Analysis of profitability ratios

If a company shows good profitability then the shareholders can expect good profit distribution on their investment. For this purpose we should also examine the dividend payment history of the company in order to make a reliable estimate of profit distribution.

So far as the Spectrum Manufacturing Company [SMC] is concerned, its profitability is decreasing. The reasons of the decrease in profitability are:

1. Decrease in sales
2. Increase in interest expenses
3. Increase in the amount of depreciation [may not be a concern, since it is non cash expense. Further increase the depreciation will ultimately decrease tax liability]

The disadvantages of using above ratios are that these ratios may not provide an accurate estimate of the company profitability if used individually. The ratios calculated above should be used with other techniques in order to get more accurate and reliable estimate of the company financial position. The above ratios also ignore the impact of items which may result in low profitability but may increase share holders wealth maximization. For example, depreciation charged and interest expenses paid will ultimately decrease the tax liability of the company resulting in more profits available for distribution. The are many methods to calculate the leveraging of the company some considers long term debt while others considers both long term and short term debt of the company so this ratio should be calculated as per the requirements.

The ratio of ROCE ignores the impact of risk taken by the company. We may use RROCE [Risk Adjusted Return on Capital Employed] in order to get a more reliable estimate.

The following additional techniques and tools can be used for the analysis of SMC:

1. Cash Flow Analysis [Liquidity Ratios]
2. Peer Group Comparison
3. Inventory turn over ratio
4. Average collection period
5. Price earning ratio
6. Taxation structure of the countries where the company wants to enter
7. Exchange rate risk.

The Board of Directors are the agent of shareholders (Principal). It is the responsibility of the BOD to act in the best interest of shareholders. But there are chances that the BOD may not act in the interest of shareholders due to some potential conflict of interest. The conflict of interest may arise due to difference in goals and objectives of BOD and shareholders. However different techniques can be used to reduce the chances of conflict of interest such as profit participation, performance based remuneration etc.

The dividend policy is related with the profit distribution of the company. The investor would like to invest in a company which has a good dividend policy. The dividend policy is normally affected by the stage of business and future expansion plans. The dividend policy is important due to the following reasons:

- The dividend policy plays an important role in attracting the investors
- High dividends may result in higher share price of the company [market capitalization]
- Distribution of dividend in the form of cash shows good liquidity position of the company.

The debt financing is normally encouraged due to the fact that the interest expenses are deductable for taxation purposes while the dividend paid to share holders is not considered as an expense for taxation purposes.

Three main sources of financing:

1. Debt Financing from financial institutions
2. Subscription money from shareholders
3. Subordinated debt form sponsors
4. Government Grants