RI HUB

A research collaboration between the University of Melbourne and the Ruthven Institute

KEY FINDINGS

1. The choice of a performance measure depends on who is assessing the firm and for what purpose. The general measures of performance are often supplemented by industry-specific measures.
2. Non-recurring and unusual items should be removed from net income when calculating performance measures.
3. And increasingly as the knowledge economy changes the structure of the economy, non-earnings and non-financial measures are also used to assess future performance.

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PERFORMANCE MEASURES: HOW SHOULD WE CALCULATE PROFITABILITY?

The Issue: ***Different performance metrics are used to assess a firm's profitability. Which is the best?***

Investors are interested in future profitability

- Return on Assets (ROA) and Return on Equity (ROE) are the most consistent and practical measures of profitability.
- Return on Market Value of Equity is also helpful when comparing the performance of public companies.
- Reflecting the importance of innovation and investment in the new age economy, R&D expenses, capital investment, and operating cash flows are becoming increasingly informative about future profitability.
- As socially responsible investing grows exponentially issues of environmental and socially responsible policies and practices, together with the quality of governance, are increasingly important.

Credit rating agencies use multiple profitability measures

- More so than the ratios above, they rely heavily on various profit margins.
- S&P and Moody's both use EBITDA margin, with Moody's also using EBIT margin, as their primary measure.
- Their secondary measure is Return on Capital. EBIT and EBITDA are the most commonly used numerators for this ratio.
- For some industries, they supplement their analysis of a firm with measures that are unique to those industries, such as earnings to total throughput barrel for the oil industry.

Industry context is important

- Industries vary in structure, level of risk, and asset intensity, so supplementary industry-specific factors are useful.

The biggest emerging trends: ESG and cyber risk

- Environmental, social, and governance (ESG) performance is increasingly important for both investors and consumers. Both groups are more willing to hold companies accountable for socially and environmentally irresponsible business models and sources of income.

- As a result, rating agencies have increased the weighting they place on ESG performance. ESG performance therefore may significantly affect companies' costs of borrowing and risk profiles. Ample anecdotal evidence suggests that the better connected a company is with its consumers and the broader community, the more able the company is to raise cash in difficult times.
- Cyber-risk is also an emerging issue, the quality of management of which will affect a firm's capacity to survive

Recommended profitability measures from each party's perspective and their calculation:

Investors

Return on Equity	Profit/Loss Before nonrecurring and unusual items / Shareholders' Equity
Return on Market Value of Equity	Profit/Loss before nonrecurring and unusual items / Market Value of Shareholders' Equity
Return on Assets	Profit/Loss before nonrecurring and unusual items / Average Assets

Creditors

EBITDA Margin	Earnings before interest, taxes, depreciation and amortisation / Revenue
EBIT Margin	Earnings before interest and taxes / Revenue
Return on Capital	Earnings before interest and taxes / Debt + Equity

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