

PROFITABILITY, RISK OR VULNERABILITY IN THE COMPANY ACTIVITY

Doina RADA¹

Submitted: 4th November 2018

Approved: 30th November 2018

Abstract

The future entrepreneur must be supported in his/her entrepreneurial activity for the chances he/she offers, without thinking about possible failure. However, the possibility of failure in the activity of a company as a result of risk must also be considered. It is necessary to pursue realistic objectives and a solid foundation of the actions necessary for their realization. Profitability is the fundamental criterion by which the efficiency of the business is assessed. Risk is an increasingly important element, being an instrument used to determine the profitability of an entity. An entity that is not profitable becomes vulnerable. Vulnerability is a stringent problem of a patrimonial entity to determine its cost. It represents the role of dimension, focus, interdependence of technology and social transformation.

Key words: enterprise, profitability, risk, vulnerability, profit, circulating assets, turnover, expenses, variables, score.

JEL: L 21

1. INTRODUCTION

The primary objective of any business is to obtain economic benefits. In this context, the keywords are profitability and, implicitly, return, represent very important concepts that need to be taken into consideration when making profitable decisions. The origin of the term „profit” is Latin and derives from the verb „proficere” which means: to result, to program, and later took on the meaning of profit.

The importance of economic activities realized by different companies, economic activities with a high degree of complexity in terms of market mechanisms, have a profound impact on the management process. Thus, the management process has to be studied on the basis of real information in a company and not on a routine basis.

Profitability is the fundamental criterion by which the efficiency of the business is assessed. This reflects all relationships between the efforts made and the results obtained.

Profitability is defined as a measurement instrument of the company efficiency and its ability to generate profit.

In today's economy, the main purpose of any business is to make profit and increase it continuously. Any patrimonial entity that is not profitable is predisposed to bankruptcy.

2. PROFITABILITY, RENTABILITY OR VULNERABILITY

When discussing profitability, one might say that it is the sovereign criterion of the enterprise. “Profit generally represents a material or spiritual income that can be the income introduced by the capital used in an enterprise, representing the difference

¹Deputy Professor PhD., “Eftimie Murgu” University of Resita, Romania, d.rada@uem.ro

between the receipts and the total expenditure. This income is the amount of money left after the investment made to provide goods or services. After spending some money, for the needs of the company, the remaining part of the total amount of money represents the fiscal result that is determined by observing and applying the principle of linking expenses called profit. If profit tax is deducted from profit or loss, the net profit is obtained.” (<https://ro.wikipedia.org/wiki/Profit>)

In simple terms, profit is achieved when the revenue of an enterprise is greater than its cost. These two terms, income and expenses are fundamental elements of profit, and they form the basis of any entity reasoning in the exploitation of scarce resources. In the case of cost-effective entity, the intent is not only to keep revenues higher than the expenses but also the continuous maximization of this difference. This can be achieved by getting higher incomes using the same amount of resources, or by increasing expenses, but to a lesser extent. Commercial profit is the mirror that reflects the capitalization level of production factors. The profit may be influenced by the market situation, the achievements of other economic entities and the economic policies of the state. In this context, three types of profit can be identified:

- Profit earned at to management's initiative;
- Profit received in favourable circumstances;
- Profit allowed, determined by the public power.

The level of return is varied for each patrimonial entity and each type of activity, according to the type of social economic environment in which an economic agent operates, but also how resources are used, influences profitability. For example, an investor who deals with the sale of goods to cover his expenses must apply a commercial addition to his/her merchandise. However, too high a trade add-on does not necessarily mean making a profit because the price is dictated by competition. Too much trade adds leads to products not being any longer competitive due to high prices.

Any investor, a small trader or a joint-stock company, seeks to benefit from the capital consumption he has invested in. However, in order to invest in an economic activity, a potential investor must also take into account the risk he assumes and the profit generated by the potential investment to be commensurate with the assumed risk.

If one pursues what is ideal in a patrimonial entity, one must highlight the factors that prevent the entity from being profitable and producing return. An entity that is not profitable or producing return becomes **vulnerable**. At present, many factors force economic entities to make more efforts in producing return and becoming profitable. Among these factors one might mention:

- the size of companies;
- the concentration of assets;
- the increased impact of technology;
- interdependence and global competition;
- interest in the environment.

At the same time, **risk** is an increasingly important element, being a tool used to determine the profitability of an entity. Risk is a determining factor and a company protects itself in this case with insurance. Insurance generally refers to pure risks and not risks due to inappropriate managerial management. In this regard, one can recall the speculative risks of driving.

2.1. Factors that influence the enterprise vulnerability

Vulnerability is a stringent problem for a patrimonial entity in the determination of its cost. It represents the role of dimension, focus, interdependence of technology and social transformation.

The enterprise is influenced by factors that determine a certain degree of vulnerability, as follows:

- **Activity management is developed.**

During this period, consumers tend to have a diversified lifestyle, which also means diversified consumer preferences. This contemporary lifestyle requires management departments to address a flexible and adaptable attitude towards consumer demands.

- **The multiplication of interaction and competition.**

To be profitable and cost-effective, companies need to focus not only on promoting the products and services they have to offer but also on reorienting the object of activity in line with the market.

- **The technical process**

The fact that technological progress increases exponentially, it makes existing businesses vulnerable. They must be up to date with technological progress and focus more on the most important resource at present, namely gray matter. So the most cost-effective patrimonial entities will be those that will turn from workers' companies into intellectuals' companies. Technological progress makes businesses vulnerable also because of production facilities that can lead to risky situations such as accidents or pollution.

- **Business legitimacy crisis.**

The fact that the production diversifies leads to a lower attachment to the workplace and in some cases it is realized that what is good for the company, but it is not necessarily good for a shareholder too. The purpose of companies is therefore to satisfy the shareholders.

- **Financial investment versus industrial investment**

There are no common elements between funding and industry. Even if the intention of enterprises is not to make funding, they do so. A financial investment is more attractive than an industrial one. Funding dominates industry. Financing is detrimental to the national and global economy because the international financial system and its vulnerability are dependent on the institutional arrangements governing the functioning of the financial markets.

2.2. Bankruptcy risk

Since the beginning, entrepreneurs try to discover the formula of success, regardless of the economic sector in which they operate. Experience gained over time has shown that success and failure are complementary concepts. The escape from failure represents a stronger desire than the realization by any means or by any methods of profit, because the vulnerability of the enterprises, regardless of their size, small or medium size, offers conditions for failure in time.

Bankruptcy risk assessment for an enterprise is a basic component of the financial analysis of a managerial nature that is determined using specific methods. These methods provide a preventive diagnosis of economic and financial problems and thus offer the possibility to address them by recommending measures with operative and strategic results to strengthen the financial state, strengthen the business, increase performance and thus eliminate the risk of bankruptcy.

The “scoring” analysis method is one of the methods used to determine the bankruptcy risk of the enterprise.

The Altman model was the first score-function, elaborated 1968 in the USA. This model made possible the anticipation of 75 % bankruptcies 2 before these appeared.

The function - score (Z) has the following expression and holds 5 variables (rates) i:

$$Z = 1,2R1 + 1,4R2 + 3,3R3 + 0,6R4 + 0,999R5, \text{ where:}$$

R1 = Current assets/Total assets - Expresses the share of working capital in the total assets, the use of working capital.

R2 = Reinvested profit/Total assets - Measures the internal financing capacity.

R3 = Gross profit /Total assets - Measures the assets return.

R4 = Capital value / Total depts (autonomy) - Measures financial independence

R5 = Bussines figure/Total assets - Mesures the totation speed of assets.

The vulnerability of the business is appreciated by using the score function in the following manner:

Z score value	Entreprise situation	Bankruptcy risk (%)
$Z > 2,675$	Good - solvency	Reduced - inexistent
$1,81 < Z < 2,675$	Precarious - difficulty	Undetermined
$Z < 1,81$	Difficult - insolvency	Iminent - maximum

Based on the annual accounts of Parabomir S.R.L. one could determine the risk of bankruptcy and the vulnerability of the ociety using the Altman model:

- Year 2016

$$R1 = \text{Current assets/Total assets} = 3.958.941 : 4.124.101 = 0,9600$$

$$R2 = \text{Reinvested profit/Total assets} = 0 : 4.124.101 = 0$$

$$R3 = \text{Gross profit /Total assets} = 1.655.946 : 4.124.101 = 0,4015$$

$$R4 = \text{Capital value / Total depts} = 1.377.154 : 2.746.947 = 0,5013$$

$$R5 = \text{Bussines figure/Total assets} = 31.929.956 : 4.124.101 = 7,7423$$

- Year 2017

$$R1 = \text{Current assets/Total assets} = 6.497.519 : 10.379.101 = 0,6260$$

$$R2 = \text{Reinvested profit/Total assets} = 0 : 10.379.101 = 0$$

$$R3 = \text{Gross profit /Total assets} = 971.500 : 10.379.101 = 0,0936$$

$$R4 = \text{Capital value / Total depts} = 309.329 : 10.070.431 = 0,0307$$

$$R5 = \text{Bussines figure/Total assets} = 38.929.151 : 10.379.101 = 3,7507$$

The values of the Z score function for Parabomir S.R.L. are presented in the following table:

Calculation of the of Z score-function - Altman model:

No.	Calculating variable (rates)		31.12.2016	31.12.2017
1	R1 = Current assets/Total assets	X 1,200	1,1520	0,7512
2	R2 = Reinvested profit/Total assets	X 1,400	0	0
3	R3 = Gross profit /Total assets	X 3,300	1,3250	0,3089
4	R4 = Capital value / Total depts	X 0,600	0,3008	0,0184
5	R5 = Bussines figure/Total assets	X 0,999	7,7346	3,7545
Z score-function			10,5124	4,8330

According to the results obtained using the Altman model calculations, one can notice, from a theoretical point of view, that in 2016 there is no risk, much less the risk of bankruptcy, because the Z score function is of 10.5124, much higher than the value of 2.675, thus the firm is solvable and has a good financial standing. It can be appreciated that S.C. Parabomir S.R.L. does not pose any risk of bankruptcy and has a low vulnerability.

For the year 2017, the value of the Z score is 4.8330, much higher than 2.675, thus the firm is solvent and has a good financial status, but much less than the previous year.

The variables influenced the score calculation for the year 2017 as follows:

✚ The R1 variable for the year 2017 represents 65.21% of the value of the previous year. The decrease in value of this variable is influenced by the increase by 1.51% of the total asset registered for the year 2015 due to the increase of the fixed assets.

✚ The R2 variable remains;

✚ The R3 variable for the year 2017 represents 23.31% of the value of the previous year. The reason for the reduced value of this variable is identical to that of the variable R1, respectively the increase by 1.51% of the total asset in 2017.

✚ The R4 variable for the year 2017 represents 6.12% of the value of the previous year in the conditions in which equity dropped from ROL 1,377,154 to ROL 309,329 and total debts increased from ROL 2,746,947 to ROL 10,070,431. The debts with the largest weight in the structure of the total debts is represented by the debts to the providers which increased by 4.96% and the credit amounting to 3.000.000 lei.

✚ The R5 variable for the year 2017 represents 48.54% of the value of the previous year. The business figure increased by 21.92% for the year 2017 compared to 2016, but this growth is lower than the total asset growth by 151%.

The conclusion that emerges from this analysis is that S.C. Parabomir S.R.L. does not have an upward trend, debt has increased, liquidity has fallen, and credit has been required. The value of the asset increased by raising fixed assets, but this growth was not the best choice because the company profit dropped in 2017.

The risk of bankruptcy does not exist but the company tends to become vulnerable in the future if managerial measures are not taken.

3. CONCLUSIONS

The enterprise bankruptcy risk is a basic element of the financial analysis of a managerial nature. Vulnerability and failure rate is high during the first five years of functioning, as new businesses have the highest vulnerability.

In market-economy countries, studies have shown that the failure rate is high, with figures around 50% for the first five years of existence.

The causes that can lead to bankruptcy are multiple and target:

- the decrease of activity volume;
- the diminishing of return margins and rates;
- the emergence and increase of management and of treasury issues;
- the bankruptcy of some clients;
- the disappearance of some outlets;
- chain blockages etc.

By analyzing the causes of bankruptcy, one can conclude that this result can be noticed when the financial situation of the enterprise progressively deteriorates. The insolvency risk occurs a few years before payments are terminated.

Vulnerability, risk and bankruptcy are the results of the financial analysis that are contingent on each other, one derives from the other, and the effect is on chain propagation.

If the risks are not properly assessed, the business may be subject to one of the following “threats”:

- ✚ Fixed asset lock-in - low efficiency use.
- ✚ Insufficient current assets - there are no available supplies and stocks to ensure continuity of activity.
- ✚ Failure to repay credits - no possibilities.
- ✚ Poor inventory management. The increase in sales does not imply an increase in stocks of the same volume. Stocks will grow only 1/4 times.
- ✚ Uncontrolled expansion - the market on which products are to be launched has not been previously investigated.
- ✚ The lack of qualifications and experience - employees do not have adequate training and there is no interest in developing their professional training.
- ✚ Fluctuation of staff - if the activity does not work well, the staff will be tempted to leave the workplace.

REFERENCES

- Petrescu Silvia, (2004) “*Diagnostic economic-financiar. Metodologie. Studii de caz*”, Sedcom Libris Publishing House, Iasi;
- PierreF., (2004) “*Valorisation d’entreprise et theorie financiere*”, Organisation Publishing House, Paris, 2004;
- Prunea Petru, (2003) “*Riscul în activitatea economică. Ipostaze. Factori. Modalități de reducere*”, Economic Publishing House, Bucharest;
- Spătaru Liviu, (2014) “*Analiza financiară*”, Eftimie Murgu Publishing House, Resita;
- ***<http://www.softagency.ro>
- ***<https://ro.wikipedia.org/wiki/Profit>