

CHAPTER FIVE

PROFITABILITY PERFORMANCE

5.1 Introduction

Firms or companies are formed to achieve some specific objectives. For owners of an enterprise, one of their objectives is to make profits. There has been disagreement about this but generally owners, over the long run, expect to receive a return on their investment of sufficient magnitude to induce them to remain in business. In other words, in the long run some minimum amount of profits is a condition of survival. Companies that cannot generate minimum profits may eventually wither or be forced to close down. On the other hand, managers may just want to achieve minimum profits to satisfy shareholders for they may be concerned with other objectives such as growth of the company or getting major market shares. Managers may also pursue activities which could enhance their own well being. When this so called principal agent problem arises, that is when managers pursue their personal goals that benefit themselves at the expense of the company, it may affect the profit level of the company. As for the owners and shareholders they may take realised profits as the yardstick for measuring past performances of their companies. One may argue if profit is an appropriate measure of a firm's efficiency in an economically relevant sense. McGee (1974) argues that well-measured profits are part of an appropriate measure of efficiency.¹ He

Refer to McGee (1974), "Efficiency and Economies Of Scale." Industrial Concentration:

argues that if a firm's unit cost under its present structure is significantly lower than when it was under a previous structure and it is able to generate profit under the present structure which is the same as in the previous structure, this profit precisely measures the superior efficiency of the present firm. This is because it simultaneously measures both the value of resources saved and the increased income of shareholders.

5.2 Definition Of Profit

Profit is typically defined as the difference between total revenue and total cost. To the accountant, "profit" usually means total revenue minus actual historical cost or actual expenditures for resource inputs: accounting profit is an ex-post concept based upon past transactions and historical fact (Thompson and Formby, 1993). However, accounting measures of profit may be inaccurate because they are based upon past events with known monetary values. Indeed, several acceptable accounting alternatives exist for determining the appropriate revenues and costs that are attributable to a given time period. There are a number of alternative techniques for calculating depreciation, valuing inventories and deciding when to adjust the costs of fixed assets for price level changes. Shepherd (1979) acknowledges that different methods of setting depreciation can sharply raise or lower profit levels. MCM uses the technique of adjusting its profit level by adjusting the percentage of depreciation. The advantage of this is that it can avoid heavy

tax on profits and hence increase net profit. Economic profit is any return over and above a normal profit. It does not merely refer to monetary expenses incurred by the firm but its calculations take into consideration the foregone profit. A normal profit is the minimum return on owner's investment to keep the enterprise in business. For the purpose of this analysis, gross operating profit is defined as the total revenue of company less its total operating costs and will be based on the accounting definitions of profit.

5.3 Profitability Performance

The profit performance of MCM for a fourteen year period is shown in Table 5.1. The figure shows the company's pre-tax profit from 1981 to 1994. Although the company gained in profit in 1981 and 1983, it incurred losses for five years when it was a public company. Between 1984 and 1987 MCM suffered losses due to the high total costs, low prices of copper and gold, and low sales revenue. The company's profit performance, however, improved in 1988 and the trend continued until 1991. The substantial improvement in MCM's profit levels during these four consecutive years explain the reasons for persistent profit performance.

The profit rates may have been heavily affected by various factors including changes in copper, gold and silver prices, higher total productivity (Table 4.4), impressive reduction in total cost (Table 3.2), and higher sales revenue. In the case of MCM, the effectiveness of marketing efforts in

generating profit is insignificant because all the products are sold to a single buyer.

Table 5.1

Mamut Copper Mining, pre-tax profit 1981-1994

Year	Profit (Million RM)
1981	11.8
1982	-13.5
1983	6.9
1984	-0.4
1985	-17.5
1986	-17.9
1987	-16.7
1988	54.8
1989	40.0
1990	28.2
1991	35.0
1992	12.9
1993	5.1
1994	8.5

Source: MCM, Annual Reports, 1981-1994

After two consecutively profitable years in 1980 and 1981, the company lost 13.5 million ringgit in 1982. According to the Chairman's report, the loss was mainly attributed to a drastic fall in metal prices.² The loss was also due to the additional cost incurred in conducting feasibility studies for the setting up of a copper smelting plant in Sabah.³ Despite the unfavourable copper prices, the company gained a profit of RM6.9 million in 1983. During this year, there was an increase in gold prices from US\$398.7 per ounce to US\$ 411.2. The high gold prices contributed to a further increase in sales revenue of about RM70 million. Table 5.2 shows the prices of copper, gold and silver. Between 1984 to 1987, the losses incurred were due to the declining price of copper, high inflation and the weakening of the US currency following the oil crisis of 1982 and 1983. The increase in oil prices adversely affected mine operating costs and pushed up the unit cost of materials. The prices of copper and gold increased in 1988 and this trend continued until 1991. Although the price of gold slightly decreased in 1990 and 1991, copper prices remained above US\$1.00 per pound. Due to the improvements in the prices of copper and gold, the company made profits between 1988 and 1992. The profit levels were lower in 1993 due to the depressed copper prices which averaged at US\$0.91 per pound compared to US\$1.04 in 1992. Consequently, MCM recorded a lower pre-tax profit of RM5.1 million

² Metal here refers to copper, gold and silver

³ RM10 million was spent in 1981 and 1982 for the feasibility studies, see MCM Chairman Report, 1982, unpublished

compared to RM12.9 in 1992. The price of copper increased to US1.01 per pound in 1994 and subsequently the profit increased to RM8.5 million. This indicates that prices of metal influence the profit level of MCM. Table 5.2 shows the average prices of copper, gold and silver from 1981 to 1994.

Table 5.2

The Average Prices Of All Three Metals From 1981-1994

Year	Copper (USD cts per lb)	Gold (USD per oz)	Silver (USD per oz)
1981	0.90	585	15.9
1982	0.76	420	9.3
1983	0.68	411.2	9.6
1984	0.68	396.5	10.2
1985	0.62	333.7	7.0
1986	0.64	331.7	5.9
1987	0.62	402.8	5.8
1988	0.99	460.8	7.1
1989	1.33	412	6.2
1990	1.18	386	5.3
1991	1.01	385	5.1
1992	1.04	386	5.2
1993	0.91	345	4.8
1994	1.02	381	4.9

Source: MCM, Annual Reports, 1981-1994

From our analysis the improvement of productivity contributed to the impressive profit performance.⁴ Between 1981 and 1987, total productivity was below 0.77. The low productivity during this period could be one of the factors that contributed to the unfavourable profit performance of the company. The total productivity has steadily improved between 1987 and 1991 compared to 1986. Since productivity is positively related to profitability, the increase in productivity could have caused the improvement in the profit level of MCM between 1988 and 1992.⁵

Although the company generated profit in 1981 and 1983, it operated at a loss for most of the year between 1982 to 1987 during which the company was a public company. One of the reasons for the loss could be the extremely high total costs incurred by the company. The company's profit performance improved after 1987 due to lower total costs. However, the increase in total cost in 1990 reduced the profit level from RM40 million in 1989 to RM28 million in 1990. The total cost decreased by 10 per cent in 1991 over the previous year which in turn resulted in the increase of profit by 23.6 per cent. This seems to indicate that a decrease in total cost which is partly due to better scale economies⁶ may have contributed to the improvement in the profit level of the company.

⁴ For the productivity performance, refer to Table 4.5 in chapter four

⁵ Sink and Swain (1983) says that an organisation can generate profit growth from productivity improvement and/or from price recovery. Rastogi and Mohanty (1988) in their studies found that productivity is positively related to profitability.

⁶ Profitability may also stem from scale economies (Shepherd 1979).

About 70 per cent of the sales revenue of MCM is derived from the sale of copper concentrates, 28 per cent from the sale of gold and 2 per cent from the sale of silver. Sales revenue performance for the eleven year period is shown in Table 5.3. It shows a decreasing trend in the early 1980s which began to increase in 1988; reflecting a favourable sales revenue performance on the part of the company.

Sales revenue is one of the factors that determines the profit level of a company. MCM's high sales revenue in 1981 resulted in a higher profit level of RM11.8 million. In 1982, the company suffered losses of RM13.5 million as a result of the decline in sales revenue from RM187.4 million in 1981 to RM152.3 in 1982. The sales revenue increased in 1983 which resulted in a profit of RM6.9 million for the company. The loss incurred by MCM between 1984 and 1987 is attributed to the continuous decline in sales revenue from RM154.7 million in 1984 to RM133.4 million in 1987; the lowest within the eleven year period. In 1988, the sales revenue increased to RM207.3 million or by 55.4 per cent over the previous year. The increase in sales revenue subsequently pushed up the profit level to RM54.8 million; the highest ever achieved by the company. Although sales revenue declined between 1989 to 1993, due to the relatively low exports and copper prices, MCM continued to make profits. The increase in sales revenue in 1994 improved the profit level of MCM.

Table 5.3**Sales Revenue Performance From 1981-1994**

Year	Amount (Million RM)
1981	187.4
1982	152.3
1983	172.7
1984	154.7
1985	145.7
1986	140.4
1987	133.4
1988	207.3
1989	184.9
1990	185.4
1991	176.2
1992	127.5
1993	122.0
1994	135.6

Source: MCM , Annual Reports, 1981-1994

Exports is another factor that may exert a positive influence on sales revenue and hence profitability. If the price of copper and total cost remain constant, an increase in the quantity of export will result an increase in sales revenue and profit. Daniels and Bracker (1989) argue that exports benefit businesses at several levels, particularly by increasing their profitability. However, Liouville (1992) found that the degree of involvement in exports does not directly determine business profitability. As shown in Table 5.4, this analysis indicates that an increase in export for copper concentrates does not seem to lead to an increase in MCM's sales revenue and profit. For instance, the export of copper concentrates between 1989 and 1991 were lower as compared to the exports between 1981 and 1987. Despite the low exports between 1989 and 1991, MCM generated a high level of profits compared to losses incurred between 1981 and 1987. In 1992 and 1993, the profit level was lower compared to 1991 despite a high export of copper concentrates. This suggests that the quantity of exports of copper concentrates may not be a significant factor in influencing MCM's profit unless it is accompanied by an improvement in the prices of copper.

Table 5.4**Mamut Copper Mining , Export Of Concentrate, 1977-1994**

Year	Quantity (metric ton)
1977	98,979
1979	112,987
1980	107,690
1981	118,682
1982	120,130
1983	130,259
1984	120,573
1985	132,057
1986	126,350
1987	108,481
1988	118,453
1989	90,641
1990	99,961
1991	96,893
1992	97,511
1993	99,206
1994	99,215

Source: MCM , Annual Reports, 1977-1994

In summary, MCM's profitability performance is linked to factors such as changes in metal prices, productivity and sales revenue and not acquired merely from reduction in average total unit production costs.