Chapter 5

Assessing the Importance of Firms Financial Management

Okpolosa Matthew Onyebuchi
Department of Accounting, Faculty of Business Studies
Ignatius Ajuru University of Education, Rumuolumeni Port Harcourt, Rivers State, Nigeria

Email: Onyebuchi,okpolosa55@gmail.com

Concept of Financial Performance

A firm's financial performance is of importance to investors, stakeholders and the economy at large. Investors are interested in the returns for their investment. A business that is performing well can bring better reward to their investors. Financial performance of a firm can increase the income of its staff, rendering quality product or services to its customers and creating more goodwill in the environment it operates. A company that has good performance can generate more returns which can lead to future opportunities that can in turn create employment and increase the wealth of people. Firm's performance is the ability of a firm to achieve its objectives resources. According to Rahul (1997) a company's performance is its ability to achieve its target objectives from its available resources. Suleiman (2013) viewed a firm's performance as the result of a company's assessment or strategy on how well a company accomplished its goals and objectives. Financial performance provides a deductive measure of how well a company can use assets from business operations to generate revenue. Van Horn (2005) defined financial performance as a subjective measure of how well a firm can use assets from its primary mode of business and generate revenues. This term according to Pandey (2001) is used as a general measure of the overall financial health of a business. Research on the firm's financial performance emanates from organizations theory and strategic management. The notion of financial performance is used to describe performance of an entity with the legal status of a company. The concept of financial performance is a controversial issue in finance due to its multidimensional meaning. In analyzing a firm"s financial performance, emphasis should be made in formulating an adequate description of the concept of a financial performance.

Measuring of firm's financial performance is one of the management strategic functions aimed at satisfying the interest of shareholders and other stakeholders in a company. Firm's performance appraisal involves a periodic and systematic evaluation of its operations to determine the achievements of the firm's objectives. Evaluation of a firm's performance requires the use of certain principles that may be either internal or external. Internal principles are the ability of a company to achieve its stated objectives, while external principles refer to the comparison of a company with its competitors in the industry in order to develop a good business strategy that will enable the firm compete favourably in the market.
The existing researches on the relationship between capital structure and financial performance used different methods of measuring firms" financial performance. Most of

the previous studies on firms" financial performance measured firm performance from the accounting based or market based methods of measuring company's financial performance. The most commonly used performance measures are accounting based which include: return on assets (ROA), return on equity (ROE), return on investment (ROI) and Tobin"s Q.
Accounting based measurement of performance is the most popularly used. Returns On Assets (ROA) was widely used as was found in the studies of Abbasali, Esfandiar, Milad and Mohammed (2012), Babalola (2012), Muhammad, Zaighum, Saeed and Muhammad (2012), Osuji and Odita (2012), Khalaf (2013) and Raheel, Shahnaz, Bashir and Umara (2013).

Dimensions of Financial Performance

Return on Assets (ROA)
The term return on Assets (ROA) is refer to a net profit or net income, the amount of earnings from sales after all costs, expenses and taxes. The more assets a company has amassed; the more sales and potentially more profits the company generate. As economics of scale help lower costs and improve margins, return may grow at a faster rate than assets, ultimately increasing returns on assets.

Total Debt to Total Assets
The total debts to total assets measure the amount of the total funds provided by creditors in relation to the total assets of a firm. Generally, creditors would prefer low ratio for all debts because the lower the ratio the greater is the cushion against creditors losses in the event of liquidation. Total debt to total assets is a debt ratio that defines the total amount of debt relative to assets. This enables comparison of debt to be made across different companies. The higher the ratio the better degree of debt and consequently financial risk. This is a broad ratio that includes long term debt and short term debt (borrowings maturity within one year) as well as all tangible and intangible assets (Akinsulire, 2014).

Debt ratio is a solvency ratio that measures firms total liabilities as a percentage of its total assets. In a sense, the debt ratio shows a company's ability to pay off its liabilities with its assets. In other words, this shows how many assets the company must sell in order to pay off all of its liabilities. This ratio also measures the financial debt of a company. Companies with higher levels of liabilities compared with assets are considered highly indebted and more risky for lenders. It helps investors and creditors analyses the overall debt burden on the company as well as a firm's ability to pay off its debt in the future especially during uncertain economic times. The debt ratio is calculated by dividing total liabilities by total assets. Both of these numbers can easily be found in the balance sheet. A lower debt ratio usually implies a more stable business with the potential of longevity because a company with lower ratio also has an overall debt posture. Each industry has its own benchmarks for debt, but 0.5 is reasonable ratio (Ojo, 2012).

The debt ratio is a fundamental solvency ratio because creditors are always concerned about being repaid. When companies borrow more money, their ratio increases and creditors will no longer loan them money. Companies with higher debt ratios are better off looking to equity financing to grow their operations. Debt ratios measure a firm's ability to repay long term debt. It is a financial ratio that indicates the percentage of a company's assets that are provided via debt. It is the ratio total debt, the sum of current liabilities and long term liabilities and total assets as well as the sum of current asset, fixed assets and other assets such as goodwill (Semiu & Collins, 2011).

Short Term Debt to Total Assets

This measures how relative short-term debts to total asset of a firm are to be repaid within an accounting period. Some scholars argued that the shorter the debt the better the firm is in improving its performance. The short term debt to total assets ratio is a measure of the financial leverage of the company. It tells what percentage of the assets is financed by short term debt. Short term debt is debt due for repayment within or less than 12 months and is not included in the long term liabilities figure on the statement of financial position. It includes creditors and accruals (Akinyomi, 2013). Short term debt to total assets ratio is the ratio that represents the financial position of the company's ability to meet its current financial requirements. It shows the percentage of company assets that are financed with loans and other financial obligations that last over a year. The short term debt ratio is calculated by dividing current liabilities by total assets. Both of these numbers can easily be found in the balance sheet. A lower debt ratio usually implies a more stable business with the potential of longevity because a company with lower ratio also has short term debt.

Long Term Debt to Total Assets

Long-term debt to total assets measures the relative weight of long-term debt to the capital structure (long-term financing) of a firm's long-term debt to- total assets. Long term debt to total assets ratio is the ratio that represents the financial position of the company's ability to meet its financial requirements. As this ratio is calculated yearly, decrease in the ratio would denote that the company is faring well, and is less dependent on debts for their business needs (Kurfi, 2003). The higher the level of long term debt, the more important it is for a company to have positive revenue and steady cash flow. It is very helpful for management to check its debt structure and determine its debt capacity (Akinsulire, 2014).

The long term debt to total assets ratio is a measure of the financial leverage of a company. Long term debt is debt due for repayment in over 12 months and is not included in the current liabilities figure on the balance sheet. It includes mortgages and long term leases, but not general trading liabilities (Akinyomi, 2013). A high ratio usually indicates a higher degree of business risk because the company must meet principal and interest obligations. Potential creditors are reluctant to give financing to a company with a high debt position. However, the magnitude of debt depends on the type of business. For example, a bank may have a high debt ratio but its assets are generally liquid. A utility can afford a higher ratio than a manufacturer because its earnings are more stable (Khalaf, 2013).

Return on Equity

Definition: The Equity Capital refers to that portion of the organization's capital, which is raised in exchange for the share of ownership in the company. These shares are called the equity shares. The equity shareholders are the owners of the company who have significant control over its management. They enjoy the rewards and bear the risk of ownership. However, their liability is limited to the amount of their capital contributions. The Equity Capital is also called as the share capital or equity financing. Equity or shares are a unit of ownership in a company, and equity capital is raised by issuing shares to shareholders. It is also referred to as share capital.
Shareholders are the owners of a business, and bring in capital, take risks and directly or indirectly run the business. When a company is formed, the memorandum of association defines how much capital the company can raise from its shareholders. This is called "authorised capital". Firms issue a part of authorised capital to raise money from prospective shareholders. This is called "issued capital". A company can change its authorised capital, subject to shareholders' approval.
Equity capital is also called as residual capital. This means that shareholders have last right on the assets of a company. In the event of closure of a company, shareholders are paid in the end, after meeting other claims. The equity capital of a company is not constant as it keeps changing due to various corporate events, such as a rights issue and additional issuance of shares. Equity capital is funds paid into a business by investors in exchange for common or preferred stock. This represents the core funding of a business, to which debt funding may be added. Once invested, these funds are at risk, since investors will not be repaid in the event of a corporate liquidation until the claims of all other creditors have first been settled. Despite this risk, investors are willing to provide equity capital for one or more of the following reasons:
Owning a sufficient number of shares gives an investor some degree of control over the business in which the investment has been made. The investee may periodically issue dividends to its stockholders. The price of the shares may appreciate over time, so that investors can sell their shares for a profit. From an accounting perspective, equity capital is considered to be all components of the stockholders' equity section of the balance sheet, which includes the par value of all stock sold, additional paid-in capital, retained earnings, and the offsetting amount of any treasury stock (repurchased shares).
From a valuation perspective, equity capital is considered to be the net amount of any funds that would be returned to investors if all assets were to be liquidated and all corporate liabilities settled. In some cases, this may be a negative figure, since the market value of company assets may be lower than the aggregate amount of liabilities.

Advantages of Equity Capital
Some of these advantages are:
1. The firm has no obligation to redeem the equity shares since these have no maturity date.
2. The equity capital act as a cushion for the lenders, as with more and more equity base, the company can easily raise additional funds on favorable terms. Thus, it increases the creditworthiness of the company.
3. The firm is not bound to pay dividends, in case there is a cash deficit. The firm can skip the equity dividends without any legal consequences.

Disadvantages of Equity Capital

There are several disadvantages of raising the finances through the issue of equity shares which are listed below:

1. With the more issue of equity shares, the ownership gets diluted along with the control over the management of the company.
2. The cost of equity capital is high since the equity shareholders expect a higher rate of return as compared to other investors.
3. The cost of issuing equity shares is usually costlier than the issue of other types of securities. Such as underwriting commission, brokerage cost, etc. are high for the equity shares.
4. The cost of equity is relatively more, since the dividends are paid out of profit after tax, but the interest payments are tax-deductible.

Profit Level:
Profit margin, net margin, net profit margin or net profit ratio is a measure of profitability. It is calculated by finding the net profit as a percentage of the revenue.

Overview
Profit margin is calculated with selling price (or revenue) taken as base times 100. It is the percentage of selling price that is turned into profit, whereas "profit percentage" or "markup" is the percentage of cost price that one gets as profit on top of cost price. While selling something one should know what percentage of profit one will get on a particular investment, so companies calculate profit percentage to find the ratio of profit to cost.
The profit margin is used mostly for internal comparison. It is difficult to accurately compare the net profit ratio for different entities. Individual businesses' operating and financing arrangements vary so much that different entities are bound to have different levels of expenditure, so that comparison of one with another can have little meaning. A low profit margin indicates a low margin of safety: higher risk that a decline in sales will erase profits and result in a net loss, or a negative margin. Profit margin is an indicator of a company's pricing strategies and how well it controls costs. Differences in competitive strategy and product mix cause the profit margin to vary among different companies.
If an investor makes $10 revenue and it cost them $1 to earn it, when they take their cost away they are left with 90% margin. They made 900% profit on their $1 investment.
If an investor makes $10 revenue and it cost them $5 to earn it, when they take their cost away they are left with 50% margin. They made 100% profit on their $5 investment.
If an investor makes $10 revenue and it cost them $9 to earn it, when they take their cost away they are left with 10% margin. They made 11.11% profit on their $9 investment.
If the revenue is the same as the cost, profit percentage is 0%. The result above or below 100% can be calculated as the percentage of return on investment. In this example, the return on investment is a multiple of 1.0 of the investment, resulting in a 100% gain.
The net profit margin, or simply net margin, measures how much net income or profit is generated as a percentage of revenue. It is the ratio of net profits to revenues for a company or business segment. Net profit margin is typically expressed as a percentage but can also be represented in decimal form. The net profit margin illustrates how much of each dollar in revenue collected by a company translates into profit.

KEY notes:
Net profit margin measures how much net income is generated as a percentage of revenues received.
Net profit margin helps investors assess if a company's management is generating enough profit from its sales and whether operating costs and overhead costs are being contained.
Net profit margin is one of the most important indicators of a company's overall financial health.
Formula and Calculation for Net Profit Margin
NPM = {R - COGS - E - I - T ÷ R × 100

where:
NPM = Net profit margin
R = revenue
COGS = cost of goods sold
E = operating and other expenses
I= interest
T= taxes
On the income statement, subtract the cost of goods sold (COGS), operating expenses, other expenses, interest (on debt), and taxes payable.
Divide the result by revenue.
Convert the figure to a percentage by multiplying it by 100.
Alternatively, locate net income from the bottom line of the income statement and divide the figure by revenue. Convert the figure to a percentage by multiplying it by 100.
The net profit margin factors in all business activities including:
Total revenue
All outgoing cash flow
Additional income streams
COGS and other operational expenses
Debt payments including interest paid
Investment income and income from secondary operations
One-time payments for unusual events such as lawsuits and taxes
Net profit margin is one of the most important indicators of a company's financial health. By tracking increases and decreases in its net profit margin, a company can assess whether current practices are working and forecast profits based on revenues. Because companies express net profit margin as a percentage rather than a dollar amount, it is possible to compare the profitability of two or more businesses regardless of size.
Investors can assess if a company's management is generating enough profit from its sales and whether operating costs and overhead costs are being contained. For example, a company can have growing revenue, but if its operating costs are increasing at a faster rate than revenue, its net profit margin will shrink. Ideally, investors want to see a track record of expanding margins, meaning that the net profit margin is rising over time.
Most publicly traded companies report their net profit margins both quarterly during earnings releases and in their annual reports. Companies that can expand their net margins over time are generally rewarded with share price growth, as share price growth is typically highly correlated with earnings growth.

Net Margin vs. Gross Profit Margin

Gross profit margin is the proportion of money left over from revenues after accounting for the cost of goods sold (COGS). COGS are raw materials and expenses associated directly with the creation of the company's primary product, not including overhead costs such as rent, utilities, freight, or payroll.
Gross profit margin is the gross profit divided by total revenue and is the percentage of income retained as profit after accounting for the cost of goods. Gross margin is helpful in determining how much profit is generated from the production of a company's goods because it excludes other items such as overhead from the corporate office, taxes, and interest on a debt.
Net profit margin, on the other hand, is the percentage of profit generated from revenue after accounting for all expenses, costs, and cash flow items.
Net income is also called the bottom line for a company as it appears at the end of the income statement.

Limitations of Net Profit Margin
Net profit margin can be influenced by one-off items such as the sale of an asset, which would temporarily boost profits. Net profit margin doesn't hone in on sales or revenue growth, nor does it provide insight as to whether management is managing its production costs.
It's best to utilize several ratios and financial metrics when analyzing a company. Net profit margin is typically used in financial analysis along with gross profit margin and operating profit margin.
Hypothetical Example
Imagine a company that has the following numbers reported on its income statement:
Revenue: $100,000
Operating costs: $20,000
COGS or cost of goods sold: $10,000
Tax liability: $14,000
Net profits: $56,000
Net profit margin is thus 0.56 or 56% ($56,000/$100,000) x 100. A 56% profit margin indicates the company earns 56 cents in profit for every dollar it collects.

Why is the net profit margin important?
The net margin is perhaps the most important measure of a company's overall profitability. It is the ratio of net profits to revenues for a company or business segment. Expressed as a percentage, the net profit margin shows how much profit is generated from every $1 in sales, after accounting for all business expenses involved in earning those revenues. Larger profit margins mean that more of every dollar in sales is kept as profit.

How can companies improve their net profit margin?
When a company's net margin exceeds the average for its industry, it is said to have a competitive advantage, meaning it is more successful than other companies that have similar operations. While the average net margin for different industries varies widely, businesses can gain a competitive advantage in general by increasing sales or reducing expenses (or both).
Boosting sales, however, often involves spending more money to do so, which equals greater costs. Cutting too many costs can also lead to undesirable outcomes, including

losing skilled workers, shifting to inferior materials, or other losses in quality. Cutting advertising budgets may also harm sales.
To reduce the cost of production without sacrificing quality, the best option for many businesses is expansion. Economies of scale refer to the idea that larger companies tend to be more profitable. A large business's increased level of production means that the cost of each item is reduced in several ways. For example, raw materials purchased in bulk are often discounted by wholesalers.

How is net margin different from other profit margin measures?
Net profit margin takes into account all costs involved in a sale, making it the most comprehensive and conservative measure of profitability. Gross margin, on the other hand, simply looks at the costs of goods sold (COGS) and ignores things such as overhead, fixed costs, interest expenses, and taxes. Operating margin further takes into account all operating costs but still excludes any non-operating costs.

What are some high- and low-profit margin industries?
High-profit margin sectors typically include those in the services industry, as there are fewer assets involved in production than an assembly line. Similarly, software or gaming companies may invest initially while developing a particular software/game and cash in big later by simply selling millions of copies with very few expenses. Luxury goods and high-end accessories also often operate on high-profit potential and low sales.

Operations-intensive businesses such as transportation, which may have to deal with fluctuating fuel prices, drivers' perks and retention, and vehicle maintenance, usually have lower profit margins. Agriculture-based ventures, too, usually have low-profit margins, owing to weather uncertainty, high inventory, operational overheads, need for farming and storage space, and resource-intensive activities.

REFERENCES

Abbasali, P., Estandiar, M., Milad, E., & Mohammad, B. (2012). The relationship between capital structure and firm performance evaluation measures: Evidence fromTehran stock exchange. *International Journal of Business and commerce, 1*(9) 166- 181.

Akinsulire, C. O. (2014). Financial management. ET-TODA Venture Ltd: Logos.

Akinyomi, O.J. (2013). Effect of Capital Structure on Firm Performance: Evidence from Nigeria Manufacturing Industry. *International Journal of Innovation research and studies,* 2(9), 1-13.

Khalaf, A. (2013). The Relationship between Capital Structure and Firm Performance: Evidence from Jordan. *Journal of Finance and Accounting,* 1(3), 41-45.

Babalola, Y.S. (2014). Triangulation analysis of capital structure and firm's performance in Nigeria. *East Ukrainian National University Journal, 69*(12), 75-82.

Kurfi, A.K. (2003). *Principles of Financial Management.* Benchmark Publishers Ltd, Kano.

Muhammad, U., Zaighum T. & Saeed, A., & Muhammad, S. (2012). Impact of capital structure on firm's financial performance: Evidence from Pakistan. *Journal of Finance and Accounting, 3*(9), 34-42

Ojo, S. A. (2012). The effect of financial leverage on corporate performance of some selected companies in Nigeria. *Canadian Journal of Social Science, 8*(1); 85-91.

Osuji, C.C.& Odita, A. (2012). Impact of capital structure on the financial performance of Nigerian firms. *Arabian Journal of Business and Management Review, 1*(12), 43-51.

Pandey, M., (2001). Capital structure and the firm characteristics: evidence from an emerging market, Working paper, Indian Institute of Management Ahmedabad.

Raheel, M., Shahnaz, A.R., Bashir, A. & Umara, N. (2013). Capital Structure and Performance: Evidence from Pakistan. *Journal of Basic and Applied Scientific Research, 3*(4) .113-119.

Rahul, K. (1997). Strategic Assets Capital Structure and Firm Performance. *Journal of Financial and Strategic Decisions 10*(3) 23-24.

Semiu, B.A. & Collins, S.O. (2011). Perceived relationship between corporate capital structure and firm value in Nigeria. *International Journal of Business and Social Science, 2*(19), 23-34

Suleiman, A. (2013). Capital Structure Effect on Firms Performance: Evidence from Saudi Listed Companies.

Van Horne, J. C. (2005). *Fundamentals of financial management*. Prentice hall International.