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Profitability as a criterion for the financial assessment of an enterprise

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ABSTRACT

The functioning of enterprises on the market definitely hinders the development of competition, constant changes in legal regulations, compliance with these regulations, as well as intense surroundings. In such an environment, a fairly frequent index interpretation of the enterprise and constant monitoring of its property and financial situation are necessary. Such actions are indicated for the best orientation of subsequent strategic actions taken.

***Keywords*:** profitability, decision area, financial planning

1. INTRODUCTION

Profitability should be understood as the degree of operational efficiency and management of the enterprise's assets. The purpose of the profitability analysis is to determine the dependence of the achieved financial result on the revenues obtained from sales, equity and available resources. It is assumed that the higher the level of profitability of a company, the better its monetary situation. Quite often, the profitability indicators are considered to be the most important part of the analysis of the financial and property possibilities of the enterprise for both those who run business as well as entities and units from the closest surrounding.

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One of the most important financial parameters of the enterprise is equity. It is equity that determines the safe and effective operation of the enterprise. The company's equity should increase its value simultaneously with the development of the enterprise.

An important element of controlling the effectiveness of a given company may be monitoring the changes taking place in the area of the company's equity. An example of such a control is definitely the verification of the profitability of equity.

2. EFFECTIVE MANAGEMENT TOOL

Each of the operating enterprises makes decisions and conducts investment and current activities. However, this requires clarification of the necessary measures and methods. The decision areas are presented below.

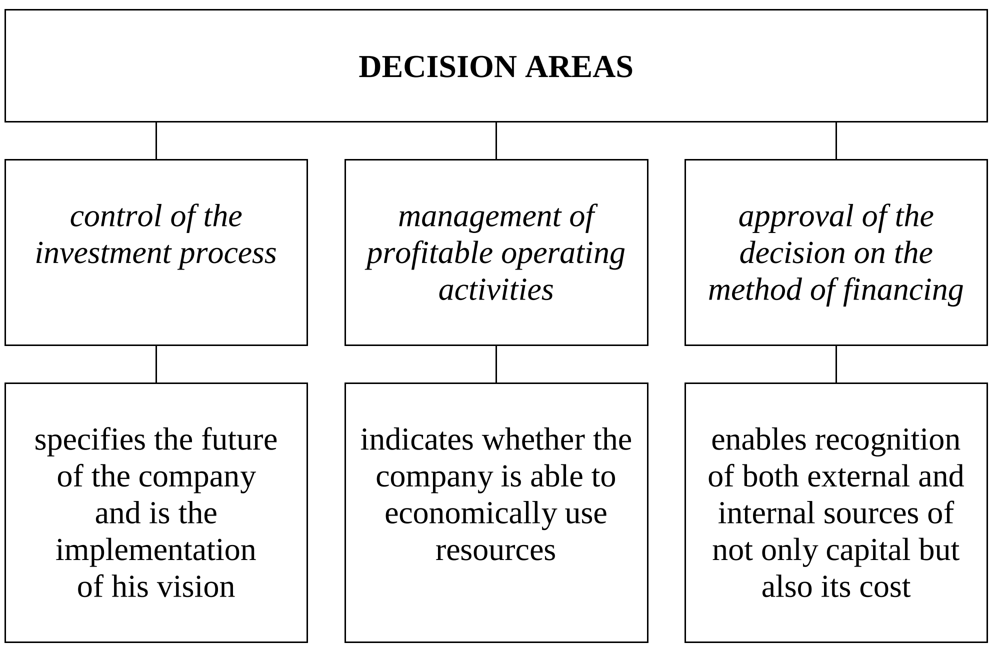


Figure 1. Decision areas coherent for all enterprises
Source: Own elaboration

In order to obtain the appropriate consequences of economic decisions, it is necessary to explore the basics of making financial decisions. The first step to make a decision is to identify the problem. We are talking about the problem in a situation when we observe a contradiction between the actual and the desired reference state. [1]

Planning is a necessary decision making process. It creates the right image for the future state of the company and, moreover, specifies the methods of its achievement. A plan is defined for accomplishing a predetermined goal. The set plan should show which of the activities lead to a specific goal, which are moving away from it, which may not match each other, and which ones are not that important. In order for the company to function properly it is necessary to create plans. The creation of the plan enables the total assessment of the activities undertaken. And at the implementation stage, it enables them to be controlled and harmonized [10].

It is worth noting that financial planning strengthens the process related to making operational and strategic decisions. This is refined as short-term and long-term financial planning. Operational plans are oriented to adapt operating dispositions and also subordinate current company activities. The main link in short-term design is the financial liquidity of the company [1].

FINANCIAL PLANNING – BENEFITS

- a perspective on the compilation of several scenarios for the development of events and an analysis of their impact on the company's situation
- motivating employees in management positions to take actions aimed at achieving the objectives
- guaranteeing the coherence and reality of operational plans, indication of the relationship between particular measures of activity (market share, sales profitability, liquidity, profitability of own capital)
- consideration of affinities between investment arrangements and the choice of the source of their financing

Figure 2. Benefits of financial planning
Source: Own elaboration

There are two priority species of plans, they are a plan of investment activity and a plan of current activity. The current activity plan is based primarily on the estimation of the previous results from the ongoing activity. The expectations for the later market modeling of the situation should also be taken into account, i.e. its significance on the price, scale of sales and costs. The plan of current activity gives us the opportunity to estimate the future results of the performed activity, as well as to predict the consequences of the arrangements that were related to the operating activity.

The investment activity plan gives you the opportunity to assess the company's development opportunities. Investment schedules enable the approval of investment projects and estimation of the impact of the projects carried out on the company's results. The investment activity plan answers the questions: what size of the property should be purchased and how the development affects the company's financial situation.

Financial studies are created based on detailed operational material plans. They include sales, production and purchase plans. It combines all planned company fragments established in adequately made lists.

This includes the planned economic and financial indicators, the balance sheet, planned modifications in own capital and the cash flow statement, as well as the profit and loss account.

In addition, the financial plan should include indicators that express the expected liquidity and profitability of the company, as well as other important indicators important for the future financial assessment of the company. Liquidity is an element that affects the company's financial conditions. It should be constantly supervised by the management staff, who evaluate and control it. This is to determine the ability to pay the current debts that the company has. The main source of collateral is the trading assets with the highest liquidity risk. [10] The liquidity note should be complemented with the assessment of the working capital, where the volume is adapted to the volume of sales in order to maintain the solvency of the company. [1] The constant detail during planning as well as when making decisions is the risk. [7] The ability to obtain economic benefits from a financial point convinces us to estimate the risk. Each company should decide what amount of risk it is able to incur. The company can also limit the risk through strategic decisions.

Owners who make decisions determine the strategy of operation in conditions where they can choose from among several options. Unfortunately, they are not sure about the risk involved. All arrangements must take into account the specific way of thinking. The planning cycle is based on the simulation of future financial effects while supporting the decision-making process. A well-structured financial strategy makes it possible to analyze the financial consequences of individual decision-making cases. Provisions include both the current activity of the enterprise and investment activity. The decisions made unfortunately are reflected in the company's finances, unfortunately not always in the plus. [10]

3. ANALYSIS OF VICTIMY

Profitability is considered one of the most important assumptions of the financial assessment of the company. The condition for an effective management system is the ability to control and measure profitability, study the factors that affect it, and explain the effects of the study. The profitability analysis belongs to one of the most important parts of the financial analysis. Among others, the profitability analysis is useful for assessing the company and management's ability to manage the company in such a way that it is possible to generate appropriately high income from the funds involved. On the other hand, profitability through the indicator enables the presentation of the results of all sections of the business.

This facilitates bringing the results of approved business decisions and the results of several areas of the company's activity to the common denominator. In this way, it makes them directly comparable. A financial report is necessary to assess the financial situation of the company both at the present time and in the future. The financial statement is perceived as the main source of information necessary to make a decision in the process of managing the company's financial resources.

The profit and loss account, cash flow statement and balance sheet are prepared for the annual period. They are the basis for the assessment of the company's financial condition and financial results as well as for dynamic and static analysis. [12]

CASH FLOW	**BALANCE**	**PROFIT AND LOSS ACCOUNT**
it shows the relationship between the state of assets, the level of financial liquidity and the surplus of revenues over costs	enterprises that operate on a small scale are entitled to carry out a simplified balance sheet	it presents synthetically all costs, revenues and burdens associated with obtaining income
is considered to reflect the difference between the balance sheet and the profit and loss account	assets are ordered by liquidity	in the Profit and Loss Account the operational cycle of the enterprise and some of the operations of the investment and financial cycle are presented
describes the cash flow in the period between the opening balance and the closing balance	the balance answers the questions: To what extent can assets create profits, revenues and cash inflows in the future? What is their real market value?	it is a reflection of financial flows

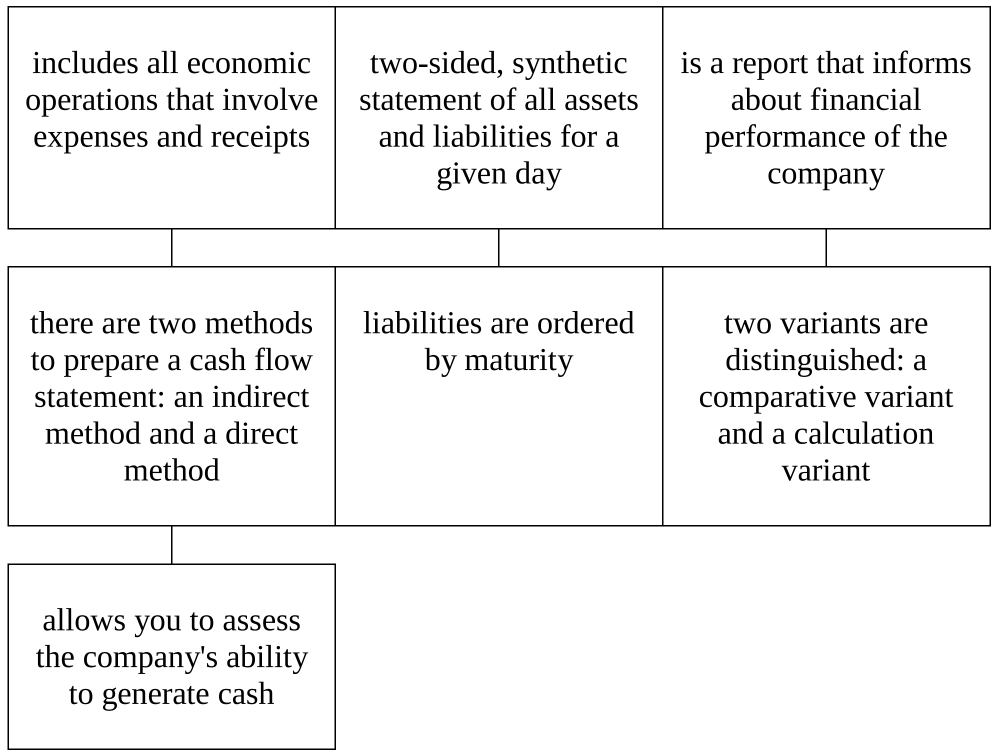


Figure 3. Characteristics of financial statements
Source: Own elaboration

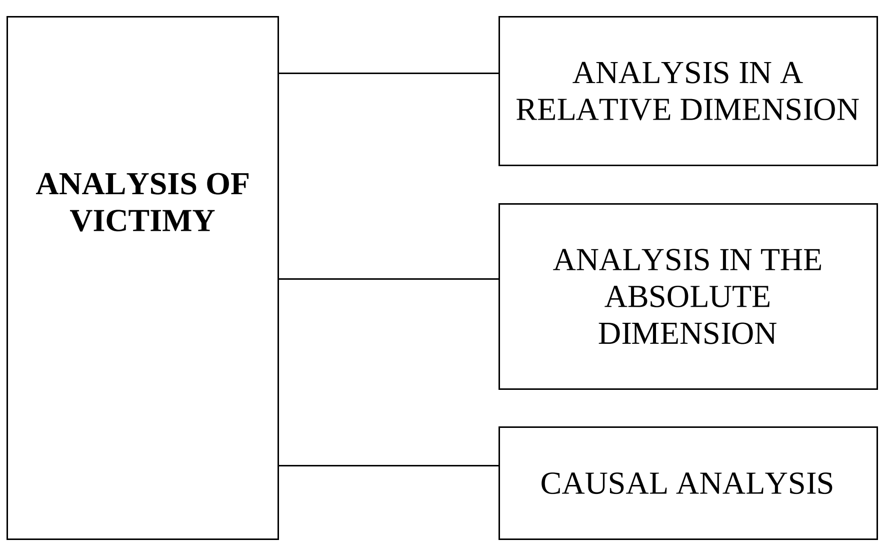


Figure 4. Stages of conduct occurring in the profitability study
Source: Own elaboration

The financial statements constituting the basis for the financial analysis should be adequate to the requirements of substantive correctness and formal and behavioral.

The substantive correctness should be understood as the uniformity of data with the existing state, while the formal and corrective regularity as such, which is consistent with the prevailing regulations. After collecting appropriate source materials, you can start defining the tasks and stages of profitability analysis.

The main task of the profitability analysis is to examine whether the company's profits are close to the profits that have been obtained by other enterprises operating in the same field? Is the analyzed enterprise profitable? Is the return on capital, which is included in the company's assets, better than alternative forms of cash investment?

Profitability is a financial result that has been calculated based on the company's business operations. It may occur as a deficit or as a profit. We talk about deficits in a situation when there is a negative financial result. However, we talk about profitability when the financial result is positive. Both the deficit and profitability of the enterprise can be interpreted in absolute or relative multiplicities.

The company's financial result, which has been recognized in absolute terms, is the algebraic sum of ordinary and extraordinary results. The next figure presents the structure of the financial result, which takes into account the items that were specified in the profit and loss account. [11]

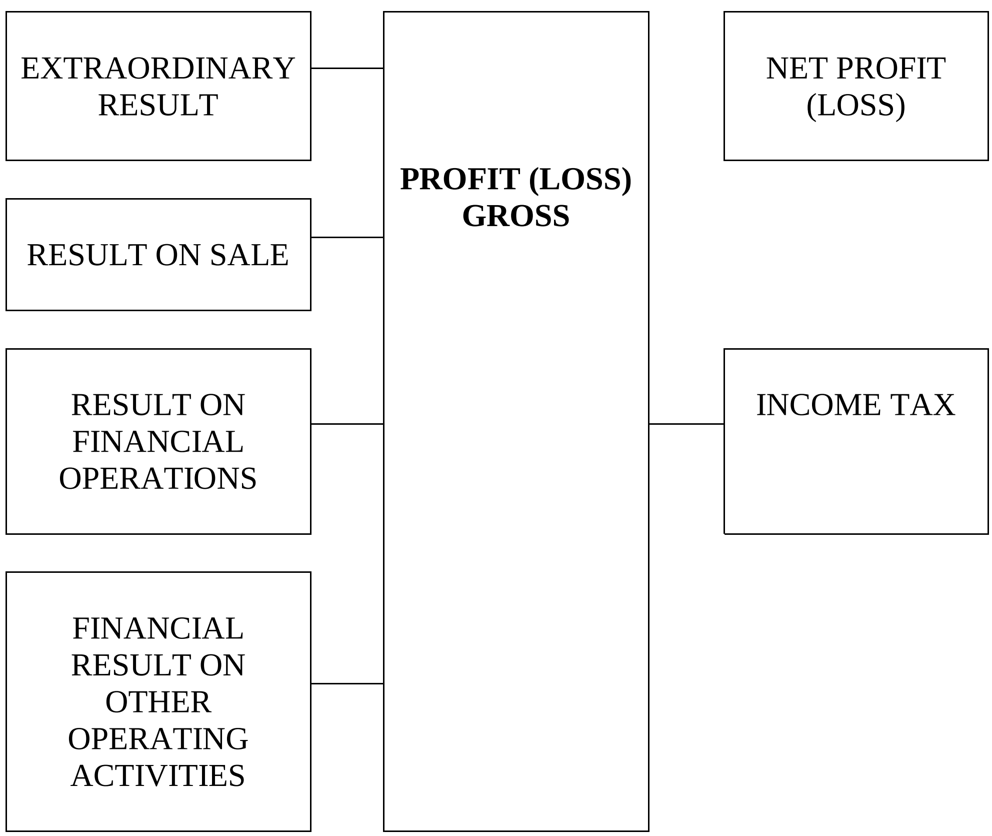


Figure 5. Construction of the financial result
Source: Own elaboration

4. ABSOLUTE AND RELIABLE DIMENSION OF PROFITABILITY

In the interpretation of profitability in absolute terms, the structure and dynamics of individual result categories indicated in the loss and profit calculations is checked. The main purpose of this interpretation is to check which types of forms give profits and through which the company loses its income. Segment interpretation is also conducted to assess the contribution of the company's financial and operating profile to net income modeling.

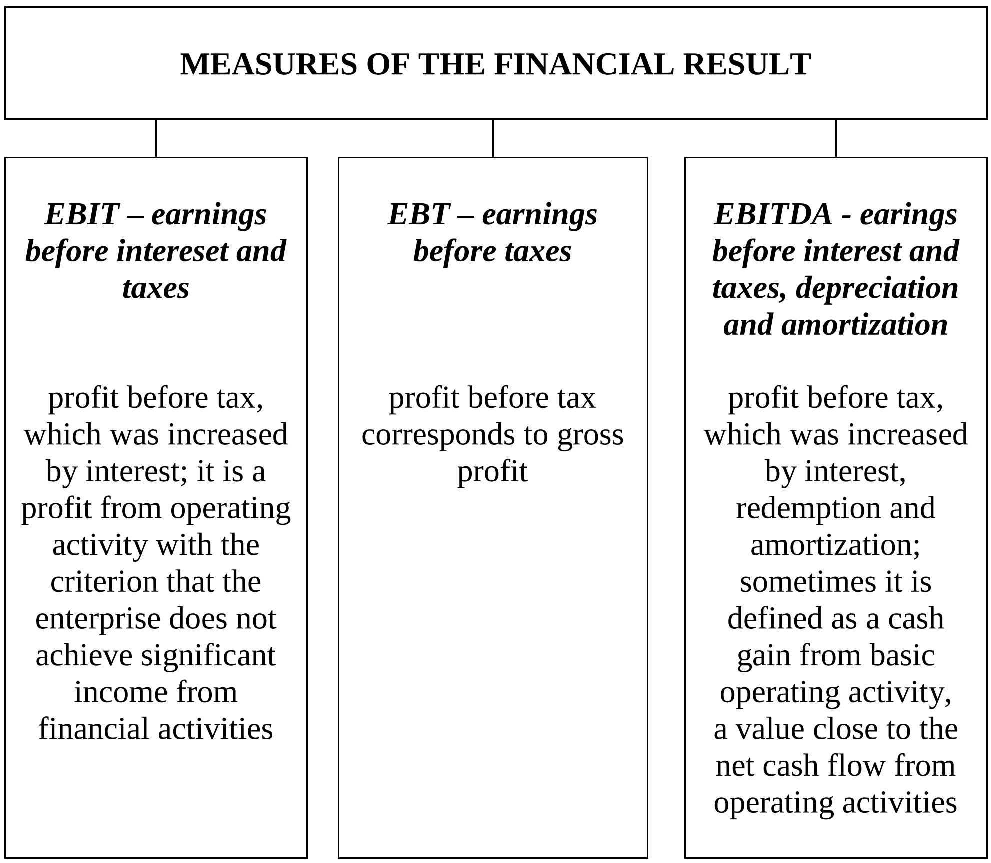


Figure 6. Measures of the financial result
Source: Own elaboration

The resulting interpretation of the financial result in the form of a preliminary review of the profit and loss calculation is incomplete. It is necessary to add to it multi-directional causal research. The financial result of the activity creates a sum from the results of extraordinary and financial events, as well as from operational activity. Operational activity can be further divided into basic and other. A comparative review of the financial result is carried out by determining the amount of profit to the results that were obtained in the preceding years. The absolute size of the profit is compared with the values included in the economic calculations. This size indicates not profitability, only about the operability of the design system in the company and forecasting the conditions of disposal. [6] From among the result categories, a particular interpretation should be given to the results which can be found in the table below.

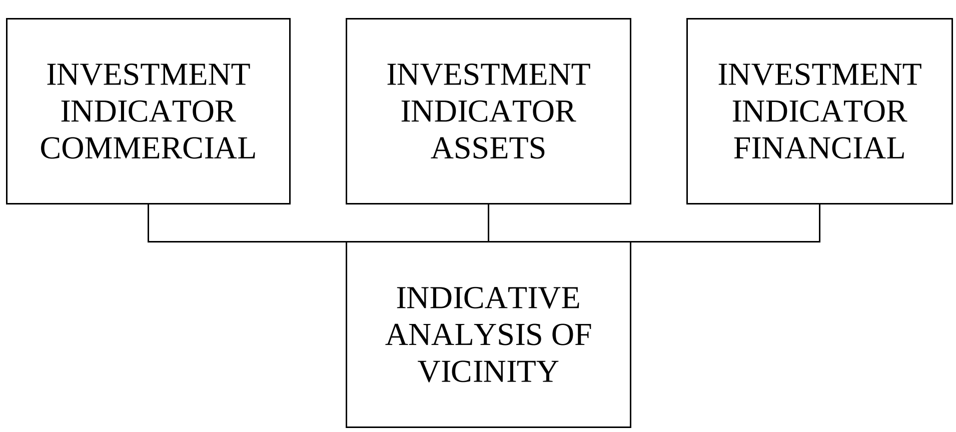
NET PROFIT	GROSS PROFIT	GROSS PROFIT FROM SALE	PROFIT FOR SALE
is considered as a comprehensive measure of property management	is defined as the profit that was achieved from the total activity, while taking into account the result on sales, other operating and financial activities as well as the extraordinary profit and loss balance	this is the difference between revenue from the sale of products and the cost of producing them	this result category should have a significant impact on shaping the remaining ones, including net profit
its size depends on the existing tax rates		it is also called a margin	taking into account the recent years, this is a particularly useful result category for comparative analyzes
due to its distribution, information and motivation functions, it plays the most important role in the financial and economic system		part of the margin is intended to cover general administrative expenses and sales costs	acts as a measure of the effectiveness of the entity's basic operations
part of the net profit that is left in the enterprise increases its equity			

in principle, each event affects the shaping of this result category			
it is possible for it to self-finance the development of the company			

Figure 7. Characteristics of the financial result
Source: Own elaboration

After completing the assessment of the cited result categories, a structural examination of the financial result should be performed. It aims to explore the essence of segment comparison. On the other hand, its task is the opinion on partial influences that are achieved in individual company departments for the final financial result. [5] In terms of this comparison, the dynamics and the magnitude of these results are compared. It is also worth mentioning here elements that shape income both on the cost side as well as revenues.

It should also be noted what the negative results from the initial results, and which have a positive effect on net income. It should also be mentioned which economic events had a critical impact on the level of the result balance for a given result segment. Conclusions resulting from the statement of financial result are absolutely included in the next stage of the profitability comparison as a ratio comparison.



Source: Own elaboration

Figure 8. Areas of enterprise profitability research
Source: Own elaboration

In relative terms, the relative task of profitability analysis is to specify the level of satisfaction with the profitability of a given enterprise, taking into account the economic possibilities, the field in which the enterprise operates, as well as the size of its assets. [3]

Relative analysis takes the form of an index analysis. Analyzes the relation of income in relation to the basic market categories. The task of the analysis is to check whether the profit that is produced is comparable to the size of the enterprise. First and foremost, it is about the scale of owned assets, operations and incorporated capital. [5]

The basic areas of conducting enterprise profitability research are presented in the Figure 8.

5. DU PONT ANALYSIS

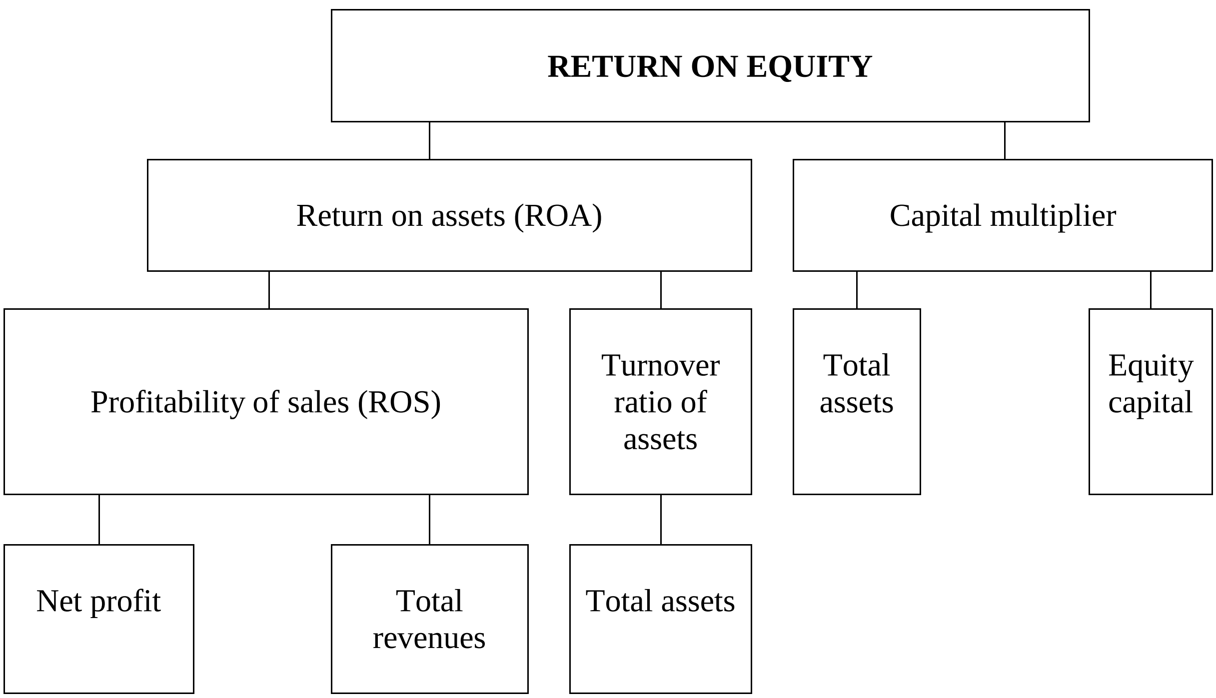


Figure 9. Du Pont's index analysis model.
Source: Own elaboration

The Du Pont analysis is a common model presenting the links between profitability ratios and other indicators. It is an analysis that largely enables not only a comprehensive, but also an internal assessment of the functioning of a given enterprise. [2] Du Pont's analysis also enables information about the company's development in the coming years. In addition, the described analysis helps in the identification and analysis of those areas that are inadequately managed and are considered presumably dangerous. [4] The pyramidal analysis is used to review financial statements. In this way, the assessment of the company's capital condition is determined. In the basic variant of the Du Pont analysis, the return on own capital is the starting point. [9]

It should be emphasized that the analysis of Du Pont makes it possible to concretise the fact how the exchange of sales profitability, assets and the level of indebtedness of a given enterprise affects the profitability of own capital.[8]

From the described analysis, it turns out that an enterprise characterized by high profitability of sales as a result of reduced effectiveness of using assets may deteriorate the profitability of its own capital. In turn, the company's lower return on sales can be compensated by means of greater asset turnover. [15]

Progressiveness of the Return on Equity indicator can be obtained by making the right decisions:

– "high turnover = low profit" or
– "small turnover = high profit".

However, it is important to pay special attention to the appropriately adjusted capital structure. The Du Pont model explains what is the profitability of a given company, which is interpreted as a return on its own capital. The Return on Equity rate is very important for each of the business owners, because it indicates how productively the funds they have invested are used up. Return on Equity is one of the key indicators used to compare various investments. [13] Summing up, the presented Du Ponta model enables the combination of Return on Equity, but above all it allows to understand what exactly such ROE and not others are taken from. Using this model, we have a chance to understand where the reason for exceptionally weak or exceptionally good capitals in the enterprise is. The Du Pont model makes it possible to decide on remedial measures. He advises if there is any chance of improvement or it may be better to look for another investment. [14]

APPLICATIONS OF THE DU PONTA MODEL

- it indicates employees elements influencing the company's profitability
- it gives the opportunity to compile companies in a specific field, it allows to compare the methods by which enterprises obtain return on assets
- allows you to observe changes over time

Figure 10. Applications of the Du Ponta model.
Source: Own elaboration

It is worth noting that in the case of manufacturing enterprises, the Du Pont analysis is best achieved. However, it should not be used either in insurance companies or banks where, firstly, the margin is calculated differently and, secondly, revenues are not directly related to operating economics. [9]

People who have basic knowledge in the field of mathematics and corporate finance may try to further enlarge the Du Pont model with innovative relationships. [8] However, it should not be forgotten that the greater the breakdown of the model into its smaller components, the cognitive value of each of these parts will be smaller. [15]

6. CONCLUSIONS

For the efficient management of a small company, managers should also set goals and try to meet them. Co-owners striving to meet the set tasks must also take into account the legal and organizational form. It is also forbidden to omit financial design because it distinguishes the sphere of decision making. For financial design, we can include the approval of arrangements for the methods of paying for business, managing operational activities and managing the investment cycle. Each of the approved arrangements affects the company's funds. The most important condition for assessing the financial situation of a company is profitability analysis. We classify it for examination in absolute and relative dimensions. Maximizing profit is considered the main goal of the enterprise's business. Both the management of the enterprise and external analysts determine their size as a crucial task. It is precisely the size of the profit earned by the enterprise in the analyzed period that the profitability ratios are based. These indicators can be measured by addressing the sales volume or the company's assets. The profit ratio that was achieved on the given levels of the loss account and profits to different basis is expressed using profitability ratios. In general, the profitability indicator counter takes into account the company's earned profit, for example:

– operating profit,
– net profit,
– gross profit,
– gross profit on sales,
– profit on business.

In turn, in a large part of cases, the denominator includes:

– company costs,
– equity,
– assets
– net sales revenues.

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