The Importance of Financial Profitability on the Activity of a Company

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Abstract

The financial rate of return is a financial analysis indicator with an important role in assessing the economic and financial performance of an enterprise. Thus, if the economic rate of return expresses the return on invested capital only from the point of view of the operating activity, the financial rate of return does nothing more than to quantify the return on capital. If we start from the consideration that the financial rate of return expresses the efficiency of the equity capital of an enterprise, we realize that it has a major importance for the shareholders of that enterprise because they can see the effect of the investments made in that enterprise, if these investments are profitable and if they will still be interested in participating in the development of the enterprise, even through new investments. The purpose of the paper is to highlight the importance of financial returns in various situations, as exemplified, and the impact on both the company and the shareholders.

Key words: financial profitability, profit, capital, total assets, income
J.E.L. classification: D24, G32, M41

1. Introduction

When assessing the performance of a company, it is essential to consider a number of indicators that can measure the financial and economic consequences of the investment, operating and financing decisions taken by managers. All these indicators must answer certain questions that shareholders may ask, namely whether resources are being used correctly, whether profits are in line with expectations, and whether financing options are being chosen correctly and, above all, prudently.

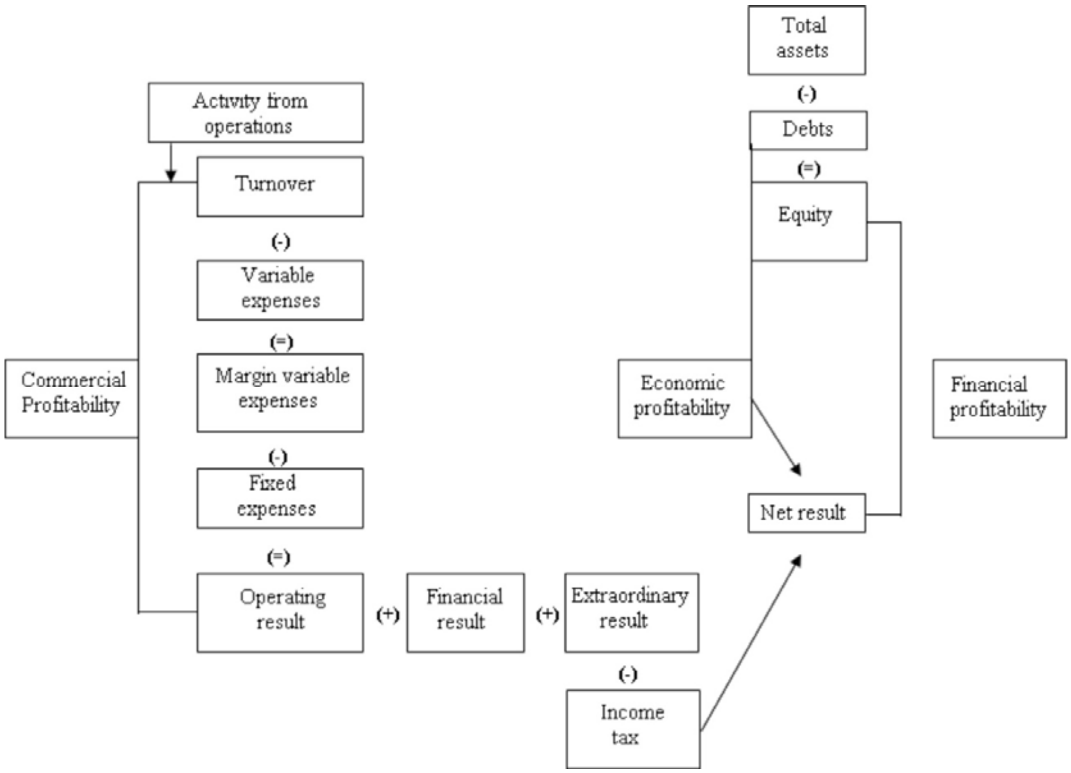
Different sets of indicators and standards may be used in internal assessments within the company, resulting in the disaggregation of decision components that may affect operational efficiency, total returns or expected outcomes for shareholders. These indicator systems function to highlight the connections and consequences of decisions on these aspects, rooted in financial profitability (Brasoveanu, 2013, 89).

The analysis of a company's financial position, with particular emphasis on the significance and impact of financial profitability on its performance, focuses on the interplay between assets, liabilities, and capital. Assets are those items of property, plant and equipment that are controlled by the company, result from past events, and are expected to generate future economic benefits in the form of cash flows. Liabilities are defined as present obligations based on past events, the settlement of which will lead to a decrease in future benefits as evidenced by lower cash flows. Capital, alternatively referred to as net assets or the capital invested by shareholders, represents the shareholders' remaining interest in the enterprise after deducting liabilities from total assets (Aivaz et al., 2023).

2. Theoretical background

The financial profitability rate considers the origin of capital, being sensitive to the financial structure of the enterprise and, to a large extent, influenced by the level of debt of the enterprise. Profit, an important source of funding for business operations, represents a portion of the company's capital and primarily compensates shareholders through dividends. An increase in this indicator reflects the efficiency of activities in terms of equity valuation. In determining the financial profitability rate of personal capital, the calculation method for depreciation and provisions, deductible and non-deductible expenses in determining the taxable profit base is considered (Munteanu & Mirea, 2023, 442). Economic and financial return rates are vital for users yet utilizing them comes with several challenges. The core issues arise from the form of the result or capital considered. The three types of profitability (financial, economic, and business) are linked in the following way:

Figure no. 1. The correlation of returns in the financial, commercial, and economic sectors.



Source: (Caruntu & Lapadusi, 2009, 101)

Calculating the financial profitability rate is crucial in evaluating a company, as it is one of the indicators of its 'health', information highly valuable to shareholders.
In addition to the dividends that these shareholders may receive, the company must be valued for transactional purposes (sale or purchase of the company, mergers, divisions and/or exchanges of ownership, capital increases, dissolution, reorganisation or even liquidation of the company, listing on the stock exchange, etc.) as well as for informational purposes (valuation for loan guarantees, taxation of company property, insurance of company property, recording the value of assets in the financial statements, but above all, informing shareholders or management). (Caruntu & Lapadusi, 2009, 102; Condrea et al., 2012, 2154).

3. Research methodology

For this paper, the analytical research methos was employed.

The analytical method entails the collection of specific information about a topic, where the data collected is scrutinised either to test a hypothesis or to confirm a certain idea.

Utilizing the analytical method served the primary purpose of substantiating the ongoing research, enhancing its credibility, or fostering novel ideas on the subject. As part of this research methodology, a review of the existing literature on the topic was carried out by revisiting previously collected data related to the studied subject (Brasoveanu, 2023, 56).

Results obtained through the analytical research method are perpetually subject to change upon the acquisition of new data or data underpinning fresh research. This holds true to varying degrees across all scientific methods, with particular emphasis on the analytical approach.

The analytic method lacks this ability, unlike other tools such as the experimental method, which can establish causality and provide robust evidence about the causes of a phenomenon. Regardless of the amount of data accessible on the issue in question, it remains inherently incomplete (Rus, 2022, 1012).

4. Findings

This rate holds significant importance for business owners as it indicates the level of profitability of the shareholders' investment after paying amounts to remunerate other capital invested in the company (interest expenses).

$$Rf = \frac{\text{Net result}}{\text{Equity (average value)}} \quad (1)$$

The Du Pont System

The significance of the financial profitability rate has led to its factorial development, in the sense of a "breakdown" based on the main factors that determine its level. This development is often referred to as the "Du Pont system". (Anghel et al., 2010, 141)

Initially, the evolution took into account two direct factors, namely net profitability (net profit margin) and equity turnover:

$$Rf = \frac{\text{Income}}{\text{Equity}} \times \frac{\text{Net result}}{\text{Income}} \quad (2)$$

This mathematical relationship shows that a company can increase its financial profitability both by using its own capital more efficiently as well as by engaging in more profitable operating activities. (Anghel et al., 2010, 141).

It is clear that equity turnover is influenced by the capital structure. Specifically, a company can increase the turnover of assets by giving priority to debt in the financing of assets. We can observe this effect if we use the following equation:

Revenue/Equity = Total Assets/Equity x Revenue/Total Assets (3)

In a company, all assets are financed by a mix of debt and equity. The higher the "assets/equity" ratio, the higher the level of indebtedness of the firm. (Anghel et al., 2010, 142; Herciu et al., 2023, 319))

By combining the two previously presented relationships, the following expression can be formulated:

$$Rf = \frac{\text{Total assets}}{\text{Equity capital}} \times \frac{\text{Income}}{\text{Total assets}} \times \frac{\text{Net result}}{\text{Income}} \quad (4)$$

To illustrate the concepts discussed earlier, the following example is provided to verify the accuracy of the formulas. Assuming a company with the following values at the end of three financial periods (expressed in units of measurement - U.M.)

Table no. 1. Evolution of a company's indicators over 3 years

	Year N	Year N+1	Year N+2
Share capital	1.000,00	1.000,00	1.000,00
Fixed assets	4.000,00	3.500,00	3.500,00
Current assets	2.500,00	2.500,00	2.500,00
Total assets	6.500,00	6.000,00	6.000,00
Equity capital	7.500,00	7.000,00	7.000,00
Income	7.500,00	7.500,00	6.500,00
Expenses	6.500,00	6.500,00	6.000,00
Net result	1.000,00	1.000,00	500,00
Rf1 (%)	13,33	14,29	8,33
Rf2 (%)	13,33	14,29	8,33

Source: Author’s processing

Financial profitability Rf1 was determined using equation (1), and the value of financial profitability Rf2 was obtained using equation (4). The results show that when the value of equity decreases but the net result remains the same, the financial profitability is higher. Conversely, if the value of equity remains constant and net income decreases, financial profitability decreases.

5. Conclusions

Financial profitability is a performance indicator whose value serves a dual purpose, informing both management and shareholders.

For the management, this holds significance as the profitability value plays a key role in securing their ongoing position. Furthermore, with the approval of the shareholders, the net result can be used for investments, material incentives for personnel and other purposes (Stan, 2019, 236).

For shareholders, this indicator is of importance as the reflected net result can be used either to make investments, thus eliminating the need for shareholders to financially support the company, or to pay dividends, thus allowing shareholders to recover their investment in financing the company (Stan & Vintila, 2021, 175).

The importance of equity should not be overlooked, as it indicates the financial health of the company and eliminates the need for significant borrowing. Where borrowing is necessary, it can be for a reduced amount and secured against components of equity, such as fixed assets.

It is essential to note that in an economic and financial analysis, it is not only the financial profitability indicator that is crucial, but also several others, such as economic profitability, immediate liquidity, general liquidity, and leverage. However, these indicators will be discussed in a future study.

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