Profit figures in income statements don't tell the whole story

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By Jian Ming and Ng Eng Juan

AS MOST investors are aware, the profit figure reported in a company's income statement is very subjective. It depends on how revenue, expenses, gains and losses are measured and recognised. Despite the subjectivity and controversy, we do have accounting standards that govern how these income statement items are measured and recognised, and we also have experts (for examples, accountants, auditors and valuers) to ensure that these items are properly accounted for in accordance with the requirements of the accounting standards. There is, however, one very major cost item that is not covered by extant accounting standards and therefore has not been accounted for in determining the profit figure.

The item is "cost of equity financing". As a consequence, the reported profit figure may not be a good reflection of the wealth created by companies. To illustrate, assume the following case:

Mr ABC has $100, and he has two investment alternatives:

- To deposit the money with a bank and receive an interest income of $3 per year, or
- To hand his money to his manager to run a company business.

Assume that Mr ABC decides to hand the money to his manager, and assume that the manager makes $2 profit for the company. It is quite obvious, in this case, that the manager is a bad manager because he is not creating wealth for the company shareholder. Mr ABC should have instead deposited the money with the bank and earned $3.

However, because the cost of equity financing is not accounted for under the extant accounting standards, the manager's income statement will show a profit of $2, which may mislead the shareholder Mr ABC into believing that the manager is a good manager, creating wealth for him.

In this case, it may be noted that if the cost of equity financing of $3 is charged against the company income statement, the income statement will show a loss of $1, which will arguably give a more accurate measure of the manager's performance.

Based on this "profit after cost of equity financing" figure, Mr ABC will then be able to make a more informed decision on his investment alternatives.

So, do "profitable" companies always create wealth for their shareholders? Could there be companies that report profits, but are not actually creating wealth for the shareholders, like in the case above?

As discussed above, companies' reported "profit" figures are arrived at before taking into account the cost of equity financing, and therefore are not good measures of wealth creation for shareholders. To measure wealth creation, the cost of equity financing should be deducted from the reported profit figures.

To determine whether a company creates wealth for its shareholders, one strategy is therefore to compute the cost of equity financing of the company and deduct it from the reported profit to arrive at "profit after cost of equity financing" (a concept similar to "economic value-added"). A company that has positive "profit after cost of equity financing" does create wealth for its shareholders, and a company that has negative figure, does not.

AN EMPIRICAL TEST

For the purpose of our empirical test, we identified the Straits Times Index (STI) constituents and examined their financial statements for the financial year ended in 2019 (to avoid the impact of Covid-19). We first estimated each STI company's cost of equity financing (per cent) using the widely-used Capital Asset Pricing Model (CAPM) model. Next, we calculated the cost of equity financing ($) by multiplying the cost of equity financing by the sum of share capital and retained earnings (the other reserves were excluded to mitigate the impact of inconsistency in some accounting policies, for example, cost vs revaluation for fixed assets).

Thereafter, we deduct the cost of equity financing from the reported profit figure to arrive at the "profit after cost of equity financing" figure for each STI company.

The results of our empirical test can be summarised below:

- All STI companies reported profit in their 2019 financial year-end income statements;
- More than a third (37 per cent) of the STI companies actually had negative "profit after cost of equity financing", indicating that they were not creating wealth for their shareholders; and
- Of the companies that showed positive "profit after cost of equity financing", this profit was, on average, 57.8 per cent lower than the reported profit figure.

This study shows that many STI companies reported profits, but did not actually create wealth for the shareholders. Of those firms that created wealth for shareholders, the amounts of wealth created were significantly lower than the reported profit figures.

One implication of our study is that companies may consider using the "profit after cost of equity financing" figures, rather than the reported profit figures, in some policy matters, for example, as an input in determining executive remuneration.

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