Providing Students with an Overview of Financial Statements Using the Dupont Analysis Approach

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Financial Management

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By John P. Racine

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Summary

The article focuses on adapting one powerful, yet common, financial ratio to the solution of financial management problems. This financial ratio, the Return on Assets (ROA), is central to what the authors term the "Dupont Analysis." Based on balance sheets and income statements, this analysis is a potent tool for diagnosing business strengths and weaknesses.

The basic premise of this analysis is that the ROA, normally computed as simply the Net Income After Taxes divided by the Assets (invested capital), can be expressed more powerfully as ROA=(NIAT/Revenue)x(Revenue/Assets), whose terms are common, powerful financial ratios themselves, so ROA=(Net Profit Margin)x(Asset Turnover). This is more interesting because the Net Profit Margin is an indicator of the firm's profitability as it relates to revenue and the Asset Turnover measures the efficiency of the firm's assets such that the higher this latter ratio, the more efficient the assets. Also, ROA will increase if any of the following three factors changes while the other two remain the same: 1) if costs decrease, income increases, so ROA increases, 2) if revenue increases, then income increases and ROA increases, and 3) if assets decrease then ROA increases.

Consequently, the firm can determine the root causes of a deteriorating ROA by examining the relative impact of asset turnover versus profit margin. ROA thus gives powerful and interesting insight into the interplay of otherwise mysterious elements of balance sheets and income statements.

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Critique

The article is short yet it effectively delivers on its promise to teach how to use an important financial ratio. It clearly delineates the relationships between the elements of the balance sheet and income statement as they appear in this ROA ratio. It uses examples well to illustrate both how to perform the analysis and what conclusions could be drawn from the analysis. The article is also empowering because it simply disseminates this piece of knowledge that this ROA equation can be broken up into such a useful set of variables.

Unfortunately, it does suffer from several drawbacks, chief among them the terseness of the article. More could be said about the variables that contribute to Net Profit Margin and Asset Turnover without making the paper too long. Likewise, if there are other interesting ratios out there that break down into more useful components, they could be covered here or even just mentioned for further reading, but they aren't. Finally, the authors mention that other financial issues can be addressed by Dupont Analysis but they fail to mention what they are or where one might learn about them, other than in the bibliography.

Nevertheless, this article could be a useful teaching aid in a Financial Management class or even be a guide to a financial manager who doesn't use these tools very often, or who is just beginning in their use. Students and faculty would find it most useful when covering all the financial ratios as it would provide both detailed knowledge of one individual ratio and create insight into the notion that the ratios are just a stepping stone to greater knowledge through drilling down into the data.