

Accounting Profit as a Determinant of Development of Entrepreneurship

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Abstract: *Account-keeping is a basic source of information for current and potential users in the procedure of business decision making for small, medium-sized and large businesses. Financial reports of entrepreneurs are intended for external users, but also internal, however, the question remains to which extent the businesses use the information obtained in such way for the management purposes. This is why this work, using the information obtained from the Register of annual financial reports in the Republic of Croatia, gives the analysis of the way in which accounting profit influences the expansion of business, especially through investment costs.*

Keywords: *financial report, accounting profit, business expansion, investment costs*

Introduction

Understanding how to run a business and achieving satisfactory work results is crucial if we want to have a secure and successful development of a business. To achieve this, it is necessary to create a good quality information foundation. Financial reports are an unavoidable source of information on financial state, business success and cash flow. In the Republic of Croatia accounting law for small and middle-sized businesses prescribes obligatory financial report as follows: Balance sheet, Profit and loss account, Cash flow statement, Statement of changes of capital and Notes on financial statements. The exception from this list are small businesses which are not under the obligation of creating the Statement of changes of owner's equity and Cash flow statement. Financial reports in small and middle-sized businesses are mainly created for the external users needs, especially to fulfill the tax regulations, while they have not been used enough as help in decision making and management control, or they have not been used at all. For large businesses, Accounting Law predicted, besides already mentioned statements, an Annual report, Audit report, if the annual reports are subject to audit, Consolidating financial report if the entrepreneur has the obligation to write them. [8, 3]

Basic financial report is the Balance sheet and it shows the state of assets, liabilities and equity on a specific day. This is why it is often emphasised that the Balance sheet is static financial report which shows financial position, or financial strength of a business at a certain moment. [9, 54] The basic elements of a Balance sheet are assets, liabilities and equity, and they are connected through a basic balance equation: $assets = equity + liabilities$. A Profit and loss account shows flow of earnings and expenses and financial result through accounting period. [1, 48] By confronting earnings and expenses at the end of an accounting period a financial result is established. The result of business (profit/loss of period) is the basic link between Balance sheet and Profit and loss account. Profit and loss account is a dynamic financial report which indicates the business success in the observed period. [7, 54]

All financial reports must be observed linked to and dependent on each other, or the users of accounting information might get a wrong impression of the quality of business of a company. Financial reporting quality is positively related to investment efficiency for companies. It means that financial reporting quality would be less conducive to the mitigation of investments inefficiencies. Also, earlier studies shows that private firms have lower financial report quality, because of lower market demand for public information. Prior research also shows that financial reporting quality is lower in countries with low investor protection, bank-oriented financial systems, and stronger conformity between tax and financial reporting rules. Using firm-level data from the World Bank,

empirical evidence suggests that financial reporting quality positively affect investments efficiency, and the relation between reporting and investment efficiency is increasing in bank financing and decreasing in incentives to minimize earnings for tax purposes. [2, 1255]

Small and medium-sized enterprise financial liquidity is primarily maintained as a hedge against the risk of losing the ability to regulate the full amount of the current commitments in the required period. The potential increase in the risk of loss of financial liquidity, and by the loss of a positive image in business partner's eyes, result in the higher interest cost of capital financing for those enterprises and works to reduce the efficiency of the enterprise, this reduced efficiency is expressed in lower forecasted growth of enterprises value. [6, 1]

Good understanding of financial reports is the foundation for any business decision or management. It is expected that companies will invest a part of their profit in further operations. In accordance with the previously statements it will be further investigated the hypothesis through the relation of accounting profit and the investment expenses which represent the expansion of business.

1. Accounting profit

A Profit and loss account is a financial statement which shows revenues, expenses and financial business result incurred during a specific period of time. It records the success in running a business in terms of revenue, expenses and financial result. Revenue and expenses are registered on an occurrence basis and usually correspond to cash flow or money receipts and money expenditures. The revenues are a consequence of increased assets or decreased liabilities, while the expenses are a consequence of decreased assets and increased liabilities. Financial result occurs as a consequence of confronting revenue and expenses and, depending on stated revenues and expenses, it can develop profit or loss.

$$\text{REVENUE} < \text{EXPENSES} = \text{GROSS LOSS}$$

$$\text{REVENUE} > \text{EXPENSES} = \text{GROSS PROFIT}$$

The profit after taxes is the difference between gross profit and revenue taxes. A positive financial result increases equity, while a negative financial result decreases it. Financial result of a business represents a link between balance and Profit and Loss account. Starting from a hypothesis that each accounting profit, as a positive financial result of running a business, is invested in further development of the company, it is necessary to find out to what degree it influences the decisions of management of development and expanding the business, which is especially seen in investments expenses. [5, 28]

2. Analysis of financial statement of entrepreneurs in the Republic of Croatia

In the Republic of Croatia small businesses make 98,5% of total number of registered entrepreneurs, while middle-sized make 1,2%, and large businesses 0,3%. [3]

Table no. 1. The shares of the entrepreneurs sorted based on total financial results in 2014. year

Description	Small	Middle-sized	Large
	Share in %		
Number of entrepreneurs	98,5	1,2	0,3
Number of employees	50,9	17,5	31,6
Total revenue	34,9	18,2	47,0
Total expenses	35,0	19,0	46,1
Income tax	53,6	14,8	31,6
Profit for a period of time	40,5	15,4	44,1
Loss for the period of time	47,6	33,2	19,2
Consolidated financial result - profit or loss period	22,2	-30,5	108,4
Investments in new long-term assets	32,6	14,1	53,3
Average monthly net incomes - relation to the average of all entrepreneurs in Croatia in %	83,3	107,4	122,7

Source: Financial agency (FINA), Register of annual financial reports [3]

With regard to the significance of these companies in the total economy of the Republic of Croatia, further it will be shown the most important results of business running of entrepreneurs, depending on the size of the company. What is analysed are the financial reports of small, middle-sized and large entrepreneurs formed based on Croatian standards for financial reports for two years, 2013 and 2014.

Sources of information used in the stated analysis are taken from the data base of Financial agency and then additionally structured for the purpose of this work.

In 2014. year, 104.470 entrepreneurs (small, middle-sized and large companies) were doing business and had income of 619,8 billions kuna or 3,3% more than in 2013, and expenses were 604,9 billion kuna or 3,3% more than in 2013. year. As seen from the data in table 2., the increase in income at the rate higher than the increase of total expenses is evident which had a favourable effect on the result of the period. At the same time on the global scale, there was a profit after taxes of 34,9 billion kuna, which is 17,4% more than in 2013.year, so the loss after taxes has been reduced for 2%. Investments in long-term assets were reduced for 7,1% in 2014. year in comparison to 2013. year, and from that it is evident that the increase in profit after tax does not necessarily mean increase in investments in long-term assets, like on of the forms of expansion. 8

Table no. 2. Financial results of entrepreneurs in 2013. and 2014. year

Description	2013.	2014.	Index 2014/2013
	Sum in mil. HRK		
Number of employees	815.496	830.116	101,8
Total revenue	599.136	618.791	103,3
Total expenses	591.215	604.884	102,3
Profit before taxes	33.896	39.147	115,5
Loss before taxes	25.974	25.240	97,2
Income tax	3.849	4.153	107,9
Profit for the period (after taxes)	29.737	34.904	117,4
Loss for the period (after taxes)	25.664	25.150	98,0
Consolidated financial loss	4.073	9.754	239,5
Investments in long-term assets	37.873	35.185	92,9
Average net income in HRK	4.819	4.878	101,2

Source: Financial agency (FINA), Register of annual financial reports [3]

By analysing the structure of total income of entrepreneurs who are taxpayers of the income tax, we can deduce that the most important is business income which make more than 96,3% of share in total income, while the rest are financial and additional income and profit shares of associated companies. In 2014. year, business income made 96,3% share in total income, financial was 3%, and additional 0,7%, while the share in profit from associated companies was less than 0,1%. In 2014. year the dominant share was from business income, which is a positive fact since it shows the moderation in business based on the activities entrepreneurs are dealing with.

Table no. 3. Structure of total income of Croatian entrepreneurs in 2013. and 2014. year

Type of income	2013.		2014.		Index 2014/2013
	Sum in mil. HRK	Structure in %	Sum in mil. HRK	Structure in %	
Business income	580.586	96,9	595.651	96,3	102,6
Financial income	14.902	2,5	18.528	3,0	124,3
Share in profit of associated companies	96	0,0	23	0,0	24,4
Additional-other income	3.553	0,6	4.589	0,7	129,1

Source: Financial agency (FINA), Register of annual financial reports [3]

Compared to 2013. year, in 2014. year business income increased for 2,6%, financial for 24,3%, and additional for 29,1%, while shares in profit reduced for 7,5%.

The structure of total expenses of entrepreneurs who have been taxpayers of the income tax in Croatia for the past ten years shows that business expenses are the most significant ones and make from 92% to almost 96% in total expenses, while the rest are financial and additional expenses and shares in losses from associated companies. The same was in 2014. year, when business expenses prevailed with 94,6%, financial expenses with 5,0%, additional expenses with 0,4% and shares in loss from associated companies with less than 0,1% of total expenses.

Table no. 4. Structure of total expenses of Croatian entrepreneurs in 2013. and 2014. year

Type of income	2013.		2014.		Index 2014/2013
	Sum in mil. HRK	Structure in %	Sum in mil. HRK	Structure in %	
Business expenses	563.030	95,2	572.291	94,6	101,6
Financial expenses	26.016	4,4	30.191	5,0	116,0
Share in loss of associated companies	20	0,0	28	0,0	140,0
Additional-other expenses	2.149	0,4	2.373	0,4	110,4

Source: Financial agency (FINA), Register of annual financial reports [3]

Compared to 2013. year, in 2014. year the business expenses grew for 1,6%, financial expenses for 16%, additional for 10,4%, while the share in loss from associated entrepreneurs grew for 40%.

Analysis of business results of entrepreneurs in Croatia comprises also the review of data of gross investments which include investments in short-term assets, and resources and investments in new long-term assets.

The analysis of investments in short-term assets is the analysis of inventory. According to the data from annual financial reports it is evident that total inventory at the end of 2014. year was 94,2 billion kuna, which is 0,2% less than at the end of 2013. year. This is the result of the decrease in finished goods for 4,2%, and work-in-progress for 8,9%. In the structure of total inventory at the end of 2014. Year, like in all the previous years, the biggest share has merchandise goods with 37,6% of total inventory, followed by work-in-progress with 22,9%, raw material and material with 16,3%, finished goods with 13,7%, long-term assets held for sale with 6,6% of share, biological asset with 1,5%, advances for purchase of inventory with 1,4% share in total inventory of Croatian entrepreneurs.

Table no. 5. State of inventory of Croatian entrepreneurs

Type of inventory	2013.		2014.		Index 2014/2013
	Sum in mil. HRK	Structure in %	Sum in mil. HRK	Structure in %	
Raw materials and materials	15.273	16,2	15.402	16,3	100,8
Work-in-progress	23.667	25,1	21.565	22,9	91,1
Finished goods	13.445	14,2	12.885	13,7	95,8
Merchandise inventory	33.282	35,3	35.416	37,6	106,4
Advances for inventory	1.270	1,3	1.349	1,4	106,3
Long-term assets held for sale	6.211	6,6	6.242	6,6	100,5
Biological assets	1.249	1,3	1.378	1,5	110,3
Total inventory	94.398	100,00	94.237	100,00	99,8

Source: Financial agency (FINA), Register of annual financial reports [3]

In business process it is crucial, besides continuous investing in short-term assets, to invest occasionally in long-term assets. Investments in long-term assets are the a precondition for future production, like a substitute for the current long-term assets to maintain the production on the existing level, but also as an investment in an increased production capacities.

Table no. 6. Investments of Croatian entrepreneurs in new long-term assets in 2013. and 2014. year

Description	2013	2014	Index 2014/2013
	In mil. HRK		
Investments in new long-term assets	37.489	35.185	93,85
Number of investors	19.956	20.493	102,69
Share of number of investors in total number of entrepreneurs in %	19,7	19,6	99,49

Source: Financial agency (FINA), Register of annual financial reports [3]

In 2014. year entrepreneurs invested 6,15% less than in 2013. year, although the number of investors increased for 2,69%.

At the end of 2014. year, the entrepreneurs in Croatia had the total assets of 1,073 billion HRK. In the structure of assets the biggest share of 65,5% have long-term assets, followed by short-term assets at 33,3%, paid expenses of the future period and calculated income at 1,2% and demand for issued but not yet paid equity at less than 0,1% share.

In the structure of the source of funds the biggest share of 34,9% goes to equity and reserves, 32,1% to short-term liabilities, while 27,5% goes to long-term liabilities. All other sources of assets comprise 5% share. Compared to the state of funds at the end of 2013. year, the growth of long-term and short-term assets was almost aligned so the structure in relation to the compared state remained almost unchanged, but still relatively unfavourable, as the share of long-term assets is too big.

Table no. 7. Assets of Croatian entrepreneurs at the end of 2014. year

Assets	State 31. December			Structure in %	
	2013	2014	Index	2013	2014
	In mil. HRK				
Demand for issued but not yet paid equity	130	112	85,6	0,0	0,0
Long-term assets	688.466	702.903	102,1	65,9	65,5
Shortterm assets	347.486	357.462	102,9	33,3	33,3
Paid expenses for future period and calculated income	8.766	12.431	141,8	0,8	1,2
Total assets	1.044.848	1.072.907	102,7	100,0	100,0

Source: Financial agency (FINA), Register of annual financial reports [3]

At the of 2014. year the assets of entrepreneurs of 1.073 billion HRK had its sources in proper equity and reserves of 374,4 billion HRK (share of 34,9%), in long-term liabilities 294,7 billion HRK (27,5%), in short-term liabilities 344,5 billion HRK (32,1%), in postponed payments of expenses 45,8 billion HRK (4,3%) and in reserves 13,5 billion HRK (1,3%). Unfavourable structure of assets is followed by unfavourable structure of equity and liabilities which, at the end of 2014. year, is characterised by the prevalence of external funds (long-term and short-term liabilities) over proper funds (equity and reserves). The share of equity and reserves in total sources was 34,9% (at the end of 2013. year it was 35,1%), so less than the long-term and short-term liabilities of 59,6% (59,7% at the end of 2013. year). [3]

Table no. 8. Equity and liabilities of Croatian entrepreneurs at the end of 2014. year

Equity and liabilities	State 31. December			Structure in %	
	2013	2014	Index	2013	2014
	In mil. HRK				
Equity and reserves	366.423	374.351	102,2	35,1	34,9
Reservations	13.039	13.522	103,7	1,2	1,3
Long-term liabilities	282.976	294.716	104,1	27,1	27,5
Short-term liabilities	341.029	344.476	101,0	32,6	32,1
Postponed payment of expenses and income of future period	41.381	45.842	110,8	4,0	4,3
Total liabilities	1.044.848	1.072.907	102,7	100,0	100,0

Source: Financial agency (FINA), Register of annual financial reports [3]

3. Indicator of business success illustrated with an entrepreneur

It will be shown how an accounting profit as a determinant of expansion of business influences financial expenses and debts by giving the example of four entrepreneurs. They have all made profit from business and are using proper and external sources of financing as sources of assets.

Table no. 9. Data from balance and profit and loss calculation of entrepreneur A, B, C and D

Position of balance and profit and loss calculation	Company A	Company B	Company C	Company D
Total liabilities	706.681	5.383.905	1.548.098	25.731.383
Total asset	6.369.732	11.261.646	6.164.509	37.138.708
Capital	5.663.051	5.877.741	4.616.411	11.407.325
Long-term assets	1.479.337	2.971.484	670.684	21.425.552
Long-term liabilities	0	0	74.654	8.151.076
Short-term liabilities	706.681	5.383.905	1.473.444	17.580.307
Expenses of financing - interest	8.490	112.161	32.996	424.796
Profit before taxes	1.417.774	2.021.929	186.416	844.362
Amortization	609.209	339.693	363.525	2.112.062

Source: Financial agency (FINA), Register of annual financial reports [3]

Based on data from balance and profit and loss calculation we obtained the calculation of financial indicators of debt as in Table 10.

Table no. 10. Financial indicator of companies A, B, C and D

Financial indicator	Company A	Company B	Company C	Company D
Coefficient of debt	0,11	0,48	0,25	0,69
Coefficient of proper financing	0,89	0,52	0,75	0,31
Coefficient of financing	0,12	0,92	0,34	2,26
Factor of debt	0,20	1,17	0,46	2,25
Level of coverage I	3,83	1,98	6,88	0,53
Level of coverage II	3,83	1,98	6,99	0,91
Interest cover expenses	168,00	19,03	6,65	2,99

Source: Authors calculations

Analysing the results of financial indicators from Table 10., it can be concluded that the coefficient of debt is satisfactory in case of companies A, B and C, because it is less than 50%, while the coefficient of debt in company D is 69%, which means that over 50% of assets is funded from external sources, which is why the financing expenses are the highest in company D. Consistently, the coefficient of private financing in company D is less than 50%, it is 32%, while the companies A, B and C have it over 50%, meaning their financing is mainly from private sources. The coefficient of financing is satisfactory in companies A, B and C, since it is less than 1, while in company D it is 2,26, which confirms the fact that total liabilities are funded from external sources, and not from the capital. The company D has the highest debt factor, and it shows that the coverage of debt would take over two years. Level of coverage I and level of coverage II is also satisfactory in companies A, B and C, it is over 1, while company D has it lower than 1, meaning long-term assets are not covered from long-term sources. Interest cover expenses shows that company D finances most of its business through interest, since interest expenses can be covered from profit only about three times, while companies A, B and C finance most of their business from private sources.

Conclusions

Effecting accounting profit does not necessarily mean the development of business, and the investment of that profit in increasing long-term assets, or the long-term sources of financing. When we discuss long-term sources of financing we primarily mean debts with banks or any other business subjects, which would increase the expenses of financing. The examples of companies A, B, C and D evidently show that companies which achieved greater financial profit in uncertain circumstances of running a business in the Republic of Croatia would rather reach for private sources of funding. On the state level the financing expenses grew in year 2014. in comparison to year 2013., while the investment in long-term assets decreased. In parallel, the short-term assets grew, just like goods, raw materials and materials, meaning that the expenses of financing are focused on short-term assets, or basic investments. This all shows unfavourable trends, as the long-term assets should be financed from long-term sources, and short-term assets from short-term sources. The fall in entrepreneur's investments is one of the reasons for the fall of economic activities, since the demand for investments and private consumption have been the main generators of economic growth in the past years, based on consumption greater than production which, year after year, increases external debt of the state.

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