

COMPANY PROFITABILITY ANALYSIS USING RATES

CĂRUNTU GENU ALEXANDRU,
ASSOCIATE PH.D, “CONSTANTIN BRANCUȘI” UNIVERSITY OF TÂRGU JIU
e-mail:cgenuc@gmail.com

Abstract

Profitability is the ability of the company to make a profit, so necessary development, as well as remuneration of capital. Return occurs when the financial result (accounting profit) reflects a profit, ie revenues exceed expenditures. The profitability analysis should take into account the financial fundamental rule, that a company is profitable if shareholders' wealth will increase.

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Classification JEL: M40, M41

1. Introduction

Profitability can be analyzed mainly by rates of return (relative sizes), linking results size and volume of resources committed to these results. The aim of the management of a company, generally, is to identify funding sources readily available and inexpensive, so as to seek a weighted average cost of capital as low as possible, with a favorable impact on company value.

Any company that aims to develop and control a big party of the market must obtain annual profits sufficient so as to distribute dividends to shareholders and at the same time, can accumulate a part of net profits to increase equity. To assess the performance of an enterprise and its ability to continue to produce wealth and value, must use the tools increasingly precise which require orientation of the sources and origins that creates value.

2. Economic rate of return

Choosing an optimal structure of capital is a strategic decision, which must be harmonized with the overall strategy of the firm. Through its funding policy, the company must ensure, at any time, the appropriate volume of foreign equity in relation to its needs (resources available to companies in connection with financing sources, internal or external).

The decision for a particular capital structure of the company should take into account the risk series associated with indebtedness, risks that may offset or even cancel its positive effects (assets, liabilities and equity are the elements that measure the financial position of the company).

Economic rate of return measures the performance of the company's total assets, without regard to how to acquire the capital (own or borrowed) for setting up this asset. For this reason, it is said that the economic rate of return is independent of financing policy promoted by the company.

Economic rate of return shall have the following meanings:

- is the rate of return on capital company;
- highlights how to use financial resources;
- measures the performance of the total assets, reflecting its economic results.

Economic rate of return (R_{re}) is expressed as the ratio between gross profit realized by the company and the value of total assets used. Economic rate of return can be analyzed by comparing the dynamic indicator values or if competitors relationship calculation is as follows:

$$R_{re} = \frac{\text{Gross profit}}{\text{Total asset}} \times 100$$

This rate reflects the total available capital efficiency, in other words without taking into account the financing

structure (sources to share their own nature and borrowed or raised). Significance for internal users of information (management company) and less external ones.

Economic profitability is also determined as a ratio between current profit and permanent capital relationship calculation is as follows:

$$R_{re} = \frac{\text{Current profit}}{\text{Permanent capital}} \times 100$$

Economic Rate of Return importance as an indicator of financial analysis, knowledge resides in need thereof by senior management of the company and comparing it to the inflation rate [2].

Between the real rate of economic return (R_{rre}), inflation rate and the nominal rate of return on a relationship of interdependence, which can be represented as follows:

$$R_{rre} = \frac{\text{Nominal rate of return} - \text{Inflation rate}}{1 + \text{Inflation rate}} \times 100$$

The level of this rate are interested, primarily, current investors and potential (shareholders and banks), which compares the profitability of other investment (interest earnings, earnings from the investment capital to other businesses, etc.), and managers, for which a high level of this ratio means effective management of capital invested. In this respect, the economic rate of return they compare to the average cost of capital employed (R_{ci}), being able to meet the following conditions [1]:

a) when $R_e > R_{ci}$ means that the work performed gives a superior economic return cost of capital, recorded a positive economic added value that will enhance the company's market value;

b) when $R_e < R_{ci}$ means that the yield obtained can not meet the demand for capital providers, registering a negative economic value adău-gată and a reduction of equity.

3. Return on equity

Each category is risky and has different rights, when we consider the likelihood of receiving dividends in the future or the size to be received in the event of liquidation of the entity[3].

Unlike debt, equity is not a defined maturity. In this regard it should be noted that the entity is not required to pay dividends only in the moment of their declaration. On equity of an entity it exercise influence the revenue-generating activities, gains, expenses, losses, investments in favor of the owners and distributions to owners.

The return on equity ratio expresses the return on equity and enables the appreciation of capital investments of shareholders and opportunity to maintain them, determining the ratio of net profit earned by the firm and equity[2]:

$$R_f = \frac{\text{Net profit}}{\text{Equity}} \times 100$$

The return on equity ratio can be analyzed dynamically or by comparison with the indicator values for competitors (with the same activity domain). It expresses the efficiency with which resources were used by their own nature, the basis for determining rates of remuneration of capital contributed by the company's shareholders[5].

The return on equity is directly proportional to the financial structure (debt / equity) and the difference between economic return ratio (R_e) and rate of interest (R_d). Practical, the return on equity is as greater as the difference between economic return ratio and rate of interest is greater[2]:

$$R_f = \left[R_e + (R_e - R_d) \times \frac{D}{C_{pr}} \right] \times \left(1 - \frac{C_i}{100} \right)$$

In which:

R_d = rate of interest;

D = value of debts;

C_i = corporate income tax;

C_{pr} = equity.

This model is used in the foundation of indebtedness degree of the company and we can draw conclusions with a strong impact for shareholders, for the operative management and not least for creditors[1]. Given the mentioned there are the following conclusions:

- If $R_e > R_d$, then $R_f > R_{ec}$, debt has a beneficial effect („lever” effect), borrowed sources are used efficiently in the operating process, the return on equity increases;
- If $R_e < R_d$, then $f < R_{ec}$, debt has a negative effect because the borrowed might not generate effects that cover financial expenses in these circumstances, the return on equity decreases, which raises questions for investors (the effect of leverage is negative).

The difference between the cost of equity and cost of foreign capital is that the first are paid if the company achieved a net accounting benefit and the others must be paid whatever the situation (profits or losses). In this case, financial expenses include interest on loans that can diminish self-financing to the company's insolvency, which reflects the financial risk [4].

For shareholders the quality of management and financial health of the company is evidenced by sufficient size and growth rate of financial return[6].

For this return to growth and reflect a healthy financial management, it must be due to efficient work regarding: the operation and marketing of the company, effective use of assets of the company and not least financial policy which consider capitalizing leverage (higher rate of pay equity driven by increased leverage) [7].

To increase the financial return there are necessary measures to ensure accelerating the rotation of assets, return on sales growth, increasing profitability and economic growth on the basis of equity, capital structure optimization based on financial leverage of debt.

4. Conclusions

A responsible financial policy involves selecting means, techniques and financing instruments for deployment in optimal conditions and with limited risks of business activity. Essentially, financial policy consists in determining the weight they have and must have equity and borrowed resources company, taking into account their actual cost.

In the current conditions of market economy, more and more entities are concerned to determine and analyze the return on capital in relation to the cost of such capital.

The cost of equity is the rate of return required by the company's shareholders, to remunerate their investment patrimony. Significant investors in this regard are the size of future profit and net profit share distribution dividend for the year. Required rate of return to shareholders is an opportunity cost based on expected return of investors for investments with the same risk.

5. Bibliography

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