Benefits of dupont analysis

The dynamic environment of the world today suggests that one should be apt enough to apply his skills immanent to a system and also external with respect to credit management function. These functions include financial planning, plausibility of a defined business strategy or whether a particular merger or acquisition is feasible or not. This has to be done in a rapid yet meaningful way so as to be of immediate need to a particular firm or investor.

There are basically four major reasons for an effective financial statement analysis. These have been mentioned as follows:

It is useful for long-run business viability so as to determine whether a firm would be able to provide adequate business return when compared to the amount of risks taken. This is essential for outside investors.

It is also used by creditors so as to find out whether a potential buyer has the capability to service the loans that are being made or not.

Also, the analysts concerned about the internal development of a firm, require financial statement analysis so as to monitor the outcome as a result of applying the policy decisions, to make future predictions with regard to the performance targets, and also make an assessment of the capital needs of a company.

The function of DuPont analysis in this is that it is used as a tool to provide an overview of financial statement analysis for the purposes as stated and also provide a focus for such analysis.

In order to assess the financial health of a firm from the perspective of an insider or an outsider, there are four major areas that are covered. These have been stated as follows:

Liquidity

Leverage

Operational Efficiency

Profitability

In this process, the DuPont analysis can be used as a compass so as to help the analysts find out the areas that are of significant strength and weakness (as applicable) from the financial statements. DuPont analysis stands as an appropriate place to commence the financial statement analysis as it measures the Return on Equity (ROE). As this indicates the rate of growth of the owners' wealth, it becomes one of the most important ratios. So, DuPont analysis might not be able to provide a detailed description just like a proper financial statement analysis, but it certainly stands places in providing an excellent snapshot an impeccable starting point of financial analysis. It covers the major areas of profitability, operating efficiency and also leverage. It can be seen in the form of equations as follows:

ROE = (Net Income/Sales) X (Sales/Average Assets) X (Average Assets/Average Equity)

Net Income/ Sales: Profitability

Sales/Average Assets: Total Asset Turnover

Average Assets/Average Equity: Leverage Multiplier

Further, as the requirement of the company stands, one can also calculate the Return on Assets (ROA) by making a DuPont Chart. This can be done in the following manner:

ROA = (Profit before Income and Tax/ Total Assets) = (PBIT/Sales) X (Sales/ Total Assets)

DuPont Calculations and Analysis

(Note: In this case we are making a comparison of two years)

Profitability: Net Income/Sales

2008

6, 536, 358, 000/ 17, 868, 672, 000 = 36. 5%

2009

3, 080, 531, 000/ 16, 015, 133, 000 = 19%

This ratio indicates the rate at which a company uses the sales to generate profits for the company. One can see that it has decreased tremendously over a year. This suggests that the company has been trying to lure the customers with better benefits so as to decrease its profits. As the total sales have increased only marginally, it indicates that the market is in a risky position with companies cutting on profits to maintain previous customers and generate new ones.

Total Assets Turnover: Sales/Average Assets: Total Asset Turnover

2008

17, 868, 672, 000/ 54, 790, 875, 000 = 0. 32

2009

16, 015, 133, 000/ 60, 690, 798, 000 = 0. 27

Return on Total Assets indicates how well a company has been using its assets to generate sales. It is significant as a company might be generating a huge amount of profit out of sales involved, but then it doesn't check the efficiency with which it is using the assets for generating the amount of sales involved. In this, case the operating efficiency has decreased which means that the company has either made long-term installations which have not been used to implement sales in the best possible manner or there is a deficiency in the company functioning.

Leverage Multiplier: Average Assets/Average Equity

2008

54, 790, 875, 000/ 36, 536, 040, 000 = 1. 5

2009

60, 690, 798, 000/ 36, 000, 753, 000 = 1. 68

The leverage multiplier is used for determining the debt financing as compared to the equity financing of a company. Generally, if a company increases the debts over equity for financing its requirements, it does it as the cost of debt is less because of tax-deductible interests but then there is a larger risks involved here. A company would have to pay a certain amount for sure before they can make use of the net income. Here, the ratio has increased indicating the fact that Emaar has taken more debt than a year before which means that it requires immediate funding to carry out its operations.

Return on Equity

The above results can be combined to calculate the DuPont ratio which in this case is ROE.

ROE for 2008: 18%

ROE for 2009: 8. 5%

Now, we know that ROE determines the profit as compared to the shareholders' equity. This has decreased over a span of one year which signifies the fact that the company would find it difficult to arrange for internal cash as it seems less attractive for shareholders. This is also evident from the fact that leverage multiplier had increased significantly.

Gross Profit Margin: EBIT/ Sales

2008

7, 053, 765, 000/ 17, 868, 672, 000 = 0. 394

2009

6, 811, 358, 000/ 16, 015, 133, 000 = 0. 425

The gross profit margin of the company has increased which is again indicative of the fact that the company is paying too much of interests which decreases the net income.

Return on Assets

2008

12. 0%

2009

5%

The net return on assets of the company has also decreased indicating the fact that the company has so far not made the type of income it has been looking to make with the assets that it has. This shows that the company looks to make long-term benefits out of the assets that it has generated.