Operating profit

The profitability and margin ratios represent the relationships between income and sales or investments. These ratios provide a basis for determining the ability of the company to be efficient in generating income from every dollar of sales revenue and to reward shareholders with profits and dividends. The gross profit margin ratio reflects the company's ability to recover its manufactured or purchased cost of merchandize from revenues. It is computed as gross profit (sales less cost of sales) over or divided by net sales.

On the other hand, the net profit margin ratio is widely used as a measure of the overall profitability of operations. It is computed as net profit (gross profit less operating and administrative expenses) over or divided by net sales. The following is the computation of such ratios for Abbott's operations during the years 2004, 2005 and 2006: The ratios show that from 2004 to 2006, Abbott's operating earnings margin ratio and net earnings margin ratio both declined as compared to their equivalents in 2004 and 2005.

However, these decreases have to be taken in a positive context. Abbott invested heavily (spending over $4 million as compared to the usual less than $2 million) in research and development. Benefits and returns from this investment should be reflected in the upcoming months. The earnings per share (EPS) of a company is one of the most important indications of its profitability. It can easily be compared to the EPS figures of other companies, then it is a handy means for investors and stockholders to see the amount they have earned for a single share of stock.

The EPS can be computed by dividing the net income by the number of shares of the company. In 2006, the EPS of Abbott Laboratories is $1. 12 while those for 2005 and 2004 were $2. 16 and $2. 06 respectively. This decrease can be attributed to the same reason the income levels of the company were not of its usual level in 2006. The price-earnings ratio is the ratio of the current price per share to the earnings per share (EPS) of stocks. In formula form, it is calculated as the price per share divided by earnings per share (EPS).

Also read about profit leverage effect

With the calculation of the price-earnings ratio, financial analysts may overcome the difficulty of comparing different-priced shares of stocks. By comparing the price-earnings ratio, one can easily see which stocks cost less for each invested unit of currency. In other words, the price-earnings ratio indicates how many units of currency are required to buy a unit’s worth of earnings. Source (except for the ratios): The 2006 Annual Report of Abbott Laboratories. The current ratio is a tool to test the company’s liquidity.

Liquidity refers to the company’s ability to pay its short-term liabilities as they fall due. No company can avail of long-term loans for expansion if it is proven that the company cannot even settle those with terms that are shorter than a year. Meanwhile, the debt-equity ratio shows how much of the total assets of the company are provided by the stockholders’ investments and how much of them are provided by creditors. The bigger this ratio is, the less attractive the company becomes for banks and lending institutions.

Source (except for the ratios): The 2006 Annual Report of Abbott Laboratories. The current ratios of Abbott Laboratories for the years 2004 to 2006 are 1. 57, 1. 54 and 0. 94 respectively. This ratio shows that the company that is in a good position to easily take care of its current liabilities using its current assets. In 2006, the current assets of the company turned out to be insufficient by only 6% to meet its current liabilities. But this is still a relatively healthy balance between current assets and current liabilities.

Companies are not advised to maintain high current ratios and in the cases of 2004 and 2005, the surplus of current assets over current liabilities is too minimal – less than one point – to even merit having to check on the management’s use of the company’s current assets. Meanwhile, the company’s debt-equity ratios for the years 2004 to 2006 are above the industry norm which stays at 40: 60. These ratios show that Abbott Laboratories is considerably in debt. Its total liabilities are higher than the total investments of its stockholders or owners.

This paints a risky picture for the creditors of the company. However, the credibility of the company management and the long-standing good records of the company as a borrower may prevail and become more than enough reasons for the release of loans. According to authors Frank Reilly and Keith Brown, beyond the original DuPont System, some analysts have suggested using an extended DuPont System which provides additional insights into the effect of financial leverage on the firm and also pinpoints the effect of income taxes on the firm’s return on equity.

Because both financial leverage and tax rates have changed dramatically over the last decade, these additional insights are important. The computations using this DuPont System are as follows: Abbott's average operating profit margin is around 20%. The margin decreased by 50% in 2006 due to the aforementioned costs in research and development which the company management is banking on the effect a much greater increase in sales and net income in the coming years.

This setback, therefore, is confined to just 2006 and is not expected to recur as part of the ordinary operations of the company. The interest expense rate increased in 2006 due to the new short-term borrowings that the company availed of during the year. Thus, the interest expense of 2005 almost doubled in 2006. After all, the new loans – classified in the company books as current liabilities - acquired during 2006 amounted to almost $4. 5 billion.

The total asset turnover in 2006 is lower than those in 2004 and 2005 due to the acquisition of land and the construction of company buildings during the year. The additional costs of land and building amounted to almost $2 billion. Based on all the foregoing, it is recommended that themoneyfor investment be used to purchase shares of Abbott Laboratories. Purchase of ABT shares is seen as a conservative move that will bring in more yield as compared to less riskier investment vehicles of investment such as time deposits and treasury bills.

The ways to reap returns through investing in ABT is by collecting regular dividends, and then to make money as well in the trading of stocks in the stock market.

REFERENCES: 2006 Fact Book of Abbott Laboratories Company website of Abbott Laboratories (www. abbott. com) 2006 Annual Report of Abbott Laboratories Value Line Publication, Inc. on Abbott Laboratories dated August 31, 2007 Website of Bloomberg (www. bloomberg. com) Reilly, F. and K. Brown. Investment Analysis and Portfolio Management. Orlando, Florida: The Dryden Press, 1997.