understand where they going wrong so that they can try to correct it. Understanding the problem is as critical as finding a solution. We will now examine the difference in Return on Owners' Equity.

(3) There are basically three factors affecting the Return on Owners Equity, which we discussed in Part A. They are Return on Capital Employed, Cost of Debt and Financial Leverage (debt to net worth). Return on Equity is more than return on capital employed if (a) cost of debt is less than return on capital employed and (b) debt to equity is positive. The Return of capital employed (PBIT divided by Total Assets less current liabilities) of the company is _______ % against the Return on Capital Emplyed of the competitor or industry _________%. The company is reporting a ________ % of Return on Capital Employed more/less than the return offered by the competitor (or industry). This excess/deficit part of the return is one component of the difference that we noted down when the return on owners' fund was compared with the return of owners fund of the competitor (or industry).

(4) The difference in the return on owners' capital of the company and ROCE of industry or competitor as computed earlier is ________% Of this ______ % is attributed to efficient/inefficient managing of assets and cost. The balance difference of ______% can be attributed to presence of debt and how efficiently the company is using its financial leverage. We will show how the balance is attributed to leverage effect.

Managing Financial Leverage

Debt will improve the return to owners if the firm uses such debt to earn a return more than cost of debt (interest cost). It will reduce the return to owners, if the firm uses the debt to earn a return below the cost of capital. Because of this, debt adds risk to the equity holders and they expect a compensation for the same. Equity holders will demand an additional return equal to difference between the ROCE of the competitor (or industry) and cost of debt multiplied by debt equity ratio. If the company earns return on debt capital more than competitors ROCE, then the company offers a reward to the shareholder for taking such additional financial risk.

(5) The company pays an interest of Rs. ______ on total borrowed capital of Rs. ________. The cost of debt or interest rate is equal to ______%. The ROCE of industry defined as PBIT divided by Total Assets less Accounts Payable and provision for expenses and taxes is equal to _______%. The difference between the competitor's (or industry) Return on Capital Employed and current interest cost of the company is equal ________%. If the difference is negative, it means the interest cost is more than business return generated out borrowed funds. If the difference is positive and multiplied by the Debt to Shareholders Fund Ratio of __________, it gives __________ as minimum required additional compensation for taking finance risk.

(6) The company's ability to exploit financial leverage can now be assessed. The company reports _______ % as Return on Equity and _____% as ROCE. Of this, the minimum required additional return for taking financial risk is ______% (see the working derived in (5)). The balance of ______% can be attributed to additional return that the company has generated by managing financial risk. If the balance value is negative, it means that the company is destroying shareholders wealth by using debt. These companies should either improve the earnings to meet the cost of debt or restructure the capital by reducing the debt.

Assessing Efficiency of Asset Management

Let us now look into the efficiency of managing assets and cost. In (3), we found that the company's Return on Capital Employed is greater/lower than the ROCE of the competitors (or industry) by ________%. There are two reasons for the same. Such positive return can be attributed to efficiency in managing the assets or efficiency in managing the cost better than the competitor or industry or both.

(7) The Asset Turnover Ratio of the company is ______ and this is more/less than the asset turnover ratio of the competitor (or industry) by _______ (enter the difference in the Asset Turnover Ratio). Such excess/deficit should have caused an impact on the difference in the return on capital employed of the company vis-à-vis competitor (or industry). For instance, if the company's total asset turnover ratio is more than the industry or competitor, it should produce a return on capital employed, which will be more than the return on capital employed of the competitor or industry (provided the profit margin is also good). The difference in the Asset Turnover Ratio multiplied by Profit Margin of the competitor (or industry) explains the benefit derived from efficient management of assets. When assets are efficiently managed, the firm produces more production/sales for a given value of asset. The difference in Asset Turnover Ratio of ______ multiplied by ______% Profit Margin of the competitor (or industry) implies ______ % of Return on Capital Employed can be attributed to the efficient/inefficient management of assets.

If the value is positive, then company needs to preserve it by keeping the productivity of the assets in good condition or keeping the market/customers with them. If the value is negative, then the company should find ways to improve it. It can either find ways to improve the sales or stripping the assets or businesses that are not profitable (that is asset restructuring).

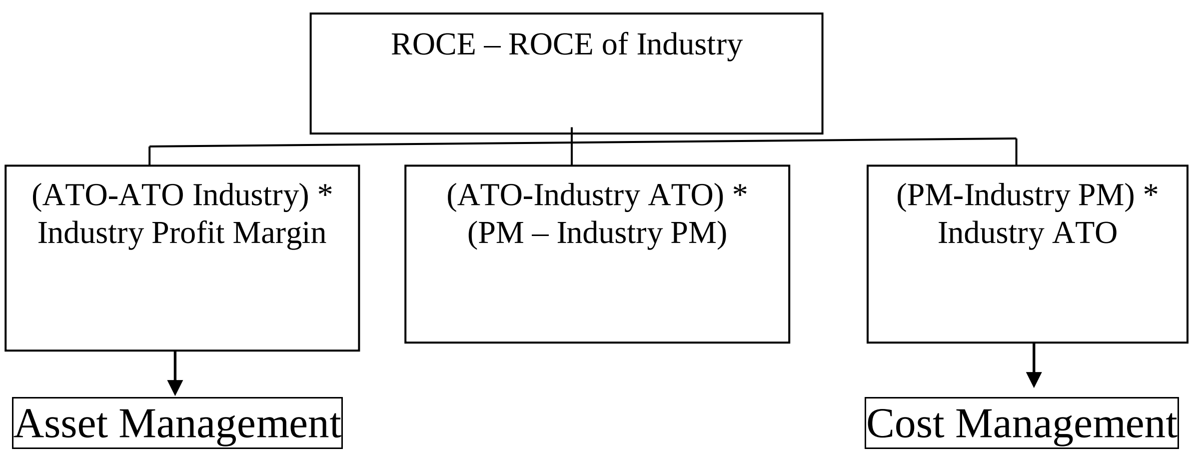
Assessing Efficiency of Cost Management

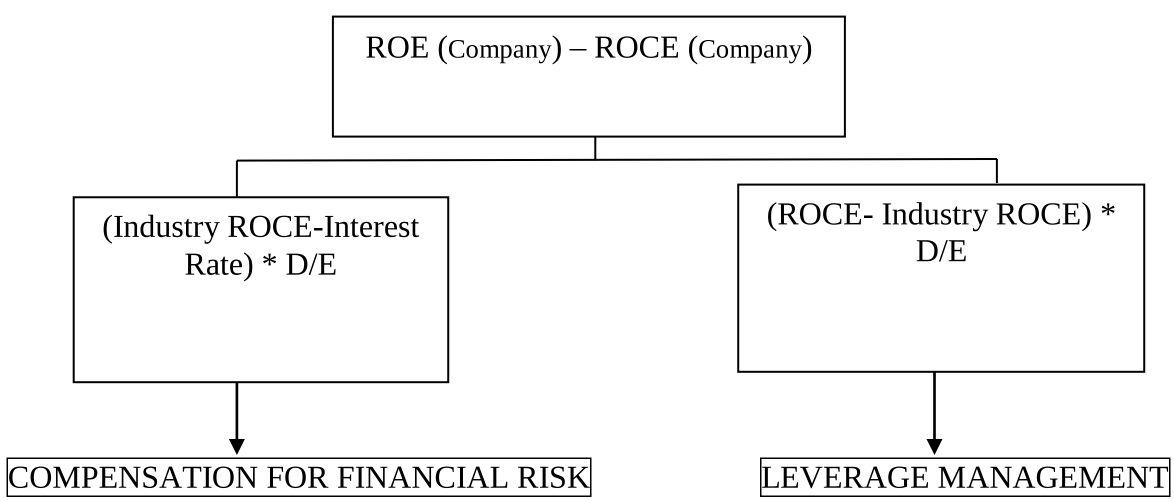
The third component of superior (or inferior) earnings of the company vis-à-vis competitor (or industry) is the efficiency of the firm in managing its cost (Cost Management). This can be determined by comparing the PBIT to Sales Margin of the company with its competitor (or industry). If the company's margin is higher than its competitor (or industry) then the company is managing its cost better than industry or competitor and hence earning more profit. If it is lower, then the company has to improve its cost management. The difference in margin has an impact on the difference in the return on total asset.

(8) The difference in PBIT to Sales margin is ______ % (positive/negative). The difference multiplied by the Asset Turnover Ratio of the competitor (or industry) is equal to ________% and this reflects the impact of cost management on return.

Summary

So far we have discussed many components of superior/inferior earning reported by the company in order to understand its strength and weakness. Enter the values in the following chart before proceeding further.





If the company is an average industry performer and has not borrowed money, it would have produced a ROCE which is also equal to ROE (due to no debt) ______%. The ROE of the company is ______%. The difference of _______% is additional return earned by the company and can be attributed to asset management, cost management and leverage management. We can summarize the difference as follows.

Asset Management	
Cost Management	
Joint Effect of Asset and Cost Efficiency	
Leverage Management	
Compensation required for additional financial risk	
Total	

(9) The three components of superior earnings are (a) Asset Management (b) Cost Management and (c) Leverage Management. From the computation done earlier, we can attribute ________% towards Asset Management, _______% towards Cost Management and ___________% towards Leverage Management. The company is doing well in ____ areas and performing poor in ____ areas. Some of the option available before the company to improve its performance are (tick one or more appropriate boxes, where you feel the company should improve its performance)

(a) Capital Restructuring
(b) Improving productivity of the Assets
(c) Managing cost better
(d) Increasing sales volume
(e) Asset Restructuring
(f) Moving on the value chain to increase sales price per unit

<u>Detach this page and use it to complete the PART B of the case</u>

Exhibit 3: Income Statement for the Years Ending March 31, YEAR-2 (Rs. in Cr)

	Company	Industry
Net Sales (excluding duties)	**581.22**	**19334.30**
Expenditure		
Raw materials, stores, etc.	316.60	10260.92
Employee Cost (Wages & Salaries)	32.94	1459.67
Energy (Power & Fuel)	51.57	1558.46
Other Manufacturing Expenses	7.25	2111.95
Repairs & Maintenance	14.06	237.25
Depreciation	32.95	793.45
Selling & distribution expenses	25.15	865.71
Total Expenses	**480.52**	**17287.41**
Profit Before Interest and Taxes (PBIT)	**100.70**	**2046.89**
Interest	35.44	652.00
Profit Before Tax (PBT)	**65.26**	**1394.89**
Tax provision	0.60	98.49
Profit After Tax (PAT)	**64.66**	**1296.40**
Conversion Cost	**138.77**	**6160.78**

Exhibit 4: Balance Sheet as at March 31, of Year 2 (Rs. in crores)

	Company	Industry
Shareholders' Equity	257.85	8204.58
Long-term Debt	336.84	2284.67
Short-Term Loan	69.44	4235.40
Accounts Payable (Sundry Creditors)	8.35	1999.27
Provision for Expenses and Taxes	76.40	3198.80
Total	**748.88**	**19922.72**
Net Fixed Assets	388.70	9889.87
Inventories	164.85	4030.01
Accounts Receivable	140.33	4197.06
Cash	55.00	1805.78
Total	**748.88**	**19922.72**
Current Liabilities	154.19	9433.47
Current portion of LT debt	40.44	754.67
Current Assets	360.18	10032.85
Capital Employed [FA + CA - CL]	664.13	14724.65