

## ASPECTS CONCERNING FINANCIAL PROFITABLENESS ANALYSIS AND ITS PURPOSE IN SUBSTANTIATION OF FIRM'S STRATEGIC FINANCING DECISIONS

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### Abstract:

*Financial profitability, relevant indicator in enterprises performance appreciation and of its position on the market, depends on the commercial policy (commercial profitability), on the engaged capital's efficiency (economic profitability), on the policy and financial structure of enterprise (debt degree) offering information both to investors and managers, orienting the enterprise in financing strategic decisions*

The analysis of enterprise' performance by means of **profitableness rates** highlights the efficiency reports between a indicator of **results** (profit or loss) and an indicator that reflects an **activity flux**, (business number, consumed resources etc.) or a **stock** (own capital, total actives). The size of rates is influenced by accountancy policies and practices used by the enterprise that has different informational valences and reflects multiple sizes of economic-financial activity.

**The financial profitability rate (R<sub>f</sub>)** expresses the efficiency degree of using the own capitals. In the case where financial profitability rate is bigger than the borrowed cost capital, then a supplementary value will be created to "payment of the shareholders' capitals (by the distributed dividends) and firm's **self-financing** (by the result in the reserve)"<sup>1</sup>.

The information given by the firm's **yearly financial situations** allow determination of financial profitability rate. The relation calculation for this rate is the following<sup>2</sup>:

$$R_f = \frac{\text{Net profit}}{\text{Own capital}} \cdot 100$$

In Anglo-Saxon terminology, the financial profitability rate corresponds to the notion of **Return on Equity (ROE)** being calculated as below<sup>3</sup>:

$$ROE = \frac{\text{Net income}}{\text{Average owner's equity}}$$

Financial profitability reflects the final purpose of an enterprise's shareholders, expressed by remuneration rate of capital investment made by them in providing enterprise's stockings or in reinvesting total/partial profit that reverts<sup>4</sup>.

The financial profitability rate's analysis allows the establishing of determining factors and the identifying of some significant aspects for appreciating the enterprise's performance.

In specific literature<sup>5</sup> few patterns of factorial analysis are known for financial profitability rate:

$$1. R_f = \frac{\text{Net profit}}{\text{Total assets}} \cdot \frac{\text{Total assets}}{\text{Own capital}} \cdot 100$$

<sup>1</sup> S. Petrescu, *Analysis and financial-accountancy diagnostic. Theoretical-practical guide, Second revised edition, CECCAR's Publish house, Bucharest, 2008, p. 238.*

<sup>2</sup> Gheorghe Vâlceanu, Vasile Robu, Nicolae Georgescu, *Economic-financial analysis*, Economic Publish house, Bucharest 2004, p.283.

<sup>3</sup> Marshall D. H., McManus W., Viele D. F., „Accounting: what the numbers means”, Seventh Edition, Ed. McGraw-Hill/Irwin, 2007, p. 77.

<sup>4</sup> Spătaru, L., *Economic-financial enterprise's analysis –Instrument of enterprise's management*, Economic Publish house, Bucharest, p. 393.

<sup>5</sup> W. Păvăloaia, D. Păvăloaia, *Economic-financial analysis Concepts. Studies*, Moldavia Publish house, Bacău, 2003, p. 310-311.

$$\frac{\text{Net profit}}{\text{Total assets}} = \text{global capital enterprise's}$$

profitableness invested in fixe and circular assets.

$$\frac{\text{Total assets}}{\text{Own capital}} = \text{multiplication factor of own}$$

average capital or the arm of the financial lever that characterizes indirectly *the debt degree of enterprise* ( $g_i$ ).

Because Total assets = Own capital + Debts, the relation becomes:

$$\frac{\text{Total assets}}{\text{Own capital}} = \frac{\text{Own capital} + \text{Debts}}{\text{Own capital}} \Rightarrow$$

$$\frac{\text{Total assets}}{\text{Own capital}} = 1 + \frac{\text{Debts}}{\text{Own capital}}$$

The financial profitability rate depend on the permanent capitals structure, meaning on the proportion existent between the borrowed capital, respective debts and own capital.

The  $\frac{\text{Debts}}{\text{Own capital}}$  report is a quotient

named "financial lever" that influences the financial profitability rate and that expresses the *enterprise's debt degree*, report that generates the appearance of financial efficiency increase or the *financial lever effect*. The effect of lever's increase may be both in favor and unsafe, on this effect the *financial risk* being connected, the one flowing from *capital cost* that assures the financing.

According to this pattern, the increase of financial profitability rate can be realized through:

- increase of net profit to a leu assets and
- growth of debt degree if economical profitability is higher than interest rate.

A growth of multiplication factor can be appreciated as favorable, but it should be reminded that this indicator reflects the debt degree, and therefore is necessary the framing of the size of the multiplication factor under certain preordained optimal values.

## 2.Rf

$$= \frac{\text{Net profit}}{\text{Turnover}} \cdot \frac{\text{Turnover}}{\text{Total assets}} \cdot \frac{\text{Total assets}}{\text{Own capital}} \cdot 100$$

The financial profitability rate represents the product between the *commercial profitability rate* (profit's net average), *assets rotation* and *global debt rate*.

The increase of the financial profitability rate of own capital is the consequence of the invested capital efficiency increase, as a consequence of the increase of the assets' speed's rotation with direct implications on the volume of sells on invested monetary unit but also because of the profit increase to a leu business number that reflects the efficiency of exploitation activity.

According to this pattern the increase of financial profitability may be realized if the following conditions are satisfied:

a).  $I_{\text{Net profit}} > I_{\text{Turnover}}$  - the increase of gross profit in an superior rhythm to turnover, possible to be realized through:

- reduction of exploitation expenses;
- increase of physical volume of physical production and of the delivered one;
- manners of amortization calculation;
- fiscal state's policy.

b).  $I_{\text{Turnover}} > I_{\text{Total assets}}$  - the increase of turnover will outmatch the total assets growth aspect that means the increase of the enterprise's speed rotation assets.

c).  $Re > d$  economical profitability (Re) will outmatch the interest rate(d).

By its calculation pattern the financial profitability rate also highlights the following specific *conditions*:

✓ financial profitability is influenced by the modality of providing capitals, reason for which is sensitive as against financial structure, meaning the debt degree of the enterprise,

✓ the size of gross profit is influenced by tax evolution, elements undeductive from a fiscal point of view and of the fiscal deductions,

✓ the financial profitability rate should be higher than the average tax rate in order to make the enterprise's actions more attractive. Under this situation, for the

enterprise, is more advantageous to make appeal to medium and long term loaning for activity financing, this assuring in this way a supplementary profit. The use of the debt should be very carefully made in order not to limit the financial independence of the firm

and to reduce the supplementary debt possibilities in crisis periods.

The data necessary for analyzing the financial profitableness rate for S.C. ALFA S.A. are presented in table nr. 1:

Table nr. 1 Indicators concerning the financial profitableness rate's analysis for S.C. ALFA S.A.

Indicator's name	MU	31.12.2005	31.12.2006	31.12.2007
Net profit	lei	125.457	324.568	257.005
Own capital	lei	508.077	2.059.013	2.049.572
Financial profitableness rate ( <b>Rf</b> )	%	<b>24,69</b>	<b>15,76</b>	<b>12,54</b>
The variation of financial profitableness rate	%	0	-8,93	-3,22
<b>Growth index Rf</b>	%	<b>100</b>	<b>63,83</b>	<b>79,57</b>
Growth index net profit	%	100	258,71	79,18
Growth index own capital	%	100	405,26	99,54
Informative value	%	25%	25%	25%
Total assets	lei	837.352	2.746.266	3.007.678
Global profitableness of invested capitals (Net profit/Total assets)	%	14,98%	11,82%	8,54%
Debt degree (Total assets/Own capital)	-	1,65	1,33	1,47
Turnover	lei	224.748	234.798	197.000
Net profit average (Net profit/Turnover)	-	0,56	1,38	1,30
The assets' speed rotation (Turnover/Total assets)	-	0,27	0,09	0,07

The evolution of financial profitableness rate for S.C.ALFA S.A is presented in figure nr. 1.

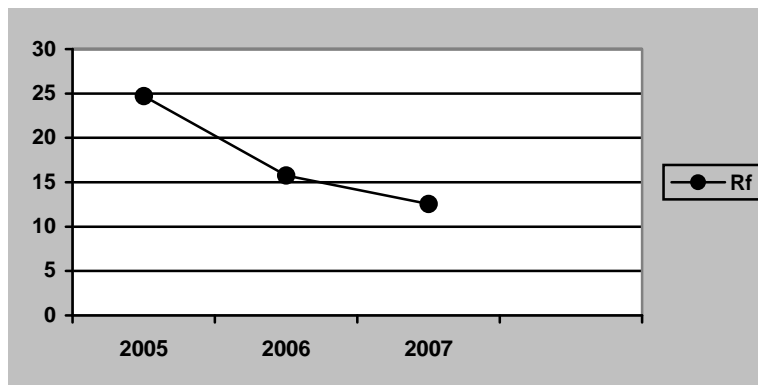


Figure 1 The evolution of financial profitableness rate for S.C.ALFA S.A

The financial profitableness rate for the analyzed period manifested a decreased tendency that is equivalent to a weak net wining remuneration of own resources, respective the decrease of the own capitals capacity of creating net profit.

During 2007 the rate's level was of 12,54% that means that for 100 lei own capitals revert 12,54 lei net profit. This level does not assure the reconstruction of own capitals only for net profits.

The rate's modification  $\Delta Rf = -3,22\%$  was determined by:

✓ decrease of global invested capitals profitability with 3,28% (from 11,82% to 8,54%) that had a negative effect on the indicator;

✓ the increase of firm's debt degree with 0,14 (from 1,33 to 1,47) with favorable effect upon financial profitability rate that did not succeed the compensation of unfavorable effect that the decrease of global invested capitals rate in fixe and circular assets. Under these circumstances, for society, it is more advantageous to appeal to loaning on medium and long term for activity financing, assuring therefore a supplementary profit. The use of debt should be carefully made in order not to limit the financial firm's

independence and to reduce the supplementary debt possibilities in crisis periods.

The financial profitability rate constitutes a relevant indicator in appreciating the enterprise's position on the market. An increased remuneration of capitals assures a facile access to financial resources due to the present shareholders' trust of reinvesting in enterprise and of potential investors – owners of financial resources available for investments as well as the development capacity.

### References:

- [1] Marshall, D. H., McManus, W., Viele, D. F., *Accounting: what the numbers means*, Seventh Edition, Ed. McGraw-Hill/Irwin, 2007.
- [2] Păvăloaia, W., Păvăloaia, D., *Economic-financial analysis Concepts. Studies*, Moldavia Publish house, Bacău, 2003.
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- [4] Petrescu, S., *Analysis and financial-accountancy diagnostic. Theoretical-practical guide, Second revised edition, CECCAR's Publish house*, Bucharest, 2008.
- [5] Spătaru, L., *Economic-financial enterprise's analysis –Instrument of enterprise's management*, Economic Publish house, Bucharest, 2004.
- [6] Vâlceanu, Gh., Robu, V., Georgescu, N., *Economic-financial analysis*, Economic Publish house, Bucharest, 2004.
- [7] \*\*\* Public Finances Minister's Command no. 1752/2005 for the approval of Accountancy Settlements according to European directives, published in Official Monitor, 1<sup>st</sup> Part, no. 1080 from 30/11/2005.