Commonwealth Bank of Australia

By Name

Course

Instructor

Institution

Date

Executive Summary

Founded in 1911, the Commonwealth Bank of Australia provides a variety of services including investment, insurance, funds management, broking services and superannuation among others. The four major banks in the Australian industry control a large market share though there are many smaller players. A financial statement analysis of the bank revealed that its financial performance for the financial year ended 30th June 2018 was poor as compared to the financial year ended 30th June 2017. The poor performance was attributed to the significant challenges faced by the bank including money-laundering scandals resulting in lawsuits, efforts by the regulator to increase competition in the industry, increased scrutiny by the regulator and other agencies and other allegations of rigging rates and customer mistreatment. The company's CEO admitted the presence of significant challenges in his message to the shareholders.

Table of Contents

Commonwealth Bank of Australia

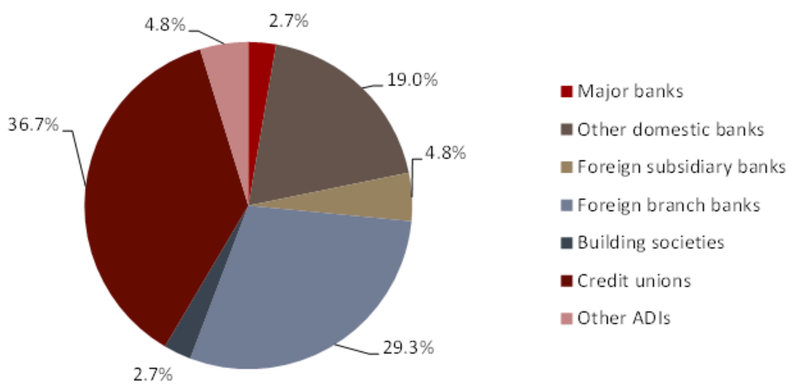
Introduction

The Commonwealth Bank of Australia (CBA) was established in the year 1911 under the Commonwealth Bank Act 1911 and later began operations in 1912. With its headquarters in Australia, CBA run operations in other regions such as the United States, Asia, United Kingdom and New Zealand. The bank provides a variety of financial services including investment, insurance, funds management, broking services and superannuation among others (CBA n.d). The bank was registered on the Australian Securities Exchange in 1991, and by the year 2015, the CBA was the largest listed company on the exchange. Over the years, the bank has grown to a major public listed company not only in Australia but also in other regions. Today, the company has more than 52, 000 employees and in excess of 800,000 shareholders and offer a variety of financial services to the people of Australia. The company serves its more than 16.6 million customers via 4,000 ATMs and 1,350 branch offices in Australia, Japan, New Zealand, Hong Kong, Singapore, Vietnam. This paper will present the financial analysis of CBA by looking at the industry background, financial ratios of the bank as well as other key financial issues that are of particular importance to the organisation.

Industry Background

The financial industry in Australia is very competitive. The banking sector is, however, the largest in this industry. As of September 2017, the sector had 147 authorised deposit-taking institutions (ADIs) which all held more than 55% of the Australian assets and financial institutions (APRA 2017). The main type of ADIs operating in Australia includes banks, credit unions, building societies and others as shown in figure 1. The ADIs are regulated by the Australian Prudential Regulation Authority (APRA). By September 2017, the major banks in Australia made up only 2.7% of all ADIs in Australia but held more than three-quarters of the ADIs total assets in Australia. The major competing banks in this sector include ANZ Banking Group Limited, Bank of Queensland Limited, Bendigo and Adelaide Bank Limited, Commonwealth Bank of Australia, Macquarie Group Limited, National Australia Bank Limited and Westpac Banking Corporation (Banking Royal Commission 2018, p. 9).

Figure 1**: Types of ADIs by number of entities**



Source: Banking Royal Commission (2018, p. 4).

In the year 2014, there were concerns in the sector with the view that the biggest four banks were working as an oligopoly thus undermining competition. Historically, many banks, building societies and credit unions were in operation in Australia. However, most of these have either merged or acquired by the large financial institutions. In the year 2013, the National government launched an inquiry into the industry competition. An inquiry report released on August 2018, by the Federal Government revealed that the financial system in Australia is conquered by four big players. While four main banks dominate the banking sector, four large insurance companies dominate the insurance sector, and some of the same companies feature predominantly in the wealth and funds management sector. Though there are many smaller institutions, the four major banks have a market share of 75% in the housing loans, business, insurance, issuance of credit cards and personal deposits (Productivity Commission 2018, p. 4).

The four largest banks have a larger geographical presence accounting for more than 60% of the branch offices, and this has contributed greatly to their brand appreciation and the consumer acuity that they are stable and safe organisations as matched to smaller competitors. Again, the regulatory arrangements can at times establish market power for players with the resources and expertise to cope with regulations. A good example of this regulatory instance is the cost of regulatory capital. The major banks use their own risk management models approved by APRA, and this lowers their funding costs when matched to other ADIs, which result to using the risk model developed by APRA (Productivity Commission 2018, p. 6). Again, due to their size, the large banks are allowed by the APRA to hold additional capital, and though this is costly, rating agencies view this as an unplanned acknowledgment by the APRA of the banks status.

Market power can also be created by operational efficiency and funding advantage. The most costly expense for financial institutions is the cost of sourcing funds. However, banks cannot compete in the lending market without funds to lend. With better credit ratings, the large banks are able to secure funds from depositors and investors and the smaller ADIs though competing with large ADIs have to borrow from the large ADIs. This introduces a gap between the operational costs of the major banks and the smaller companies. Integration is yet another source of market power in the industry (Productivity Commission 2018, p. 6). The major banks are highly integrated which allows them to control pricing, entry and exit into specific markets. Cross-product addition, for example, offers the large banks the opportunity to cross-subsidise prices and offer consumers bundled services, which in turn bid consumers to the banks.

Financial Ratio Analysis

The ratios have been calculated based on the figures from the audited financial accounts of the CBA for the financial year ended 30th June 2018. For easier comparison of the ratios, the previous year ratios will also be calculated. Again, the bank's figures will be used as opposed to the group figures since the report is concerned about the financial performance of CBA in Australia. All figures are in $m.

Ratio	Formula	2018	2017
Net Profit margin	$\frac{\text{Aftertax profit}}{\text{Revenue}}$	$\frac{9{,}010}{23{,}776} = 0.38$	$\frac{8{,}979}{22{,}725} = 0.40$
ROE	$\frac{\text{Net Income after tax}}{\text{Average Shareholders Equity}}$	$\frac{9{,}010}{36{,}397.5} = 0.25$	$\frac{8{,}979}{34{,}693.5} = 0.26$
ROA	$\frac{\text{EBIT}}{\text{Total Assets}}$	$\frac{13{,}166}{970{,}552} = 0.01$	$\frac{13{,}165}{958{,}796} = 0.01$
ROCE	$\frac{EBIT}{Capital\ Employed}$	$\frac{13{,}166}{86{,}169} = 0.15$	$\frac{13{,}165}{78{,}033} = 0.17$
Asset Turnover Ratio	$\frac{\text{Revenue}}{\text{Average Total Assets}}$	$\frac{23{,}776}{970{,}552} = 0.02$	$\frac{22{,}725}{958{,}796} = 0.02$
Current Ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$	$\frac{970{,}552}{884{,}383} = 1.10$	$\frac{958{,}796}{880{,}763} = 1.09$
Quick Ratio	$\frac{\text{Current Assets} - \text{Inventories}}{\text{Current Liabilities}}$	$\frac{970{,}552}{884{,}383} = 1.10$	$\frac{958{,}796}{880{,}763} = 1.09$
Debt Ratio	$\frac{\text{Total Liabilities}}{\text{Total Assets}}$	$\frac{906{,}632}{970{,}552} = 0.93$	$\frac{898{,}722}{958{,}796,} = 0.94$
Equity Ratio	$\frac{\text{shareholders funds}}{\text{Total assets}}$	$\frac{63{,}920}{970{,}552} = 0.07$	$\frac{60{,}074}{958{,}796} = 0.06$
Debt To Equity Ratio	$\frac{\text{Total Liabilities}}{\text{Equity}}$	$\frac{906{,}632}{63{,}920} = 14.18$	$\frac{898{,}722}{60{,}074} = 14.96$

EPS	$\frac{\text{Net profit}}{\text{Number of ordinary shares}}$	**517.7** cents	**558.8** cents

Source: CBA, 2018

Profitability and Efficiency

The profitability and efficiency ratios measure the profitability of an organisation. The profitability ratios quantify the ability of an organisation to generate profits within a specific context such as time. They compare the ability of a company to generate profits relative to different periods (Birt et al. 2014, p. 358). The efficiency ratios, on the other hand, measure how efficient a company utilise resources available to make profits. They measure how well a company uses the assets and liabilities to generate income.

Net profit margin

The net profit margin illustrates the portion of each sales dollar left after costs are paid. The net profit margin for CBA was 0.38 and 0.40 for 2018 and 2017 respectively. This indicates that for every dollar in sales, 62% and 60% went to expenses for 2018 and 2017 respectively. The ability of the bank to generate profits was low in 2018 as compared to 2017 in that more of the revenue collected from income generating activities went to paying expense in 2018 as compared to 2017.

Return on equity (ROE)

Return on equity discloses the profit a company makes as compared to the shareholder capital employed in a specific period. It shows how profitable a company is to the shareholders or the investors in that the shareholders are the owners of the company (Birt et al. 2014, p. 360). The higher the ratio, the higher the efficiency of operation of the company. For CBA, ROE was 0.25 and 0.26 for 2018 and 2017 respectively. CBA operations were inefficient in 2018 as compared to 2017.

Return on assets (ROA)

Return on assets ratio demonstrates the percentage of profits made by an organisation in relation to its total resources. It displays the profit made by a company on every dollar worth of asset. It indicates the capital intensity of the company, which depends much on the industry. The ROA for the Commonwealth Bank of Australia was found to be 0.01 for both 2018 and 2017. This indicates that though the company increased its assets over the year, the profitability of every dollar of assets remained the same.

Asset turnover

The asset turnover ratio indicates the value of revenue generated in relation to the value of assets. It is a measure of the efficiency with which the company deploys assets in revenue generation. For the bank, the asset turnover ratio was 0.02 for both 2018 and 2017. This indicates that the course of the year, the bank did not increase its efficiency in deploying assets to generate revenue.

EPS

Earnings per share is the portion of the organisational profit that is owed to the common stock. It is a gauge of a company's profitability. The diluted earnings per share for CBA were 517.7 cents and 558.8 cents in 2018 and 2017 respectively.

Liquidity, Capital Structure, Market Performance Ratios

Quick ratio

The quick ratio is a degree of the Bank's ability to meet its immediate commitments by using its quick assets. The liquid assets are the current assets, which can be easily converted to cash when a need arises but not including inventories (Birt et al. 2014, p.362). The quick ratio indicates the financial strength of a company or its financial weakness and informs creditors about how much of the immediate debts can be covered by disposing the liquid assets. The quick ratio for the Commonwealth Bank of Australia was 1.10 and 1.09 for 2018 and 2017 respectively. This indicates that that bank can fully repay all its current liabilities by liquidating the current assets. The liquidity is much better for the year 2018 as compared to the year 2017 although the difference is small.

Current ratio

The current ratio shows the capacity of a company to meet its immediate responsibilities. It is more so the same as a quick ratio but considers inventories as current assets. The higher the ratio the higher the liquidity of the company. Being a service company, the Commonwealth Bank of Australia does not have inventories, and thus its current ratio is similar to its quick ratio.

Debt ratio

The debt ratio specifies the share of a company's debt that goes to total assets. It assesses the rate at which a company depends on debts to finance its assets. The higher the ratio, the higher the risk in that the company is depending on debts to finance operations (Birt et al. 2014, p. 359). For Commonwealth Bank of Australia, the debt ratio for 2018 is 0.93 meaning that 93% of the assets in the bank have been financed through debts. This indicates a high risk in that the bank can only borrow in future at a higher risk indicating radical financing. However, the rate was 94% in 2017 indicating the company has made some progress.

Equity ratio

The equity ratio indicates the proportion of equity applied to the financing of company assets. Company assets can be bought using loans or equity. The ratio indicates the proportion the shareholders would receive of the company was to liquidate. It shows the percentage of assets the shareholders can claim. The bank's equity ratio is 7% and 6% for 2018 and 2017. This indicates that by 30th June 2018, 7% of the bank's assets were financed by shareholders equity. The percentage is low for the year 2017 indicating an improvement in the capital structure of the bank.

Debt to equity ratio

Debt to equity ratio specifies the part of a company's equity and debt that has been used to finance assets. It is used to judge a company's financial standing and its ability to meet its obligations. An increase in that ratio indicates that the company is being financed by creditors, which may be dangerous. For CBA, the equity to debt ratio reduced from 14.96 in 2017 to 14.18 in 2018 indicating that the bank is reduced debt financing.

From the financial ratio analysis, it is clear that the profitability of the bank has reduced over the year. The net profit margin has reduced from the previous year, and the return on equity indicates inefficiency in operations. The asset turnover ratio also indicates a decrease in the efficiency at which the bank deployed assets to generate revenue. All the profitability and efficiency ratios indicate a decrease in the financial performance of the company when compared to the previous year. However, the liquidity, capital structure and market performance of the company look good. The quick ratio indicates that the bank can fully repay its current liabilities by liquidating current assets thus meeting its current obligations. However, the debt ratio indicates that by end year, 93% of the assets were financed by dent meaning only 7% of the assets were financed by shareholders equity. However, the company made some progress given that the debt ratio was 94% in 2017. The debt to equity ratio is also very high at 14.18, but the bank is making progress having reduced it from 14.96 in 2017. Overall, the company was inefficient in utilising the assets to generate profits. All the profit ratio ratios indicate inefficiencies.

Key Issues Affecting the Organisation

A major issue that is critical to the financial viability is the slowing down of the housing market in Australia. The housing market transactions have dropped by 5%, and as estimated by Deloitte, the trend is expected to continue. With prices in the housing market declining, there is a slowdown in mortgage growth, which is a major source of earnings for the banks in Australia (Jacobs 2018). Investors who are the shareholders want an increase in ROE and not a decrease. When shareholders loose trust in the financial performance of a company, they look to dispose of their shares, and thus the supply of shares increase while demand decreases leading to a drop in price. A drop in share price affects the credibility of the company.

Another major external issue affecting the bank is the efforts by the regulator to address community concerns, which affect the returns. There have been concerns that the four biggest banks in Australia have market power derived from aspects such as operational efficiency, larger geographic presence and regulatory arrangement among others as discussed in the industry background section of the paper. The federal government formed a Productivity Commission to establish the competition in the industry, which recommended that the four major banks have a market advantage. Several measures have been implemented to increase competition in the market such as the housing market measures (Reserve Bank of Australia 2018, p. 5). This increased the competition in the industry, which has negatively affected the large banks including the Commonwealth Bank of Australia.

Another major issue facing the bank is increased scrutiny. In the 2018 annual report, the CEO of the bank reported that the bank had faced significant challenges in the course of the year. The CEO acknowledges that this happened because the bank let the customers down, compliance capabilities, operational risks were not good, and the bank fixed mistakes slowly (CBA 2018, p. 7). The effect of these challenges is evident from the decreased profitability capacity of the company. One of the significant challenges the CEO is referring to is the money laundering scandal. In 2015, the NSW police arrested two people for suspected money laundering. The individuals pleaded guilty in court and were sentenced. However, in that the individuals were using the CBA bank to launder the money, the bank was not left behind. In August 2017, the bank was accused of failing to report suspicious matters either at all or on time for transactions involving $77 million. The bank took too long to report suspicious activities with a good example being the case of one of the arrested individuals whose account triggered an alert on 27th October 2014 (Eyers 2017). However, the bank took two months before reporting this issue to the Anti-Money Laundering Team. Such scandals affected the consumer trust with the bank, which ultimately affects revenue and share prices.

The Australian securities regulator also sued the bank early this year over the allegations of rigging the “benchmark bank-bill swap rate”. The Australian Securities & Investments Commission argued that the bank engaged in market manipulation and unconscionable in 2012 (Chalmers 2018). The money-laundering allegation led to a class-action lawsuit and a probe by ASIC. Again, in this year, the ban also faced an inquiry into their mistreatment of customers. The company set aside A$575 million to cover potential fines, cover legal fees and compensate customer it mistreated (Cadman 2018). An increased cost of A$575 million with no returns significantly affected the financial performance of the bank. Though the gross income for 2018 was higher than in 217, the operating expenses were much higher in 2018 than 2017 resulting in a lower net profit for 2018 as compared to 2017.

Conclusion

The Commonwealth Bank of Australia (CBA) is among the top four banks functioning in the Australian banking sector. These four major banks hold 75% of the total assets held by authorised deposit-taking institutions (ADIs). This indicates that they have a market power from their size, the efficiency of operations and other advantages such as financial stability. However, the financial performance of CBA for the year ended 30th June 2018 was poor as compared to the year ended 30th June 2017. All the profitability and efficiency ratios indicate that 2017 was a better year for the bank than 2018. The liquidity and capital structure of the company were relatively stable for the year as compared to the previous year.

There are several factors attributed to the low financial performance of the company including money-laundering scandals resulting in lawsuits, efforts by the regulator to increase competition in the industry, increased scrutiny by the regulator and other agencies and other allegations of rigging rates and customer mistreatment. The company CEO admitted that the company had faced significant challenges over the year mainly due to the failure of the bank. The fact that the CEO admits that the challenges were significant is an indication that they had an effect on the financial performance and position of the company and the financial ratio analysis has proven that the company was inefficient over the past year.

References

APRA 2017, *Statistics: Quarterly ADI Performance (September 2017)*, in, www.apra.gov.au, viewed 9 October 2018, <http://www.apra.gov.au/adi/Publications/Documents/0512-QADIPS-Sep-2017.xlsx>.

Banking Royal Commission 2018, *Some Features of the Australian Banking Industry*, in , Financialservices.royalcommission.gov.au, viewed 9 October 2018, <https://financialservices.royalcommission.gov.au/publications/Documents/some-features-of-the-australian-banking-industry-background-paper-1.pdf>.

Birt, J, Chalmers, K, Maloney, S, Byrne, S, Brooks, A & Oliver, J 2014, *Accounting business reporting for decision marking*, 5th edn, Wiley, New York.

Cadman, E 2018, *Bloomberg - Are you a robot?*, in , Bloomberg.com, viewed 9 October 2018, <https://www.bloomberg.com/news/articles/2018-02-06/commonwealth-bank-s-first-half-profit-falls-on-scandal-costs>.

Chalmers, S 2018, *CBA involved in rigging key market interest rate, ASIC alleges*, in , ABC News, viewed 9 October 2018, <http://www.abc.net.au/news/2018-01-30/cba-allegedly-involved-in-rigging-key-market-interest-rate/9375832>.

Commonwealth Bank of Australia (CBA) 2018, *Annual report 2018*, pp. 5-147, viewed 9 October 2018, <http://www.republicast.com/cbaar2018/2018/cbaar2018v2/#d=1&p=1&m=1>.

Commonwealth Bank of Australia (CBA) n.d., *History - CommBank*, in , Commbank.com.au, viewed 9 October 2018, <https://www.commbank.com.au/about-us/our-company/history.html>.

Eyers, J 2017, Commonwealth Bank, safe haven for criminal activity, in , Financial Review, viewed 9 October 2018, <https://www.afr.com/business/banking-and-finance/financial-services/commonwealth-bank-safe-haven-for-criminal-activity-20170804-gxp54g>.

Jacobs, S 2018, *JP Morgan explains how falling property prices could affect Australian bank stocks*, in , Business Insider Australia, viewed 9 October 2018, <https://www.businessinsider.com.au/australian-house-prices-could-hit-bank-stocks-2018-2>.

Productivity Commission 2018, *Competition in the Australian Financial System*, Productivity Commission Inquiry Report Overview & Recommendations, pp. 4-15, viewed 9 October 2018, <https://www.pc.gov.au/inquiries/completed/financial-system/report>.

Reserve Bank of Australia 2018, *Competition in the Australian Financial System Supplementary Submission to the Productivity Commission Inquiry*, pp. 1-11, viewed 9 October 2018, <https://www.rba.gov.au/publications/submissions/financial-sector/competition-in-the-financial-system-2018-03/pdf/supplementary-submission-to-productivity-commission-march-2018.pdf>.