

Return on Assets: The Management Perspective

Return on Assets (RoA) assesses whether a business – run by a firm’s management – creates value and, in consequence, whether it shall be continued as a going concern.

Applying a SWOT analysis, the Porter Model or similar schemes are all helpful in qualitatively assessing a firm’s strategic position. They assist in specifying internal as well as external factors that contribute favorably or unfavorably in achieving a firm’s objective. - From a Corporate Finance point of view, the fundamental issue is merely a quantitative one, though: When and under which circumstances should management cease operations, perhaps even shut them down for good.

A firm’s management is entrusted with a broad set of tangible and intangible assets with the assignment to generate revenues, cash flows and ultimately profits. From a Corporate Finance point of view, a firm’s operational basis comprises all assets listed on the active, left side of the balance sheet. However, numerous categories 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.

Assets on a firm’s balance sheet have to be funded, with respective means and instruments listed on the passive, right side of a balance sheet. – Funding will be ignored, though, when performing a first, preliminary RoA analysis, as will be the role of a firm’s Chief Financial Officer (CFO): Instead, focus will be merely on those management functions and responsibilities which are directly linked to production, operations or delivering a service.

When taking a look at a firm’s income statement, then Earnings before Interest and Taxes (EBIT) appears to be the appropriate indicator for measuring a firm’s operational performance: EBIT represents the last line in the income statement, before dealing with a firm’s funding structure as well

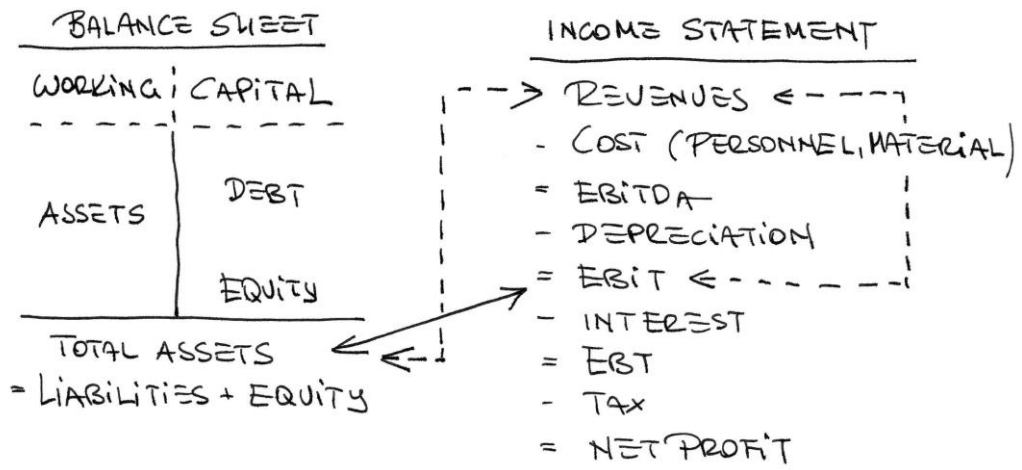
as related costs (i.e. interest payments or interest income), and taxes of course. Hence, EBIT is also the last line in the income statement exclusively focused on management performance, before all funding-related themes and topics are addressed and accounted for.

Therefore, linking entrusted assets with a firm’s EBIT seems appropriate in evaluating a management’s operational performance, at least from a Corporate Finance point of view. And, apparently it also reflects management’s unique perspective on running the operations of a business: Therefore, RoA (EBIT / total assets) is the appropriate ratio in assessing the feasibility and viability of an operation.

However, RoA has to be put into context: Observing trends in a firm’s RoA performance over time provides insight, as does benchmarking vis-a-vis industry peers. – Even more relevant, though, is the definition of an absolute threshold for RoA: the minimum RoA has to be.

The relevant benchmark in this regards are the funding costs of a firm’s assets and its operations. In reality, though, calculating, even merely estimating a firm’s average cost of capital can be a cumbersome, certainly time-consuming exercise. Instead, in the context of a swift corporate health check a short cut may be considered: Instead, a firm’s relative cheapest source of funding can be used as a benchmark: its average Cost of Debt (CoD). Latter can be quickly calculated by merely dividing a firm’s interest expense by its interest bearing short- and long-term liabilities.

This approach seems fair, at least in the context of a 5-minute analysis. Assuming that the most basic funding structure of a balance sheet comprises equity and debt only, 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 to exceed a firm’s CoD, as a minimum. Of course, there could be years when this benchmark may not be met. However, if RoA undershoots CoD long-term, then the viability of a firm’s operations should definitely be in question.



For more concepts click on:



Corporate Finance Concepts

Christian Schopper



COPYRIGHT www.christianschopper.com - DO NOT COPY OR PASTE