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Significance and Types of the Profitability Ratios

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Abstract

This article highlights the significance of profitability ratios. Also, the article reveals the types of profitability ratios and their role in evaluating the company's activity.

Keywords: *profitability, economic profitability, financial profitability, revenue, profit, net profit, asset, liabilities*

INTRODUCTION

The profit indicator plays an important role in the development of the country's economy and the improvement of the financial condition of economic entities. Currently, enterprises in economic sectors are given wide opportunities to expand their activities, produce exportable products, and increase their profits. Modernization of production, implementation of modern management methods, introduction of production of new types of products will have a positive effect on the activity of enterprises and serve to increase their profit.

The important place of profit in the development of the enterprise, in ensuring the interests of owners and workers, requires its effective and continuous management. In the current environment, manufacturers try to increase the volume of production of products needed by the consumer and reduce costs. However, it is not possible to assess the financial status and activity of the enterprise based on profit ratios alone. It is worth noting that profitability ratios require special attention when making a summary assessment and corresponding management decisions. These ratios describe the final results of economic management more accurately than profit, because their size shows the ratio of the effect to the available or used resources. Only creating an effective system of profitability management in the enterprise serves to achieve the maximum result.

LITERATURE REVIEW

Types of profitability ratios and issues of their determination have been studied by many economists.

According to Charles Gibson, “profitability is the ability of the firm to make a profit, and its analysis is very important because shareholders receive income” [2, 297].

It should be noted that while recognizing the importance of the analysis of profitability ratios, the ratios used and the calculation methodology differ according to the opinion of different authors.

According to M. Tulsian, “profitability refers to the ability of an economic entity to make a profit” [2].

According to Anna Rutkowska-Ziarko “Assessment of the profitability of a company is made on the basis of financial profitability ratios. The ratios measure economic effectiveness. Aprofitability analysis is one of the major issues in a ratio analysis. In this study, the profitability of a company was analysed in three aspects, concerning return on assets (ROA), return on equity (ROE) and return on sales (ROS)” [3].

According to a group of economists “The basic reason why firms exist is due to profitability. Profit is the life blood of any business which enables business remains a going concern. Profitability is the primary goal of all business ventures” [4].

Bianda Puspita Sari, Wiwiek Mardawiyah Daryanto concluded as follows: “Financial performance is one of the most critical things in a company, both internal and external. In measuring economic performance, financial statements are crucial benchmarks in assessing how the company can survive in the coming period. One way to calculate this financial performance is by utilizing a profitability ratio calculation, with Du Pont analysis as a tool for the method. Companies can find out how strengths to be maintained and weaknesses that must be fixed. Investors can compare the level of operational efficiency of two companies engaged in the same field” [5].

RESEARCH METHODOLOGY

During the research, monographic research, comparison and other methods of scientific research activity were used in order to study the methodological aspects of determining profitability ratios.

ANALYSIS AND RESULTS

Profitability management is necessary to organize the effective operation of the enterprise. In the management of profitability, the economic activity of the enterprise is managed, the development perspective is determined. Ultimately, the financial status of economic entities will depend on the profitability management system. It is of particular importance in the conditions of the development of market relations and the manifestation of crisis situations.

Based on the study of the above, it can be concluded that profitability is one of the most important objects of management in the market economy. Profitability ratios describe the efficiency of the enterprise, as well as the profitability of various areas of its activity.

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Profitability is becoming more and more important in management activities. Profitability can be evaluated differently depending on the means used in production. For a joint-stock company and, above all, for investors, its capital and total capital return or growth rate will be important. Therefore, only the ratio of profit to capital used shows how successfully the capital of the enterprise was used in production, that is, how much profit was obtained per unit of capital.

Management decisions should be based on the identification and use of a small number of the most important indicators that describe the operational, investment and financial activities of the enterprise in the present and future.

Often, profitability ratios of individual asset groups are also calculated: profitability of long-term assets, profitability of current assets, as well as profitability of productive assets and profitability of funds. In our opinion, it is necessary to combine these ratios into the «economic profitability» group, which considers the ratio of profit ratios to the indicators of the average annual residual value of assets.

The system of profitability ratios of enterprises is shown in figure 1.

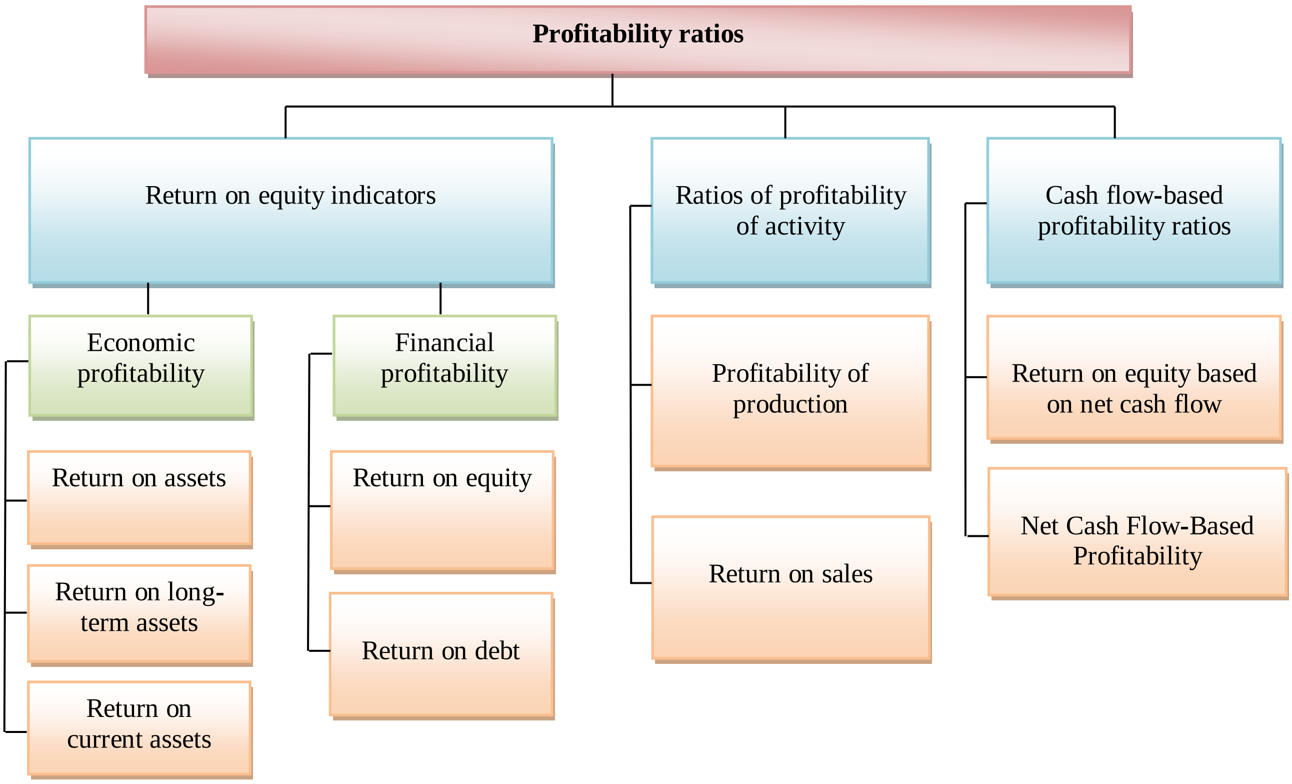

Figure 1. Types of profitability ratios[1]

[1] Made by author.

This system allows for a comprehensive assessment of the profitability of the activity, the use of capital taking into account the cash receipts, and the development efficiency of economic entities from the point of view of activity.

CONCLUSION

1. In conclusion, it should be noted that profitability indicators more accurately describe the activity of the enterprise compared to categories such as net profit or profit before tax. That is, it determines how much profit each unit of expenditure or investment will bring. Therefore, it is necessary to determine this indicator regularly and take measures to increase it.

2. When calculating profitability indicators, it is required to choose one of the following basic indicators: 1) calculation based on data at the end of the period; 2) calculation of the average indicator for the period.

3. In our opinion, it is appropriate to use the second method, because using the method of average indicators, the analyst obtains the result of the activity being studied, that is, more reliable results of the research.

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