JEL M41

Mikova M.

FINANCIAL ANALYSIS WITH FOCUS ON RETURN ON ASSETS

The paper describes the importance of return on investment in financial decision making. The most common ratios of return on investment are stated together with the main areas of use. It is stressed that return on investment must be always considered against the risk as the factor influencing financial decision making.

У статті розглянуто важливість віддачі від інвестицій для прийняття фінансових рішень. Найбільш загальні співвідношення прибутку на інвестований капітал відображено відповідно до основних напрямків їх використання. Підкреслено, що віддача від інвестицій завжди залежить від ризику, фактору, що впливає на фінансові рішення.

Statement of a problem in a general view. Financial analysis represents a systematic analysis of data obtained mainly from financial statements, an analysis of their individual items, and aggregate data and an analysis of relationships and development tendencies. Analytic procedures, used data and corresponding conclusions are impacted by the objective and usage of the analysis. The presentation of results of the analysis depends on the analysis target and questions which are to be answered by the analysis.

A number of ways exist to analyze financial statements. These are for example: a comparative analysis of financial statements, vertical analysis and analysis using ratios. Out of these, the best one can be selected serving given needs. The main areas of the analysis of the financial statements are: short-term liquidity, cash flows, equity/debt structure, long-term solvency, return on assets, use of assets, operating performance.

Owners, management and investors are interested in the successful operation of an enterprise. The desired return on assets combined with the sustainable satisfactory financial situation is one of the major objectives.

An optimal compromise between the financial stability and the return on assets depends on specific conditions under which the enterprise operates. The financial analysis helps to analyze the specific situation of the enterprise. However, the analysis does not provide fully comprehensive information on the reasons and consequences of the situation of the enterprise. A broader perspective is always needed. Character of the activity, barriers to enter the industry, strength of competition and general economic conditions define the boundaries that the enterprise operates within. The goal of the management is to find an optimal position on the market so that the enterprise accomplishes the best possible results without going beyond acceptable level of risk for the investors. The enterprise is to maximize investors` wealth and needs to operate both within short-term and long-term time horizon.

The analysis of researches and publications of last years. Both theory and practice for the return on assets, as known today, have been the result of longer historical development. First practical experience with its use was received in several largest enterprises in the USA such as DuPont and General Motors. Specifically DuPont developed useful indicators for the return on assets that were to serve both as indicators for effectiveness of various controlled departments and as indicators for financial effectiveness of the whole enterprise.

Unsolved parts of the general problem. In terms of the position and importance of the return on assets among various indicators for effectiveness of economic activity, it is important to emphasize that it perhaps receives much larger attention in comparison with other indicators for effectiveness for following reasons. The return on assets belongs to decision-making processes which consider and compare economic benefits against used financial funds for a specific objective.

These considerations are needed for most long-term decisions consequences of which will emerge in a number of years. Decisions which project should be financed, if the enterprise should continue or stop its business, are good examples of these. The indicator has its irreplaceable position in the management of larger intra-enterprise departments with huge responsibility and authority assigned.

The idea of the article. The aim of this article is to demonstrate the importance of the return on assets for the financial management.

Statement of the basic material. The indicator of the return on assets is used in practice in various modifications depending on the reason or the recipient. Necessary and adequate general preconditions must be created in order to indeed use the return on assets and other aggregate indicators for economic activity for the management of the whole economic activity of the enterprise. I consider the following ones to be the most important:

– objective pricing;
– economic equilibrium between supply and demand;
– proper organizational structure of the enterprise in terms of authority and responsibility assignment;
– direct relationship between the return on assets and material motivation;
– high level of competition;
– functioning financial market.

The return on assets is a tool of the financial management and as such it represents an integral part of the financial strategy and the policy of the enterprise. The indicator represents the most complex illustration of effectiveness of the enterprise and that delivers its fundamental advantage. The return on assets must be always confronted with the risk attached since the return and the risk are two interconnected factors influencing the financial activity of the enterprise. The financial decision-making of the enterprise can be divided into three large blocks: the target of the investment, how to finance the investment and how to distribute the generated profit. Optimal combination of these three areas of decision-making is a necessary condition and contributes to the growth of the enterprise value [1, p.123-277].

The financial analysis represents the evaluation of the past, present and future financial performance of the enterprise. Financial and non-financial information is the source for the financial analysis.

The financial statements including notes are the main source of the financial information. The analysis of the financial statements uses analytic methods and techniques in the financial statements and related data sources to derive connections and mutual relationships important for business decisions. It is the tool to predict the future financial conditions and their consequences. It is also a diagnostic tool to analyze the financial, investment and operating activities and thus it serves to evaluate the business decisions of the management. It can also serve as a method to select investments or possible partners for a merger. The analysis of the financial statements thus reduces the dependence on estimations, expectations and intuition and reduces the uncertainty in decision-making process. It does not diminish the need for the professional assessment, however, it delivers a systematic basis for business decisions. A number of methods exist for the analysis of the financial statements and the best specific one needed for the specific requirements can be selected.

The analysis of the financial statements represents a systematic analysis of the data obtained from the financial statements, analysis of its individual items, analysis of aggregate data and analysis of relations and development trends. Analytic procedures, use of the data and the corresponding conclusions are impacted by the objective and the usage of the analysis. The presentation of the analysis results depends on the object of the analysis and pertinent questions to be answered by the analysis. It is extremely important to assess the existing situation of the enterprise and its future, or in other words, to interpret the received data even for the future. The financial analysis thus covers not only the immediate past but also the future. The comparison of various components of the financial situation over longer period, therefore, delivers conclusions that are important for the future.

I will focus now on the return on assets which belongs to the category of so-called financial indicators. It is a tool for the financial management. The major advantage of this indicator is the complex description of the effectiveness of the enterprise. It measures the return on assets employed into a certain activity. Thanks to this prime advantage, it a little bit pushed back other indicators traditionally used (such as the return on expenses) and, therefore, it delivers important information in relationship with EVA indicator (Economic Value Added). The indicator measures not only the consumption of assets during certain period of time or the expenses/revenues ratio but it also observes the fixture of assets needed for the desired level of profit. The return on assets started to be intensively used in market economies in the 20th of the last century. The need for it was brought by the increased pressure of investors to improve the profitability. The extensive use of the financial ratio indicators including the return indicator is based upon the simplicity of their construction, higher level of complexity, availability of the input data and, important signal ability (ability to alert of possible financial problems). The calculation of the return must take into the account the object (enterprise, departments of enterprise, product groups etc.) and the proper type of the return indicator can then be selected. In addition, availability of the necessary data, especially from accounting and calculations also influence the selected type of return.

The return indicator can cover following areas [2, p.57-73; 3, p.391-418; 4, p.27-85; 5, p.72-73; 6, p.15-23]:

– operating effectiveness in terms of effective use of assets;
– financial effectiveness – effective use of debt/equity structure;
– overall effectiveness.

The most used indicators of the return draw data both from the balance sheet and the profit and loss account. The most important and used indicators are [7, p.12-27; 8, p.30-46]:

– return on assets (ROA);
– return on equity (ROE);
– earnings per share (EPS);
– price-earnings ratio (P/E).

In my view, the main areas of using the return on assets are:

– assessment of return on assets for an individual shareholder;
– assessment of return on assets for shareholders as a whole;
– assessment of overall return on assets for the enterprise;
– assessment of return on assets for individual investment projects and individual newly introduced products;
– assessment of return on assets in individual enterprise departments;
– criterion for decisions to acquire another enterprise or its controlling stake;
– control tool to measure the performance of the management.

To measure and assess the operating performance is a complex exercise. Different criteria and measures are applied by the management in this process. The decision to invest should be followed by an ongoing analysis of how each department contributes to the total profitability of the enterprise. Should the return on assets decline under the minimal determined level, decisions must be made to modify or even terminate such a department. The management should be able to determine the return on assets in all areas of the activity of the enterprise. It would be ideal to have the guideline how to determine the optimal and maximal return on assets. However, it does not unfortunately exist and the decision makers must rely on their own judgement and experience.

The primary attention of the top management towards the return on assets is based upon its responsibility vis-à-vis owners. Therefore, should the achieved return on assets in the organizational departments of the enterprise be less than planned over longer period of time, the capital should be transferred to the more productive enterprise assets. The top management must take the following position. The enterprise as a whole must achieve certain return on assets otherwise its financial and economic stability would be jeopardized. Investors (shareholders and creditors) must receive the return on investment (dividends, interest). Furthermore, the enterprise must dedicate a portion of the profit for the further development. This is why any enterprise must objectively determine and calculate the adequate return on assets. This Is the condition number one for a long-term sustainable existence. Of course, the crucial question is the size of the return. Any enterprise must focus on this. The return is calculated as the ratio of pre-tax or after-tax profit compared to the total assets. Certain modifications of net profit and assets are applied. The extensive use of the financial ratio indicators including the return indicator is based upon the simplicity of their construction, higher level of complexity, availability of the input data and important signal ability.

All these intra-statement indicators must be analyzed carefully since they take the input from the financial statements. Therefore, various valuations, different depreciation etc. directly impact the indicators. The individual indicators are used for the different purposes and also provide information for the different users. A shareholder will be interested in the return for one ordinary share while the top management will want to see the return on equity and on total assets.

Conclusions and prospects of further investigations. The article serves to emphasize the importance of the return on assets for the financial decision-making of enterprises in a market economy. The history of this indicator dates back and came into existence in the 20th century. The return on assets is not a doctrinal or rigid pool of postulates. On the contrary, the issue dynamically develops and various aspects and modifications of this indicator are used. Following fundamental preconditions must be achieved so that the indicator fulfils its functions:

1. Organizational structure of the enterprise must enable the analysis of individual components of the return on assets.
2. Exact criteria for the measurement of the return on assets must be determined.
3. The strategy for profit growth should be rather based on the ability of assets to generate the profit than on increased sales (revenues).
4. Specific targets for the return on assets should be determined for the individual enterprise departments as well as for the whole enterprise using such criteria as the comparison with the past, typical results in the whole industry, expected future results etc.

The ratio indicators do not have the meaning of their own. They only make sense through the comparison with former ratio indicators, upfront defined standards of comparable companies or indicators of competition. It needs to be emphasized that the ratio indicators have limited predicative properties since they describe only a specific activity of the enterprise. For this reason, sets of indicators have come to existence and these briefly and clearly describe the relationship between the return on assets and the financial stability of the enterprise. A typical example would be pyramid analyses, specifically the DuPont diagram.

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Прийнято до друку 12.05.2011