Section 2:

Profitability Analysis

In this section, we describe and explain how the profitability analysis process works. As mentioned in the Introduction, the information reported in the financial statements can be related back to the firm’s business strategy. Initially oriented to past performance, the information reported in the financial statements provides a foundation for forecasting or estimating future performance.

The information reported in the firm’s financial statements (the input) is transformed (through the profitability analysis process) into an assessment of the firm’s business strategy. Profitability analysis can be visualized as an input-processing-output approach to corporate accountability and business strategy as shown below.

Profitability analysis can be applied to firms of any size, business units within those firms, joint ventures, and business partnerships. All that is needed to start the process is a set of financial statements for the business to be analyzed.

The information reported in the financial statements is processed through two strategy models to assess the firm’s business strategy. The Strategic Profit Model (SPM) focuses on key profitability relationships that
managers and investors use to monitor the performance of the business. The Strategic Financing Model (SFM) focuses on how the long-term investment needs of a business are financed from long-term debt and equity sources.

In Chapter 6, we introduce the management communication principles that underlie profitability analysis. We then present a “quick overview” of the Strategic Profit Model using a limited amount of information reported in the balance sheet and the income statement. As we shall see, the key concepts underlying this model are return on investment (ROE), profit margin, asset turnover, return on assets (ROA), and financial leverage.

In Chapter 7, we start the process of taking a closer look at the components of the SPM by looking at the margin management component of the model. Margin management focuses on the interrelationships among the expenses reported on the income statement and revenue (net sales). These interrelationships are captured by the profit margin concept.

In Chapter 8, we take a closer look at the asset management component of the SPM. Asset management focuses on the interrelationships among the financial elements reported on the asset section of the balance sheet and net sales (from the income statement). These interrelationships are captured by concept of asset turnover.

In Chapter 9, we “broaden the lens” so to speak by the combining margin management and asset management components of the SPM under the concept of return on assets (ROA). The interrelationships among the financial elements reported on the income statement and the asset section of the balance sheet provide additional insights into the business that help clarify the firm’s business strategy.

In Chapter 10, we take a closer look at the financial management component of the SPM. We use the concept of financial leverage to show how a firm’s relationships with its creditors and shareholders are linked to the management issues captured by the concept of return on assets.

In this chapter, we also present a summary version of the SPM. As we shall see, the summary version is nothing more that the “quick overview”
supplemented by the knowledge of the business that we have developed by working our way through each of the components of the SPM.

In Chapter 11, we will introduce the second business strategy model, the Strategic Financing Model (SFM). The SFM help us develop a better understanding of how management builds the firm’s long-term investment and long-term financing base.

Whether justified or not, senior management is often accused of “sacrificing the long run future of the firm for short-term profits.” The only way to counteract this accusation (or agree that it is correct) is to be able to the language of investing and financing. Based on the information reported in the financial flow statement, we show how management has grown (or downsized) the business over time.

In Chapter 12, we extend our analysis of the long-term investment and long-term financing activity by bringing the customer back into the picture. Starting with the customer financing provided by net sales, we show how internal equity financing is used to grow the long-term investment base. We also show how any deficiency (or excess) of internal equity financing must be made up from external debt and equity sources.

By the end of Section Two, we will have linked management control to corporate accountability and business strategy. In Section Three, we close the loop by linking business strategy back to management control.