# THE ROLE OF PROFITABILITY RATES AND PROFIT MARGINS IN ASSESSING THE COMPANY'S FINANCIAL PERFORMANCE.

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***Abstract :***

*At company level, business performance analysis plays a pivotal role in establishing the economic and financial strategy and with the help of post-factum analysis based on certain variables, known also with a system of profitability indicators and a well-structured profit margin, with a high practical relevance, company management can make decisions whose results provide significant financial resources for the company's future development.*

*For the assessment of financial performance, we used a system of indicators of practical relevance and this study is based on profit and loss account data so that financial decisions from the perspective of shareholders and creditors are fully understood and well justified.*

*Regardless of the object of activity, a company to grow and survive must be cost-effective and create surplus value in order to be able to reward direct or indirect participants to the economic circuit. Profitability means comparing the capital invested by those who have available funds with the results obtained. If the results obtained in the economic process are in line with the expectations of the investors, then we can say that the company's current management has made the right financial decisions based on the accounting data and the financial indicators of performance appraisal.*

***Keywords:*** *return; profitability; efficiency; economic results;*

***Classification JEL: M40, M41***

## 1. Introduction

In order to assess the efficiency of the company's activity, an important analysis indicator is the rate of return, which is the comparison of the financial results obtained at all stages of the economic circuit with the financial effort of the internal and external investors.

If profitability implies the level of return on invested capital, profitability measures the performance of the economic process or, more precisely, the company's ability to generate profit. The need to diagnose profitability and profitability stems from the goal pursued by entrepreneurs in setting up the company and this goal is to increase the value of the company, increase the wealth of the property, and at the same time earn profit or gain more than invest in other areas of the economy.

Diagnosis of profitability involves identifying all necessary measures to increase the company's profitability, taking into account both the strategic objectives and the interests of the direct or indirect participants in the economic process (shareholders, creditors, employees, suppliers, customers, state, local community).

## 2. Diagnosis of profitability rates and profitability

The approach to profitability logically integrates into investigating the efficiency and effectiveness of an enterprise's business by privileging monetary performance evaluation [10]. The study of the evolution of the profit in absolute sizes is only a preliminary stage of the profitability analysis, for the relevance of the reasoning it is necessary to refer to other indicators, the resulting rates providing information with complex economic and financial significance [5]. Profitability can be expressed by two indicators: profit (as a volume indicator) and rate of return (an indicator of relative profitability) that expresses the extent to which capital or use of enterprise resources brings profit [3].

Profitability characterizes the ability of a lucrative activity to generate higher incomes than the expenses necessary to carry it out. [11].

**Table no. 1. Data extracted from the balance sheet at S.C. Elpromex Consult S.R.L.**

| *Nr. Crt.* | **INDICATORS** | *2012* | *2013* | *2014* | *2015* | *2016* | *2017* |
|---|---|---|---|---|---|---|---|
| 1. | Fixed assets | 196.367 | 208.198 | 1.604.149 | 851.350 | 852.241 | 651.982 |
| 2. | Current assets, of which: | 1.465.550 | 1.017.504 | 2.046.588 | 847.601 | 1.025.713 | 1.587.828 |
| 3. | - Stocks | 62.554 | 83.386 | 67.211 | 90.623 | 4.057 | 39.014 |
| 4. | - Claims | 1.263.602 | 690.003 | 1.890.373 | 519.426 | 904.093 | 1.016.053 |
| 5. | - House and bank accounts | 139.394 | 244.115 | 89.004 | 237.552 | 117.563 | 532.761 |
| 6. | Expenses in advance | 2.330 | 2.330 | 2.330 | 2.330 | 2.330 | 2.330 |
| 7. | Liability | 1.181.451 | 861.939 | 2.341.752 | 1.125.837 | 1.388.387 | 1.295.206 |
| 8. | Income in advance | - | | 1.008.750 | 268.043 | 71.976 | - |
| 9. | Provisions | 238.595 | 88.595 | - | - | 87.044 | 273.234 |
| 10. | Personal capital | 244.201 | 277.498 | 302.565 | 307.401 | 332.877 | 673.700 |

Source: http://www.mfinante.gov.ro/infocodfiscal.html

**Table no. 2. Data extracted from the profit and loss account at S.C. Elpromex Consult S.R.L.**

| Nr. crt. | **INDICATORS** | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|---|---|---|
| 1. | Net turnover | 3.216.565 | 1.926.219 | 1.688.753 | 1.334.469 | 1.547.404 | 3.848.865 |
| 2. | Total income | 3.247.560 | 1.936.307 | 1.842.389 | 2.128.375 | 1.771.907 | 4.048.696 |
| 3. | Total expenses | 3.148.496 | 1.891.685 | 1.810.099 | 2.122.234 | 1.721.004 | 3.301.073 |
| 4. | Gross profit | 99.064 | 44.622 | 32.290 | 6.141 | 50.903 | 747.623 |
| 5. | Net income | 82.514 | 33.296 | 25.068 | 4.836 | 41.688 | 647.822 |
| 6. | Number of employees | 9 | 9 | 12 | 15 | 16 | 16 |

Source: http://www.mfinante.gov.ro/infocodfiscal.html

## 3. **Diagnosing company profitability rates**

Profitability is the capacity of an invested or placed capital to secure revenue in financial terms that are higher than its cost, or the ability to generate profit [7]. Rates of return result from the reporting of a result indicator as a result of an effort indicator expressing either the overall activity flow or the means used to obtain the result (economic capital, equity, costs) [6].

The rate of economic return reflects the ratio between the economic result and the means employed to obtain it [9].

The economic profitability rate measures the performance of the company's total assets, regardless of how the equity (or borrowed) allocated to it was purchased, being independent of the company's funding policy [1]. The rate of return on equity, also called the rate of return on equity, makes it possible to assess the efficiency of share capital investments and gives shareholders the opportunity to reevaluate their options, either withdrawing from the business or maintaining the investment. In order for investors to maintain their investment, it is imperative that the remuneration of their own capital be high so that the profit obtained motivates them to leave the company at their disposal, thus ensuring the optimal performance of the economic circuit.

Financial profitability is an indicator through which capital owners appreciate the efficiency of their investments, ie the opportunity to maintain them, and in a given competition system, an enterprise must develop, invest, and this investment must be funded [4].

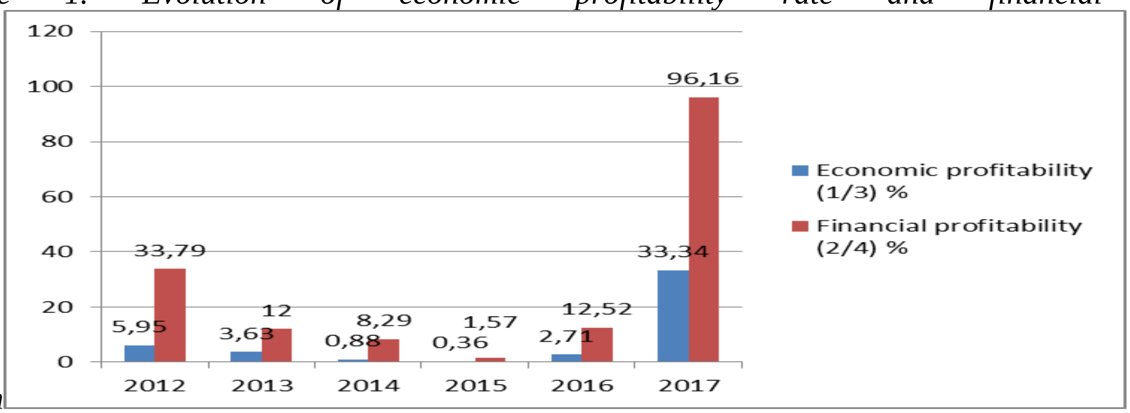
The leverage occurs when a company's capital structure contains fixed interest rate obligations [10]. Leverage is the ratio between debt and equity and represents the degree of indebtedness of the firm being very important in analyzing the company's profitability (financial structure).

**Table no. 3. Economic and financial profitability at the company under review**

| Nr. Crt. | **INDICATORS** | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|---|---|---|
| 1. | Gross profit | 99.064 | 44.622 | 32.290 | 6.141 | 50.903 | 747.623 |
| 2. | Net income | 82.514 | 33.296 | 25.068 | 4.836 | 41.688 | 647.822 |
| 3. | Total active | 1.664.247 | 1.228.032 | 3.653.067 | 1.701.281 | 1.880.284 | 2.242.140 |
| 4. | Personal capital | 244.201 | 277.498 | 302.565 | 307.401 | 332.877 | 673.700 |
| 5. | Economic profitability (1/3)% | 5,95 | 3,63 | 0,88 | 0,36 | 2,71 | 33,34 |
| 6. | Financial Profitability (2/4)% | 33,79 | 12,00 | 8,29 | 1,57 | 12,52 | 96,16 |

Source: *authoring, on the basis of the annual financial statements for 2012-2017*

*Figure 1. Evolution of economic profitability rate and financial rate of return*




Source: Author's processing, according to data available on http://www.mfinante.gov.ro/infocodfiscal.html

**Table no. 4. Financial leverage at the company under review**

| *Nr. Crt.* | **INDICATORS** | *2012* | *2013* | *2014* | *2015* | *2016* | *2017* |
|---|---|---|---|---|---|---|---|
| 1. | Liability | 1.181.451 | 861.939 | 2.341.752 | 1.125.837 | 1.388.387 | 1.295.206 |
| 2. | Personal capital | 244.201 | 277.498 | 302.565 | 307.401 | 332.877 | 673.700 |
| 3. | Leverage (1/2)% | 4,84 | 3,11 | 7,74 | 3,66 | 4,17 | 1,92 |

*Source: authoring, based on the annual financial statements for 2012-2017*

The research showed that the economic profitability during the period 2012-2017 had significant fluctuations, meaning that in the year 2015 it reached the minimum period, namely 0.36%, meaning that the means employed by the company in the economic circuit were not maximized as expected the economic result was reduced (6,141 lei) and the peak of the economic profitability was reached in 2017, ie 33,34%, when it maximized its performance and the company obtained a gross result in the amount of 747,623 lei. These fluctuations were influenced by the company's performance either due to the increase in asset rotation speeds or by the increase in the trade margin mainly of the increase or decrease in turnover.

The analysis of financial profitability highlights an efficient use of equity in 2017 (96.16%), due to increased business volumes, efficient inventory management, intensive use of property, and reduced working capital requirements.

If economic profitability is influenced by turnover, fixed capital and gross earnings, the variation in financial profitability takes into account the cost effectiveness, the company's financial structure and taxation.

The leverage must be subunit to have positive effects, and a supra-unitary value means a high degree of indebtedness. At the analyzed company, this indicator recorded a very high value of 7.74 in 2012, when the debt level reached the highest level of 2.341.752 lei. Since 2012, the leverage has declined each year to 202 at the lowest 1.92 level, due to the debt reduction and the rise in equity.

At the company under review, the level of financial return exceeds the level of economic profitability, and this means that debt has a beneficial effect on the company as the borrowed sources lead to increased return on equity.

## 4. Diagnosis of company profitability

The profit margin is the level of profitability obtained by the company from the production and marketing business, taking into account the income and expense fluctuation, because these margins mean the percentage of profit that the company remains after all expenses have been paid.

Sales revenue is one of the main components of profit margins, depending on their fluctuation, with the level of profitability increasing, falling or remaining constant [11].

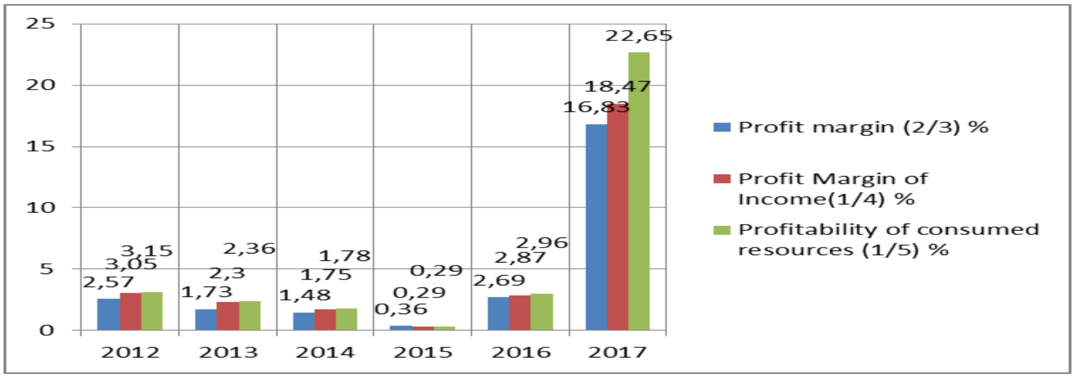
Profitability of consumed resources is an indicator that measures the company's profit surplus over the amount of resources used in the economic cycle. Through the profitability of consumed resources, the company's management has the ability to track costs and mainly to increase production costs. Indicators that measure profitability are known as profitability rates or accumulated margins [11].

**Table no. 5. Analysis of profit margin, profit margin of income and profitability of consumed resources**

| Nr. Crt. | **INDICATORS** | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|---|---|---|
| 1. | Gross profit | 99.064 | 44.622 | 32.290 | 6.141 | 50.903 | 747.623 |
| 2. | Net income | 82.514 | 33.296 | 25.068 | 4.836 | 41.688 | 647.822 |
| 3. | Net turnover | 3.216.565 | 1.926.219 | 1.688.753 | 1.334.469 | 1.547.404 | 3.848.865 |
| 4. | Total income | 3.247.560 | 1.936.307 | 1.842.389 | 2.128.375 | 1.771.907 | 4.048.696 |
| 5. | Total expenses | 3.148.496 | 1.891.685 | 1.810.099 | 2.122.234 | 1.721.004 | 3.301.073 |
| 6. | Profit Margin (2/3)% | 2,57 | 1,73 | 1,48 | 0,36 | 2,69 | 16,83 |
| 7. | Income Profit Margin (1/4)% | 3,05 | 2,30 | 1,75 | 0,29 | 2,87 | 18,47 |
| 8. | Profitability of consumed resources (1/5)% | 3,15 | 2,36 | 1,78 | 0,29 | 2,96 | 22,65 |

*Source: authoring, based on the annual financial statements for 2012-2017*

**Figure 2. Evolution of profit margin, profit margin of income and profitability of consumed resources**




Source: Author's processing, according to data available on http://www.mfinante.gov.ro/infocodfiscal.html

The profit margin is the percentage that the company remains after paying all the costs (wages, taxes, expenses) and must be between 5 and 15%. The company analyzed this margin in 2012 -2016 was below 5% (2012-2,57%, 2013 - 1,73%, 2014 - 1,48%, 2015 - 0,36%, 2016 - 2,69 %), and in 2017 the profit margin reached 16.83%. This increase in margin was the consequence of several factors including: cost optimization, effective, targeted and measured marketing strategies, employee specialization, and motivation by sales commissioning.

The sales profit margin peaked in 2017 by 18.47%, an increase of 543% over the previous year. This increase was mainly due to sales growth, which in 2017 amounted to 4,048,696 lei. Sales have grown thanks to the company's business strategies that remind you of: quality service, complete product range overview, stock always available, extended warranty period, free advice and information for customers.

Profitability of consumed resources reflects how the company manages the used cost resuscitation and it should be between 9 and 15%. In the period 2012-2016, this rate was reduced due to the fact that the resources used had high costs, this increase in costs was due to increased consumption, rising purchase prices, and thus unfavorable inflation. In 2017, this rate reached 22.65%, which means higher spending efficiency, with workable consequences on the company's profitability.

## 5. Conclusions

Profit is the primary objective for any company, as it is indispensable both for the distribution of dividends and the conduct of the economic process, ultimately increasing the market value of the company, increasing the shareholders' wealth. The size of the profits also contributes decisively to the shareholders' decisions either to continue investing or to withdraw from the business according to the remuneration of equity and the expected profit, as profitability is a prerequisite for the optimal operation of the company. In the analyzed company, the economic and financial situation is favorable to the pursuit of a cost-effective activity, the profitability rates are positive, which financially reflects the maximization of the shareholders' wealth, profit maximization, and the expected profitability level falls within the expectations of the shareholders because the risks accompanying the profitability are minimal.

In order to evaluate how to capitalize the invested capital, regardless of the source of the sources of financing and the appreciation of the company's performance, profitability and profitability rates are used because these analyzed in dynamics highlight the financial condition of the company and give investors the opportunity to choose where to place their capital available on the basis of the risks assumed.

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