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# **Lecture 8**

## **Results and effectiveness of economic activity**

- 1. Financial results of economic activity  
(revenue and profit)**
- 2. Effectiveness and Financial diagnostics**

to read

## in Ukrainian

1. Економіка підприємства./ За заг. ред. С.Ф. Покропивного – К.: КНЕУ, 2001. – 528 с.
2. Економіка підприємства./ За ред. Шегди А.В. – К.: Знання, 2006. – 614 с.
3. Accounting standard # 3 “Financial results”

## in English

<http://en.wikipedia.org/wiki/Revenue>

[http://en.wikipedia.org/wiki/Profit\\_%28accounting%29](http://en.wikipedia.org/wiki/Profit_%28accounting%29)

<http://en.wikipedia.org/wiki/Income>

[http://en.wikipedia.org/wiki/Financial\\_ratio](http://en.wikipedia.org/wiki/Financial_ratio)

[http://en.wikipedia.org/wiki/Income\\_statement](http://en.wikipedia.org/wiki/Income_statement)

# Financial results of economic activity.

## Part 1 Revenue

### Revenue

- is the amount of money a company receives in exchange for its goods and services.
- is usually listed on the first line of the income statement as revenue, sales, net sales or net revenue.

**"Other Revenue"** is money a company receives for activities that are not related to its original business.

**For example,** if a clothing store sells some of its merchandise, that amount is listed under revenue. However, if the store rents a building or leases some machinery, the money received is filed under "other revenue."

## Part 2. Profit

### Profit

- is that money that your business retains after all expenses have been paid and accounts have been settled.
- is financial benefit that is realized when the amount of revenue gained from a business activity exceeds the expenses, costs and taxes needed to sustain the activity.

Calculated as:

$$\text{PROFIT} = \text{TOTAL SALES less TOTAL COSTS}$$

## Part 2. Profit

Sales	Costs	Profit or Loss?
£100,000	£75,000	£25,000 (profit)
£100,000	£125,000	£25,000 (loss)
Total sales greater than total costs		= Profit
Total costs greater than total sales		= Loss
Total sales = total costs		= Break-even

# Profit formation (Ukrainian Accounting Standards)

## Revenue

- VAT
- Excise duty

= **Net revenue**

- Production costs

= **Gross profit**

# Profit formation (Ukrainian Accounting Standards)

## Gross profit

- + other operating revenues
- administrative expenses
- selling expenses
- other operating expenses
- = **Financial results of operation activity**



## Profit formation (Ukrainian Accounting Standards)

### Financial results of operation activity

- + yield on capital
- + other financial incomes
- + other incomes
- financial losses
- capital losses
- other losses

**= Financial results of main activity before taxation**

### Financial results of main activity before taxation


– income tax

= **Financial results of main activity**

+/- extraordinary incomes or losses

– taxation of extraordinary incomes


= **Net profit / losses**



**Gross profit equals sales revenue minus costs of good sold (COGS).**

**Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)** equals sales revenue minus cost of goods sold and all expenses except for interest, amortization, depreciation and taxes.

**Earnings Before Interest and Taxes (EBIT) or Operating profit** equals sales revenue minus cost of goods sold and all expenses except for interest and taxes. It is also known as **Operating Profit Before Interest and Taxes (OPBIT)** or simply **Profit Before Interest and Taxes (PBIT)**.



**Earnings Before Tax (EBT) or Net Profit Before Tax** equals sales revenue minus cost of goods sold and all expenses except for taxes. It is also known as pre-tax book income (PTBI), net operating income before taxes or simply pre-tax Income.

**Earnings After Tax or Net Profit After Tax or Net Income** equals sales revenue after deducting all expenses, including taxes.

**Income before extraordinary expenses** represents the same but before adjusting for extraordinary items.

**Earnings After Tax (or Net Profit After Tax) minus payable dividends** becomes **Retained Earnings**.

# Functions of profit

- Evaluation – characterizes effect of economic activity
- Distribution – distribution of income between company and budget
- Promotional – a source for promotion
- Reproductive – a source for extended reproduction of capital and circulating assets

# What influences profit?

Changes in

- sales
- structure of assortment
- prices of goods
- prices of raw materials
- level of inputs of material and labour resources

## 2. Financial diagnostics

**Economic diagnostics** – analysis and evaluation of results of activity of the enterprise based on study of individual results and incomplete information with the purpose of exploration of possible perspectives of development and consequences of current management decisions

## Effective economic activity

- Enterprise utilizes existing assets effectively
- Enterprise pays off its debts in time
- Enterprise is profitable



## Financial diagnostics (1)

Full-scale financial analysis of results of economic activity of the enterprise

- Horizontal – by years
- Vertical – internal structure
- Financial ratios

# Forms of financial statements

- balance sheet
- income (financial results) statement
- cash flow statement
- equity capital statement
- notes on annual financial accounts

# Financial ratios

- Operational analysis
- Analysis of operational expenses
- Analysis of assets management
- Liquidity analysis
- Analysis of long-term solvency
- Profitability analysis

# Profitability ratios

Gross Profit Margin=

$$\frac{\text{Gross Profit}}{\text{Net Sales}} \quad \frac{\text{Net Sales} - \text{COGS}}{\text{Net Sales}}$$

Return on Sales =

$$\frac{\text{Operating Income}}{\text{Net Sales}}$$

Net Profit Margin =

$$\frac{\text{Net Profit}}{\text{Net Sales}}$$

## Profitability ratios

$$\text{Return on equity (ROE)} = \frac{2 * \text{Net income}}{\left( \frac{\text{Shareholders equity beginning} + \text{Shareholders equity ending}}{2} \right)}$$

$$\text{Return on assets (ROA)} = \frac{2 * (\text{Net income})}{\left( \frac{\text{Total assets beginning} + \text{Total assets ending}}{2} \right)}$$

$$\text{Return on capital (ROC)} = \frac{\text{EBIT}(1 - \text{Tax Rate})}{\text{Invested Capital}}$$

# Liquidity ratios

Current Ratio =

*Current assets*

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*Current liabilities*

Quick Ratio ("Acid Test")=

*Cash + Marketable securities + Accounts receivable*

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*Current liabilities*

Absolute Liquidity Ratio =

*Cash*

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*Current liabilities*

*Cash and Marketable Securities*

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*Current Liabilities*