

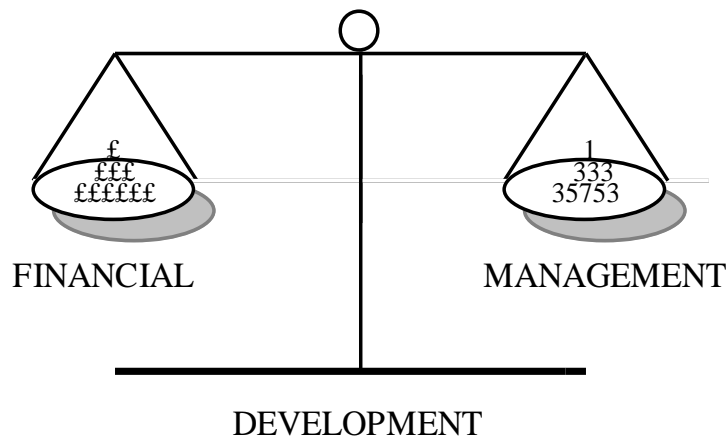
FINANCIAL MANAGEMENT DEVELOPMENT

Financial Accounting

Basic Accounting

NO 114

MEASURING BUSINESS PERFORMANCE



ONE OF A SERIES OF GUIDES FOR
FINANCIAL MANAGEMENT DEVELOPMENT

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This is one of a series of documents produced by David A Palmer as a guide for managers on specific financial topics to assist informed discussion. Readers should take appropriate advice before acting upon any of the issues raised.

MEASURING BUSINESS PERFORMANCE

WHY DO BUSINESSES EXIST?

The short answer..... to make a profit..... is too simple. The reason most businesses exist is to provide a better return on capital employed than the alternative investments. Once the return falls below the alternatives the business will be starved of funds and will eventually cease to exist. This is why ROCE (Return on Capital Employed) is widely regarded as the best measure of business performance. It links Sales, Costs, Assets, and Liabilities to produce one performance measure. However complex the calculation of ROCE is in practice, it can be used to identify not only how a business is performing; but also help in identifying areas where performance can be improved. It is, therefore, worth examining the concept in detail.

WHAT IS ROCE?

The owner of a business will expect the manager of his funds to maintain records to show two key results:

Profit - Sales less Costs

Net Worth - Assets (items owned) less Liabilities (Amounts owed)

ROCE links these two by relating the amount of profit compared to the value invested in the business to generate that profit. It is this Rate of Return which is the true measure of performance - not just the value of profit. There are long and heated debates about definitions of profit and the true value of assets such as goodwill and brand names. In many cases reality is that provided the definitions are reasonable and used consistently comparison of returns will yield useful information on the relative success of the business.

The key Ratio "Return on Capital Employed" can be broken down into a number of other ratios; each of which can be compared over time or with other organisations - to yield trends or to highlight areas worthy of further investigation.

GEARING

There is one other ratio worth considering when measuring business performance. This is a measure of risk called GEARING and it can affect the Return to the owners of a business. Gearing, sometimes called the Debt to Equity Ratio or Leverage, is a measure of the relative risk of a company's capital structure. The impact is best illustrated by way of a simple example:

If you buy a house for £100,000 and sell it one year later for £130,000, you have made a profit of £30,000 and a Return on Capital of 30%.

However, "sophisticated" house purchasers will know that it is a good idea to take out a mortgage. Assume you borrowed half the cost of the house at an interest rate of 20%. The operational return from the transaction is unaffected by the way it has been financed. The total transaction however has a profit and loss account that looks like this:

SALES	130,000
COST OF GOODS SOLD	100,000

OPERATING PROFIT	30,000
INTEREST	10,000

PROFIT AFTER ALL COSTS	20,000
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Original investment £50,000, (remember the other £50,000 has been borrowed).

A return of £20,000 on an investment of £50,000 is a Return on Capital of 40%.

By borrowing at a rate of interest lower than the operational rate of return you have geared up and increased the return on your funds. If you had borrowed the entire purchase price you would produce an infinite return of £10,000 on zero investment.

However there are dangers in being overgeared or overborrowed and it is vital to consider whether the profit will be sufficient to cover the interest and whether the cashflow will be sufficient to cover the loan repayments.

PROBLEM AREAS

Six areas are worthy of further consideration.

Profit is defined as sales less costs. However, because it is easy to measure this is often defined as Historic Cost. In some cases this can give a wrong or misleading answers.

1. Opportunity Cost

A business may show a profit because the staff or the assets are "working for free". Just because a salary is not being charged does not mean that there is no "cost". Profit should be calculated after deducting the opportunity cost - the amount which could have been earned by working elsewhere.

2. Undervalued Assets

In many business no account is taken of the fact that some assets have increased in value since acquisition. If the value of the assets, if sold, is greater than their book value then it is important that the return is calculated on their real value. In the 1970's asset strippers benefited from buying companies whose owners failed to appreciate this fact.

3. Overvalued Assets

People in business make mistakes. If you don't make some mistakes you are not trying hard enough things to do. "A bad buy results in an asset which has less value than its book value." Write it down; take the pain and then move on to the future. Do not make the same mistake again; but do not let the past error cause wrong decisions in the future.

4. Old Assets

"Any fool can have a good return on capital just run the company into the ground". (Sir John Harvey Jones). The operation of depreciation in accounts is merely a way of showing that assets are being used up. Unfortunately, some organisations use their high ROCE as a way of justifying lack of investments. "Silly Germans and Japanese - fancy building new factories after the war, ours were built in 1930 and are in the books at zero - they will have a rotten return on capital, especially after charging depreciation". British Leyland, British Docks, British Rail, British Coal, etc.

5. Replacement Cost Profit

In a continuing business it is important to consider the need to ensure that profits are real not fictitious. Buying stock for £1 and selling it for £2 will show a profit of £1, but if the replacement cost of the stock is £1.50, then it could be argued that the true profit is only 50p.

6. Don't Forget Cash

People only die from lack of blood to the brain. Business only fail from lack of cash. "it is perfectly possible to make losses but stay in business provided you have cash." This has been proved by UK Banks and Insurance companies 1994 and 2008 - Will they never learn?). A good Return on Capital Employed merely means profit is acceptable. This means that there is a good investment opportunity - it does not mean anyone will want to take it. Very often institutions will prefer a lower return and a lower risk (UK Banks 1995 onwards).

Managing Sales, Costs, Assets and Liabilities properly should result in proper cash management. Managing three out of four is not good enough.

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David is an experienced financial professional who has devoted his skills to management training in practical understanding and utilisation of financial information. A Graduate, Chartered Accountant, and Associate of the Institute of Taxation, he is also a Member of the Chartered Institute of Personnel and Development and has been an Ordained as a Deacon in the Catholic Church.

He has worked as a Financial Controller and Company Secretary in the Finance industry and as a Director of Finance and Administration in the Computer Services industry. Since 1990 he has conducted management development programmes for over forty major organisations including Arla Foods, Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, Royal Mail, Unilever and Zeneca. He also runs programmes for the Leadership Foundation and the management teams at a number of Universities. International training experience includes work in Belgium and Holland for CSC, in Denmark, Kenya and the Czech Republic for Unilever, in Holland and the US for Zeneca, in Dubai for Al Atheer, in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. In addition he has run courses in acquisition evaluation (The Economist, Eversheds, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). All training is specifically tailored to the needs of the organisation with the emphasis on practical applications to enhance profitability and cashflow. He has developed material for delivery by in-house personnel (Royal Mail, Lloyds Bowmaker and Conoco), computer based training packages (The Post Office, Unilever and BP), and post course reinforcement self-study workbooks (CSC and Zeneca). He has also produced a training video on Cashflow Management.

He is a prolific writer of case studies, role plays and course material. He has also published articles on the financial justification of training, financial evaluation of IT investment proposals, the use of Activity Based Costing and Customer Profitability statements, commercial considerations for consultants, the need for taxation awareness training for general managers, evangelisation and Christian business ethics.

Many of his generic documents are freely available on his website:

FinancialManagementDevelopment.com including papers on Charity Management.

In addition to his Diaconal work in the Church, he has held a number of voluntary positions including University, College and School Governor, Hospice Treasurer and Trustee of various charitable institutions. He continues to provide ad hoc commercial advice to several other charitable organisations. He has been married for over 35 years and has one daughter and three granddaughters.

This series of papers is designed to help managers by providing a basic understanding of key financial concepts to assist them in their work. It is provided at no cost since this knowledge is a Gift from God and thus to be shared (Matthew 10:8).