GNITED MINDS
Journals

# RELATIONSHIP BETWEEN OPERATING PROFIT MARGIN AND ASSET TURNOVER OF INDIAN MANUFACTURING COMPANIES OF INDIA

*International Journal of Information Technology and Management*

*Vol. V, Issue No. I, August-2013, ISSN 2249-4510*

AN INTERNATIONALLY INDEXED PEER REVIEWED & REFEREED JOURNAL

www.ignited.in

# Relationship between Operating Profit Margin and Asset Turnover of Indian Manufacturing Companies of India

**Shreekara K.**

Research Scholar, Sai Nath University, Ranchi, Jharkhand

***Abstract – This paper is based on the relationship between operating profit margin and asset turnover of Indian manufacturing companies of India. Operating profit is also known as EBIT and is found on the company's income statement. EBIT is earnings before interest and taxes. The operating profit margin looks at EBIT as a percentage of sales. The operating profit margin ratio is a measure of overall operating efficiency, incorporating all of the expenses of ordinary, daily business activity. Asset management (turnover) ratios compare the assets of a company to its sales revenue. Asset management ratios indicate how successfully a company is utilizing its assets to generate revenues. Analysis of asset management ratios tells how efficiently and effectively a company is using its assets in the generation of revenues. They indicate the ability of a company to translate its assets into the sales.***

***Keywords: Operating Profit Margin, Asset, Manufacturing, Business, Companies***

--------------------------♦-----------------------------

## INTRODUCTION

Indian industry has shown a decent growth over past few years. At present there are different manufacturing companies operating its business through its various plants in India. Every business is most concerned with its profitability. Profitability is the ability to make profit from all the business activities of an organization, company, firm, or an enterprise. It shows how efficiently the management can make profit by using all the resources available in the market. One of the most frequently used tools of financial ratio analysis is profitability ratios, which are used to determine the company's bottom line. Profitability ratios show a company's overall efficiency and performance. Profitability and management efficiency are usually taken to be positively associated: poor current profitability may threaten current management efficiency and vice versa; poor management efficiency may threaten profitability (Eskandari, 2007).

The operating profit margin is a type of profitability ratio known as a margin ratio. The information with which to calculate the operating profit margin comes from a company's income statement.

Operating Profit Margin = Operating Income/Sales Revenue = ________%

Operating income is often called earnings before income and taxes or EBIT. EBIT is the income that is left, on the income statement, after all operating costs and overhead, such as selling costs and administration expenses, along with cost of goods sold, are subtracted out.

Operating Profit Margin = EBIT/Sales Revenue = ________%

This is the ratio of operating profit to sales or turnover. A high operating profit margin is due higher sales prices or low costs. Other factors to consider include inventory valuation, overhead allocation, bulk discounts and sales mix. Low profit margins are not normally good news as it suggests poor performance. But there may be other factors to consider relating] to the business activities and industry. For example the company may be entering a new market which requires low selling prices.

## REVIEW OF LITERATURE

Eljelly (2004) found significant negative relationship between the firm's profitability and its liquidity level, as measured by current ratio. This relationship is more pronounced for firms with high current ratios and long cash conversion cycles. At the industry level, however, he found that the cash conversion cycle or the cash gap is of more importance as a measure of liquidity than current ratio that affects profitability. The firm size variable was also found to have significant effect on profitability at the industry level. Lazaridis & Tryfonidis (2006) conducted a cross sectional study by using a sample of 131 firms on the

Athens Stock Exchange for the period of 2001 – 2004 and found statistically significant relationship between profitability, measured through gross operating profit, and the cash conversion cycle and its components (accounts receivables, accounts payables, and inventory).

**Strategies to improve operating and financial performance -**

Strategies to improve operating and financial performance are particularly critical in periods of low prices and incomes. What is the payoff or benefit of various strategies? And how can you analyze that payoff to determine which one is the best to pursue? Fundamentally, for any business there are two primary ways to enhance operating performance as measured by ROA (return on assets):

1) Increase net income per dollar of revenue or unit of output—operating profit margin, and 2) increase revenue per dollar invested—asset turnover. If operating profits exceed the cost of borrowed capital, you can augment operating performance through the use of debt or leverage to generate the ultimate performance measure for the individual investor:

ROE (return on equity). Thus, there are three primary levers that affect bottom line financial performance: 1) operating profit margin, 2) asset turnover, and 3) leverage. The relationship among these three levers is summarized graphically in Figure.

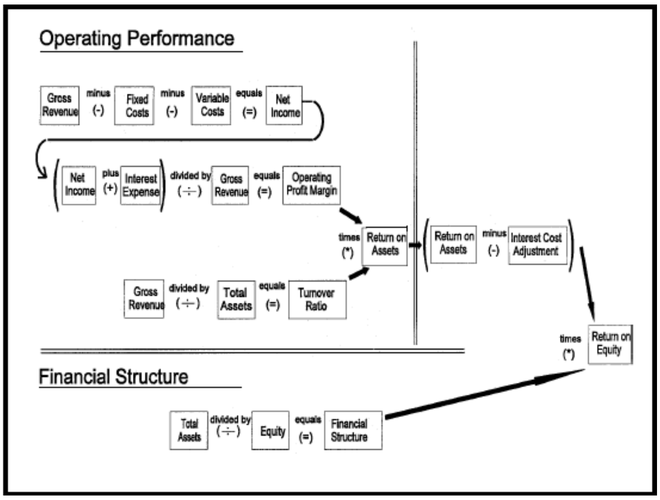


Figure: Relationship among Operating Profit Margin, Asset Turnover, and Leverage

As illustrated in Figure, you assess operating performance by first calculating net income (gross revenue minus fixed and variable cost). Fixed costs are those costs that will not vary with the level of production. Depreciation expenses, real estate and property taxes, interest on term debt, and payments for operator labor and management contributions are examples of these costs. Variable costs are those items that will change with the level of production. Seed, fertilizer, and fuel expenses are examples of these expenses. Specific decisions on cost control, efficiency, and productivity will affect net income. Net income will also be affected by product pricing and input procurement decisions.

## GROSS PROFIT MARGIN

The gross profit margin is a margin ratio. In order to calculate gross profit margin, you have to look at your company's income statement.

Gross Profit = Sales Revenue - Cost of Goods Sold

In order to understand gross profit, you have to understand fixed and variable costs . Variable costs are those that the company incurs as a result of producing its product. They are, essentially, cost of goods sold. So, the gross profit equation can be restated as:

Gross Profit = Sales Revenue - Variable Costs

Gross profit is expressed on the income statement as a dollar amount. Gross profit margin is expressed as a percentage:

Gross Profit/Sales Revenue = Gross Profit Margin ______%

Gross profit is what you have left over after you pay all your variable costs or costs associated with producing your product or service. It is important to track the gross profit margin in order to track profitability (bizfinance.about.com).

## ASSET MANAGEMENT RATIOS

Asset management ratios are computed for different assets. Common examples of asset turnover ratios include fixed asset turnover, inventory turnover, accounts payable turnover ratio, accounts receivable turnover ratio, and cash conversion cycle. These ratios provide important insights into different financial areas of the company and its highlights its strengths and weaknesses.

High asset turnover ratios are desirable because they mean that the company is utilizing its assets efficiently to produce sales. The higher the asset turnover ratios, the more sales the company is generating from its assets.

Although higher asset turnover ratios are preferable, but what is considered to be high for one industry, may be low for another. Therefore it is not useful to compare asset turnover ratios of different industries. Different industries have different requirements with regard to assets. It would be unwise to compare an ecommerce store which requires little assets to a manufacturing organization which requires large manufacturing facilities, plant and equipment (www.readyratios.com).

## CONCLUSION:

In this paper we found that every firm is most concerned with its profitability. One of the most frequently used tools of financial ratio analysis is profitability ratios which are used to determine the company's bottom line and its return to its investors. Profitability measures are important to company managers and owners alike. If a small business has outside investors who have put their own money into the company, the primary owner certainly has to show profitability to those equity investors.

## REFERENCES:

1. Eskandari J (2007) Accounting principles. Tehran Sazeman Publ.

2. Amir Hossein Jamali , and Asghar Asadi "Management efficiency and profitability in Indian automobile industry: from theory to practice" Indian Journal of Science and Technology Vol. 5 No. 5 (May 2012) ISSN: 0974- 6846

3. Eljelly A 2004 Liquidity-profitability tradeoff: an empirical investigation in an emerging market. Int. J. Commerce & Manage. 14, 48-61.

4. Lazaridis I and Tryfonidis D (2006) The Relationship between working capital management and profitability of listed companies in the Athens stock exchange. J. Financial Manage. & Analysis. 19, 26-25.

5. http://bizfinance.about.com/od/financialratios/f/Gross_Profit_Margin.htm

6. http://www.readyratios.com/reference/asset/