# SUSTAINING OPERATIONAL PERFORMANCES

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## INTRODUCTION

Organisational performance plays important role in measuring actual output with the desired goals and objectives. For evaluating the operational performance, the organisation uses the ‘balanced scorecard’ technique. It includes four major areas: operational management, financial performance management, growth (innovation and sustainability) and customer services (customer loyalty, market and sales performances). In the current essay, focus is on the financial performance management that will help in understanding different capabilities and actions along with taking the actions regarding investment in MDM plc. The essay will highlight different profitability ratio, risk assessment ratio related to investment and will suggest the ways of financing for the project of MDM plc.

## DESCRIPTION

Profitability Ratio

These ratios are the class of financial metrics that helps in assessing a firm’s ability to earn the revenue by comparing to it with expenses and other financial cost incurred during the particular time period. Investors and creditors take a key interest in profitability ratio to judge return on investment with the level of resources and assets they have invested. Profitability ratio’s is related to efficiency ratio as it shows how well organisation uses their assets to generate profits (Gibson, 2012). Some of the important profitability ratio’s that the client will consider while investing in MDM plc organisation:

**Gross Profit Ratio -** This ratio shows that how efficiently the organisation is using its resources, materials and labour. It also measures business manufacturing and delivery efficiency during the production process. A higher gross profit ratio indicates that the business have control over its cost (Delen et.al. 2013). The client will use this ratio to compare the profitability of the business in the same industry and also in different industries. The formula is:

- Gross profit ratio = Gross profit/net sales*100

**Net Profit Ratio (Operating Margin) -** It is the key ratio in profitability. It shows the amount of sale rupee left over after all expenses have been paid. A higher net profit indicates that the business is more efficient in converting sales into actual profits. The formula is:

- Net profit ratio = operating profit (after tax) / net sales*100

**Return on Assets-** This ratio calculates that how effectively the MDM organisation generates income from its assets. It is calculated by dividing net income after tax for the current year by taking the value of organisation assets (Minsky, 2015). The formula is:

- Return on Assets = Net Income / Assets * 100

**Return on Equity (ROE) -** It measures how much organisation makes for each currency that investors put in. It is calculated by taking the net income earned by the amount of money invested by shareholders (Plewa and Friedlob, 1995). The formula is:

- Return on Equity = Net income / Shareholder Investment * 100

**Cash Flow Margin Ratio-** This ratio depicts the internal workings of the organisation. It very well measures how business operations are creating cash from sales. High cash flow margin indicates the organisations efficiency in debt collection and high earnings.

- Cash Flow Margin Ratio = Cash Flow from Operating activities / Net Sales

The above ratio will help the client in drawing his opinion regarding investment in MDM plc. This different profitability ratio takes into account every aspect from where the profitability can be measured.

Risk assessment ratio

For assessing the level of financial risk and for measuring the overall financial health of the organisation the risk analysis ratio is calculated. It assess the MDM plc capital structure and existing risk level as evaluated in connection with organisation's debt level. Debt levels and debt management critically impact the organisation profitability since the debt service required funds and thus reduced the net profit margin and affects the growth of the business (Wahlen.et.al, 2014). The risk assessment ratio's are:-

**Debt to Capital Ratio:** This ratio provides the basic financial structure of the organisation in terms of how it is capitalizing its operations and reflection of financial soundness. It is comparison of organisation short and long term debt with the total capital invested by shareholder fund and debt financing. Lower debt to capital ratio is a good sign as it reflects more of higher proportion of shareholder funding over debt financing (Bender, 2013). The formula is:

- Debt to Capital Ratio = Total debt (short term debts + long term debts) / Total Capital (shareholder's equity + debt financing)

**Debt/Equity Ratio:** It is key financial ratio that gives a direct comparison of debt financing and equity financing. This ratio indicates the organisation ability to meet the outstanding debt liability. Again lower Debt/Equity ratio is preferred as it indicates organisation financing operations are more through own financing resources rather than through debt financing (Plewa and Friedlob, 1995). Higher D/E ratio will have negative impact on a MDM plc ability to secure additional funding when needed. The formula is:

- Debt/Equity Ratio = Total debt (short term debts + long term debts) / Shareholder's Capital

**Interest Coverage Ratio:** It is the measure of organisation capability to handle its short term financing costs. This ratio reflects the number of times organisation can pay the required annual interest instalments on its outstanding debt with its current income before interest and taxes. Lower ratio will indicate that higher debt service liability on the organisation and simultaneously higher risk of default or financial insolvency (Gatti, 2013). Lower ratio also reflects lesser amount of earnings available to make financial payments and also shows MDM plc is less capable to handle any increment in interest rates. Preferred ratio is 1.5 or lower and higher ratio depicts that the organisation fails to take benefits of available financial leverage.

- Interest Coverage Ratio = EBIT (Earnings before Interest and Taxes) / Interest Expense

Different possible ways of financing

A MDM plc organisation can adopt numerous ways for financing the projects. The different sources are:

**Capital markets-** Most commonly the organisation issues new shares for additional funding or through right issues. In new share issues, organisation can offer sale of new shares to the public for that the prospectus is issued and them placing is done and at last an introduction is carried. And in right issue, organisation can arrange funds through offering the shares to the existing employees, shareholders and attracting them to subscribe for new shares in proportionate with existing shares for cash.

In right issue MDM plc needs to keep the price low for its shares to meet the acceptance of shareholders who will provide additional funds but not so low that it avoid excessive dilution of the earnings per share (Finnerty, 2013). This method is appropriate as risk factor is less as compare to other ways but it sometimes inappropriate also as new investor will join there would be dilution of control and authority power of the existing owners.

**Retained Earnings-** Many organisations prefer this way rather than paying higher dividends on raising the new investments. Retained earnings include reserves and surplus of the organisation although in reality it doesn't exist. The benefits of using this method is that it avoid issuing cost, interest cost, avoid change in control, no actual payment of cash, easy source of financing the project without involving either the shareholders or any outsiders (Howard, 2007). The organisation can restricts its self financing through retained profits as shareholders expects the reasonable dividend with respect to their real investment and directors would rather like to keep the funds for re-investing.

**Bank loans-** Bank borrowings are the important source of finance to the organisation. Lending from bank is generally for short term although now medium term lending is common. The organisation can use medium term loan that are normally for 3-10 years and the rate of interest charged on this loans from large organisation will consider the set margin, with the size of the margin depending on the credit standing and riskiness of the borrower (Lock, 2014). A loan may have fixed rate of interest and variable rate of interest depending upon the base lending rate. The

MDM can prefer this method for financing the project as no new shareholders are invited that will dilute the existing shareholder control and power. The organisation only needs to pay specific interest instalments and is not answerable to anyone.

**Government funding-** Normally big projects are government funded. The government assist in funding the organisation through cash grants or other forms of direct assistance. The government performs this role as a part of helping to develop the country's economy. It mainly provides assistance in areas of high technology industries and in areas of high unemployment. The benefit of this method is no interest and only justification of project through issue of prospectus for the projects.

**Loan stock-** It refers to long term capital debt raised by the organisation while giving the interest usually half yearly or fixed rate. It has been seen that holders of long term stock are usually the long term creditors of the organisation. The MDM plc can issue secured debentures and this usually involves two types of charges i.e. fixed and floating charge. Fixed charge is on fixed asset especially on land and building and floating charge is on current asset like stocks and debtors. The organisation needs to decide in this respect depending upon the availability of assets (Yescombe, 2013).

The organisation while issuing the debentures will consider the redemption period also. The benefits for the organisation is when the bank interest rate is high as compare to issue of new debenture interest rate. For instance if the bank borrowing rate is 13 % and debenture interest rate is 10% then it is advisable for the organisation to fund their project through debenture as it is cheap source of fund and also secured as compare to bank loans.

**Leasing-** It is the agreement between the two parties, the lessor and the lessee. The lessor acquires the own capital asset and allow it use to the lessee. The lessee makes payments to the lessor for a specific period of time under particular terms and conditions. The leasing assets are plant and machinery, cars and heavy commercial vehicles, computers and operating equipments. There are two types of leasing i.e. operating lease and financial lease. Operating leases are rental agreements between the lessor and lessee where lessor is responsible for supplies and maintenance of the asset on the other hand financial lease the responsibility whole lies with the lessee for maintenance.

The benefit of finance lease is that it is cheaper as compare to bank loan. The cost of payment under the bank loan may exceed the cost of lease. And the benefit of operating lease is that the leased equipments are needs not be shown on lessee financial balance sheet which reflects no increase in gearing ratio (Brusov et.al. 2012). The other benefit is that lessee will allowed a deduction in lease payments while calculating taxable profits.

**Hire purchase-** It us similar to leasing only with the exception of ownership of goods passes to the buyer at last instalment of loan whereas in leasing lessee never becomes the owner of the assets. The organisation can use this method for financing the asset that is required in the project that the organisation is undertaking. The benefit is that MDM plc can easily pay monthly instalment while the project is running and it may be possible that by the end of project the instalments are also completed and organisation will have the benefit of having new asset that will enhance the financial stability.

The above various methods of financing the projects are essential and it is advisable for the client as well for the MDM plc to have a analysis on this method with considering their benefits and limitation while undertaking new project of €200 million.

## CONCLUSION

In the current essay, the financial element for sustainability of operational performance had been highlighted. The essay had explained the various profitability ratios that the client need to consider while investing in MDM plc. It had further laid the importance of different risk assessment ratio that provides an assistant to client to invest in the organisation. At the end, the essay had clearly depicted different ways that the MDM plc can undertake for financing their new project and client would also consider this ways as he knows that the organisation is considering new project.

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