Return on Assets: The Management Perspective

Return on Assets (RoA) assesses whether management – responsible for running a firm´s operations – creates value from a financial point of view and, in consequence, whether the business shall continue as a going concern.

Applying a SWOT analysis, the Porter Model or similar schemes are all helpful in qualitatively assessing the strategic positioning of a firm. They assist in specifying internal and external factors that contribute favorably or unfavorably in achieving a firm´s objective. - From a Corporate Finance perspective, the fundamental issue is merely a quantitative one: When and under which circumstances should management hold operations, possibly even shut them down.

A firm´s management is entrusted with tangible and intangible assets. It is its job to generate revenues, cash flows and ultimately profits. To start with, management´s operational basis comprises all assets under the umbrella of a corporation: From a Corporate Finance point of view this is the active, left side of the balance sheet. One should note, though, that numerous types of "assets" are actually not accounted for in a balance sheet, such as the quality of staff, a firm´s good standing, its image or customer relations.

All assets on the balance sheet have to be funded, the means and instruments of which are found on its passive, right side. - In the RoA analysis, however and for the time being, funding will be ignored, as well as the role of the Chief Financial Officer (CFO): Focus is merely on those management functions and responsibilities which are directly linked to production, operations or delivering a service.

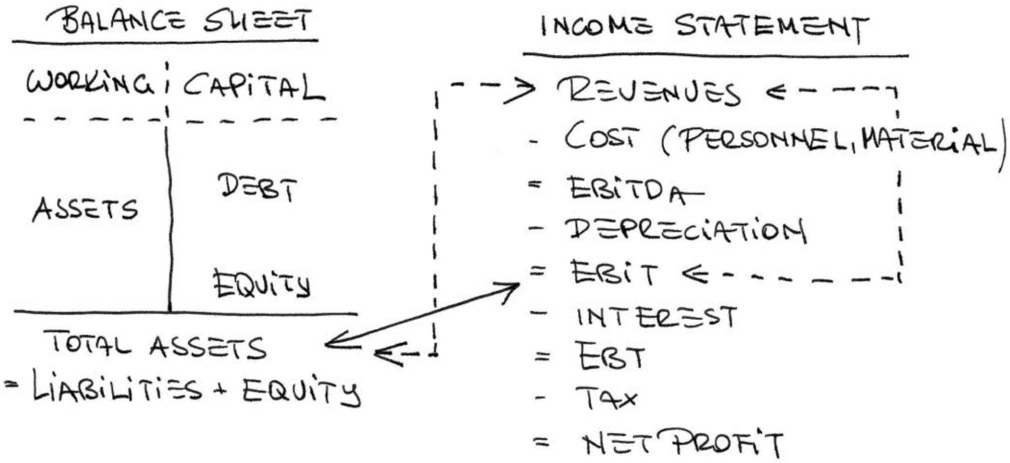
Taking a closer look at the income statement, then Earnings before Interest and Taxes (EBIT) appears the appropriate indicator for measuring operational performance: EBIT represents the last line in the income statement, before dealing with funding (interest payments or income) and taxes. Hence, EBIT is also the last line in the income statement exclusively focusing on management performance, before all funding-related themes and topics are addressed and accounted for.

Therefore, linking entrusted assets with EBIT fairly evaluates a management´s operational performance, at least from a Corporate Finance point of view. And, it also reflects management´s unique perspective on running the operations of a business: Therefore, RoA (EBIT / total assets) is also the most relevant ratio to assess the feasibility and viability of an operation.

However, RoA has to be put into context: Of course, trends in RoA over time provide some insight, as does benchmarking with industry peers. – Even more relevant, though, is the definition of a threshold for RoA: Exceeding that would support a continuation of operations.

The relevant benchmark in this regards are the funding costs of a firm´s assets and operations. In reality, though, finding out, even estimating a firm´s cost of capital can be a quite cumbersome task. In undertaking a swift corporate health check a reasonable short cut is (just) considering the firm´s average Cost of Debt (CoD) as the relevant, preliminary threshold: CoD can be quickly calculated in dividing the firm´s interest expense by its interesting bearing short- and long-term liabilities.

This approach seems fair enough, though, at least to begin with: Assuming that the most basic balance sheet funding structure just comprises equity and debt and with CoD always lower than cost of equity, a basic rule can be formulated: For management to continue operations medium- / long-term, RoA has (minimum) to meet or exceed a firm´s CoD. Of course, there could be years when this benchmark is not met. However, if RoA undershoots CoD long-term, then the viability of a firm´s operations should certainly be in question.


BALANCE SHEET
WORKING CAPITAL
ASSETS
DEBT
EQUITY
TOTAL ASSETS
= LIABILITIES + EQUITY
INCOME STATEMENT
REVENUES
- COST (PERSONNEL, MATERIAL)
= EBITDA
- DEPRECIATION
= EBIT
- INTEREST
= EBT
- TAX
= NET PROFIT

For more concepts click on: