THE COMPANY'S PERFORMANCE EVALUATION USING THE PROFITABILITY RATE

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Abstract: What is financial statement analysis? The analysis of financial statements means different things to different people, depending on their particular interests. Creditors, current and prospective investors, and the corporation's own management look at different parts of the analysis to find the answers to the questions that are of greatest concern to them.
If you look at a balance sheet or income statements, how would you decide if the company was doing well or badly? Financial statements analysis attempts to answer the following basic questions: How well is the business doing? What are its strengths? What are its weaknesses?
This article presents various financial statement analysis tools that are useful in evaluating the company's current and future financial condition. These techniques include horizontal, vertical, and ratio analysis, which provide relative measures of the performance and financial health of the company.

Each firm must provide information about its activity because there are different groups of people who are interested in such information on its financial statements. We should get an idea about the categories of persons who need information about the company. In addition, we should know what type of information would each category want. Therefore, next, we will try to present the people who might be interested in the information provided by the financial statements of the companies. There is a long list[1] of accounting information users, and their expectations from accounting are quite different.
The firm managers are those persons put in charge by the business owners to supervise the daily activity. They need information both about the current financial situation and the forecasts for the following period. This can help them to run the business as efficiently as possible and to carry out an effective control over the company, in order to make the best decisions.
The shareholders (the investors), such as the business owners, will want to evaluate the management performance of the team they've hired. They will want to know how profitable managers' activity is, and how much profit they can afford to withdraw from the firm at any time. Also, they need information, in order to decide whether it is worth to retain the shares in this company or to sell them.
The trading partners including the company's goods suppliers and the customers who purchase the firm's goods or services. *The suppliers* will want to know if the company can pay its obligations; *the customers* need to know if the company is a reliable source which can provide them their goods and if there is no danger of going into liquidation.
The company's funds suppliers may include the banks, which may enable the firm to work on bank overdraft, or the term funds suppliers by guaranteeing the loans. The banks want to assure themselves that the firms are able to pay their interests and to repay the amounts that they had borrowed.
The tax authorities will want to know information about the company's profits in order to evaluate the taxes owed by the company.
The employees will want to know information about the company's financial situation, because the raise, the increase of pensions and other benefits as well as their future careers depend on it.
The financial analysts and the spokespersons need information for their clients and for the

[1] Under the general framework of preparation and presentation of financial statements prepared by the IASB

public. For example, a broker needs information to inform his investor about the number and value of the shares, a credit agency will seek information to inform the company's potential goods suppliers, the journalists need to communicate information to the public.
The Government and its institutions are interested in resource allocation and hence the activity of the enterprises. They, also want to provide information to the statistical institutions.
The public. The enterprises influence the public in different ways. For example, firms may have a substantial contribution to the local economy, by providing labor and by signing contracts with the local suppliers. Another important factor is the company's effect on the environment, for example the pollution.
Although the financial statements may appear similar from country to country, there are some differences based on social, economic and legal factors, and the fact that some countries, in the moment when the national requirements were established, took into account the different needs of local users of the financial statements. Next, we will try to show which are the most important *factors* that influence the financial statements provided by accounting:
The national legislation. Companies are required by law to prepare and to publish annually the financial statements. Their form and content are elaborated firstly under national legislation, but most of them take into account the IAS and the IFRS.
The accounting principles and conventions. The financial statements prepared, are based on a number of fundamental accounting principles. The majority of the data from the financial statements derive from the implementation of these conventions.
It is clear that the different categories of people have different ways of thinking, which may lead to different conclusions. For example, we suppose that a firm which trains accountants has an excellent reputation among students and employees. How can we evaluate that? The company may have invested a little amount of money in tangible assets, possibly a building, offices and some computers. At a first glance of the balance sheet, we would think that the company's value is not too high, due to the relatively small size of its assets, but it has the potential to produce much more gains. This is the truth about a lot of service providing companies, where the most valuable asset is its employees.
While operating with the same type of data, different groups of people will obtain very different financial situations. If the thinking process is completely "free", any comparison between the accounts of the various organizations will disappear. This will be one of the most sensitive points, when there will be made a deliberate manipulation of information, in order to present the accounts in the most favorable light.
The accounting standards. In order to remove the subjectivity and to make available the comparisons between different companies, we have developed the accounting standards. These have developed both nationally (in most countries), and also internationally.
Other international influences. There are other international influences worth mentioning: The United Nations Commission. The United Nations have a commission which deals with the reporting of the transnational corporations, which holds information about the activity and the reporting of the multinational firms. This committee has a strong political focus and perhaps it reflects the attitude of the governments from the developed countries with multinational companies.
The European Commission, which has recognized the role of the IASB in harmonizing the regulations, the accounting standards and the procedures related to the financial statement presentation and has already appointed an investigation committee to discover the differences between the European rules (the guidelines) and international standards, in order to make a comparison between them.

Before IASB's existence there were frequently differences, both at the form and in the content, between the accounting standards published in each country. IASB studied the exposure projects or the already issued standards on each subject, and based on such knowledge it develops international accounting standards, in order to have a widespread acceptance. Behind this concept is the fact that one of the IASB's objectives is the „harmonization", as much as possible, of the various accounting standards and policies of various countries. Starting from this objective, the specialists in the field raise some questions: Are there advantages to global harmonization? What benefits will the companies have from it? Are there any barriers to this process? Which are these?

The benefits of harmonization are based on the benefits of those who prepare, interpret and use the financial statements as follows:

- investors, both individual consumers and corporations, will be able to compare the financial results with the ones of other national and international companies, to make the best investment decisions.
- multinationals can benefit from harmonization from several reasons, including:
  - they can gain a better access to foreign funds investments
  - the control management can improve, because the harmonization can help the internal communication regarding financial information
  - the evaluation of the foreign companies, if we want to buy them, will be much more documented
  - it will be much easier to subject to the reporting requirements of some stock exchanges worldwide
  - preparing the group accounts will be much easier
  - it can also mean a reduction of the audit costs
  - the transfer of the financial accounting personnel from one company to another can be carried out more easily.
- the governments of the developed countries can save time and money if they adopt the international standards and, if they are used internally as well, these governments can achieve a control on the foreign multinational firms in their countries.
- the tax authorities will be able to calculate, much easier, the taxes owed by the investors, including the multinational firms who obtain income from foreign sources.
- the major accounting firms will be able to conduct audits and to give accounting advice easier, if the accounting practices are similar worldwide.

Besides these obvious advantages, experts consider that there are some *barriers of the harmonization,* among which we mention:

- the differences between the legal systems. This can prevent a real development of the accounting policies and can restrict the options available.
- the various purposes pursued by the financial reporting. In some countries the only purpose is the calculation of the taxes owed to the state, while in other countries they are mainly addressed to the investors, in order to make the investment decisions.
- the different groups of users. Countries have different points of view regarding the relevant group of users and the importance assigned to each person. For example, in the U.S. The creditors group and investors group is predominant, while in Europe, they pay more attention to employee satisfaction.
- the countries' needs for development. The countries' development rate is usually behind the implementation of standards, so some of them need to develop first the basic accounting principles, which, in the developed countries has existed for a long time.

- nationalism is classified as an unjustified rejection of other countries' standards.
- certain features of the moment. Certain countries may face some less common situations, that mark the way in which the financial statements are prepared, such as hyperinflation, civil wars, some temporary restrictions, etc..
- the misfortune of not having a strong accounting professional body. Many countries do not have such a body which can put pressure on the internal authorities, to introduce standards and to achieve an international harmonization.

As noted, there are different groups of people who have different expectations from the financial statements. The creditors, the current and the future investors, and the company's management focus on different parts of the financial analysis to find out the answers to the questions, they are interested in.

The creditors are primarily interested in the company's ability to cope with its debts. The short-term creditors, such as good sellers or service providers are concerned about the business partner's ability to pay the bills in time and want to be sure of the partner's liquidity. The long-term creditors, such as banks or other credit institutions, are interested in the company's ability to pay the interest and to repay the loans in time.

The investors are interested in the current and the future earnings and risks (such as liquidity, debt). Investors evaluate the bond, based on a review of the financial statements of the company; they compare the way a bond is evalued in the financial statements, to its market value.

The management is focused on all the issues raised by the relationship with the creditors and the investors, and its obligation is to satisfy both of them, in order to obtain the capital necessary for its business.

A company's financial statements reflects its financial position at a moment in time and its work performance over a past period of time. The true value of the financial documents consists, however, of the fact that they can be used to predict the the company's future earnings and dividends that its shareholders can obtain. From an investor's point of view, predicting the future is the most important aspect of the financial analysis, while, from the management team's point of view, the financial statements analysis is useful both as a way to predict the future conditions and, more important as a starting point for planning the actions, that will influence the future actions.

The comparison of the financial data from two or more years is known as *the horizontal analysis*. The horizontal analysis helps us focus on following the trends of certain elements, in order to have an overview on the company, in its evolution over the years. The preparation of some, more complex financial statements is known as *the vertical analysis*, where each element of the financial statement is used as an evaluation basis, and all the other accounts which appear in the financial statement are compared to it.

The vertical and horizontal analysis compare one item with others from the same category. However, it is very important to compare items from different categories. This can be achieved through **the financial rates analysis**. We believe that an analysis of the financial rates of a company is, generally, the first step in a financial analysis. The rates are designed to highlight the links between the company's accounts. For example, the A company may have a 150.000.000 lei debt and 3.000.000 lei interest expenses, while the B company may have a 5.000.000.000 lei debt and 460.000.000 lei interest expenses. Question: which company is stronger? The true weight of these debts, as the firms ability to pay its debts can be analyzed by: a) comparing the debt of each company with the assets possessed by them, and b) comparing the interests that each company has to pay from its available income, from which the interests may be paid. Here's how we conclude that such comparisons can not be made without the financial rates analysis.

Next we will present how to calculate and how to interpret a series of financial rates, which are important for analyzing the financial health of an enterprise. We believe that it is useful, for starters, to classify the financial rates. Thus, scientists have identified six basic types of financial rates:

1. *Liquidity rates*, which measure the firm's ability to meet pay its short term obligations, with a low maturity.
2. *Debt management rates*, which explain to what extent, the company is financed by loans.
3. *Assets management rates*, which measures the firm's degree of effectiveness, while using its available assets.
4. *Profitability rates*, which measure the overall effectiveness of the management team, as evidenced by the revenues from sales and by the investments' rentability.
5. *Growth rates*, which measure the firm's ability to maintain its economic position, when the economy and the industry are in a period of expansion.
6. *Market value rates*, which measure the ability of the management team to create a market value that is higher than the business costs and investments.

These evaluation rates are, by far, the most complete measurements of performance, meaning that, they reflect the risk associated with the company (the first two rates), as well as the rentability rates (the next three rates). Moreover, these market value rates are of great importance because they related, directly, to the main objectives of any company, such as the maximization of the firm's value and of the shareholders' wealth.

The liquidity rates. Usually, a financial analyst's, first concern is the liquidity: will the company pay its obligations, that have the due date in the near future? Although a full liquidity analysis requires using the cash budgets, we believe that the analysis of the rates resulted from comparing the in-house money and other current assets with the current financial obligations, it can provide a quick and easy to use measure for liquidity. Next we will present two of the most used liquidity rates.

The current rate. The current rate (the current ratio) or the current liquidity can be calculated by dividing the current assets value to the current debts value. In the current assets, are usually included cash, highly liquid securities, receivable trade goods and stocks. In the current debts are included payable trade goods, short-term bank loans, the part of the long-term bank loan which expires within the time considered - ie currently, the payable income taxes and other liabilities, especially those with wages.

If a company is going through financial difficulties, it begins to pay its debts (payable trade goods) as late as possible, to acquire bank loans and so forth. If these current liabilities grow faster than the current assets, the current rate decreases, which may indicate a problem.

The current rate, in the experts' point of view, is the most common way used to estimate the liquidity of a company, because it indicates the extent to which the rights of the short-term creditors are fully covered by the value of the assets, which can be converted into cash during a period of time, which corresponds to the maturity period of the debts.

The current rate calculation is based on the following relationship:

The current rate = Current assets / Current debts

The quick rate (or ***the acid test***). The quick rate or the acid test is calculated by deducting the value of the stocks from the value of the current assets and dividing the obtained difference to value of the current debts. Stocks, are usually, the least liquid of all the components of the current assets of a company; the possible losses may appear, especially when we must liquidate these stocks. Therefore, this report is considered to be an acid test for measuring the firm's ability to pay its short term obligations.

The quick rate calculation is based on the following relationship:

The quick rate or the acid test = (Current assets – Socks) / Current debts
Besides these two rates, we can also use to measure a firm's liquidity **the net working capital**. The net working capital is calculated as the difference between the current assets and the current debts, according to the relationship:
The net working capital = Current assets - Current debts
The solvency rates. The solvency expresses a firm's ability to pay its long-term debts. The extent to which a company uses the financing credit – or ***the financial leverage*** - has important implications on its financial health. First of all, the creditors analyze the value of the equity, or the amount of funds brought in the business by its owners, to get an idea about the credit's safety. If the business owners bring to its funding only a small proportion of the total funding necessary, then the risks will be undertaken, primarily by the creditors. Secondly, by acquiring funds through loans, the business owners maintain control over the business, although they have invested a limited amount of funds in it. Thirdly, if the company, as a result of using funds from loans, earns more than the amount owed as interest, this surplus will increase the welfare of the owners. For example, if the assets used have a 10% rentability rate and the debt has a 8% rate, there is a 2% difference between these two rates, which flows to shareholders.
But the financial leverage has more other effects. If the assets' rentability rate decreases to 3%, the difference between it and the payable interest rate must be covered from the equity. In the first case mentioned, where the assets' rentability rate exceeds the payable interest rate, the outcome of the financial leverage is favorable for the company, however, in the second case, the result is negative.
The firms that have a lower financial leverage - ie a lower credit proportion in the liabilities' total - have a lower risk when the economy is in a recession, but equally, they get smaller profits in periods of economic boom. On the contrary, the companies that have a high financial leverage - ie a large credit proportion in the liabilities' total - are in danger of suffering substantial losses, but have also the chance to make larger profits as well. The prospects for higher profits are more attractive, but, we all know, that, investors do not like risks.
Therefore, the decisions regarding the use of the financial leverage must to be taken so that they can create a balance between the risks and the expected profits.
For the financial analysis in the debt management we will examine two of the most used rates, which are complementary and used by most of the analysts. Both of them use balance sheet rates to determine the extent to which the assets' funding was made through borrowed funds, and, moreover, both of them use rates based on the profit or loss account to determine how many times the value of the fixed costs (such as those with the interest payment) gets in the value of the operational profits.
The borrowing rate. The ratio between the total value of the debt and the total value of the assets, is known as the borrowing rate, and measures how much percent of the total funding comes from credit. The debt includes all the current liabilities and all the bonds. The creditors prefer lower borrowing rates, because the smaller this ratio is, the greater protection against possible losses suffered by creditors in the case of a bankruptcy, there is. Unlike the creditors desire for a reduced borrowing rate, the business owners could pursue a high financial leverage, either to increase their earnings or not to lose control over the company, if they are forced to issue new shares.
The borrowing rate calculation is based on the following relationship:
The borrowing rate = Total debts / Total assets
The interests coverage rate. This rate is calculated by dividing the value of the company's profits before paying the interests and taxes, to the value of the interest costs. This ratio defines the extent to which earnings can decrease without causing any financial

problems for the firm, as a result of the firm's incapacity to pay its annual interests. This may lead to several lawsuits, and a possible bankruptcy.
The interests coverage rate calculation is based on the following relationship:
The interests coverage rate = The profit before paying the interests and taxes / interest costs
Besides these two rates, we, also consider it necessary to introduce the so-called ***capital borrowing rate***, which shows the size of a firm's debt from the structure of its permanent capital. A large debt may mean that the company has to pay regularly large sums of money, which are the borrowed amount of money plus the interests. And it can mean a huge liquidity risk for the company, which can lead to major dysfunctions in time.
The interpretation of this rate depends on many variables, including the rates of other companies from the same industry, the ability to access loans and the stability of business.
The calculation relationship of this rate is:
The capital borrowing rate = Long-term total debs / permanent capital
Where:
Permanent capital = Total equity + long-term total debts
Although the analysis of the rates presented above, can provide us a reasonable picture of a firm's position, taken in comparison with the average from its industry, this picture is somewhat incomplete, because it does not takes into account the time factor. Here's how the analyzed financial rates are just distinct moments in the company's life; but there may be also trends, which can lead to the weakening of a position which, at the moment is good. **The trend analysis**, ie the financial analysis of these rates over several years may reveal that, a relatively weak position is in the process of improvement.
Next we will make a summary of the financial rates that have been presented above.

THE SUMMARY OF FINANCIAL RATES ANALISIS

The rate	The calculation relationship
The liquidity rates	
The current rate	Current assets / Current debts
The quick rate or the acid test	(Current assets – Socks) / Current debts
The solvency rates	
The borrowing rate	Total debts / Total assets
The interests coverage rate	The profit before paying the interests and taxes / interest costs
The capital borrowing rate	Long-term total debs / permanent capital

Although the financial rates analysis can provide useful information about the financial and operational conditions of a company, there is still some *problems and limitations* in this analysis, which must be taken into consideration very carefully. Some of the most common problems are listed below.
Using different operation and accounting methods, can lead to distorted comparisons. For example, stocks and depreciation methods can influence the financial documents submitted and thus lead to wrong results in the comparison.

Inflation distorts the balance sheets of firms, so profits suffer because of it. Therefore, a financial rates analysis for a firm, over the years, or a comparative analysis between companies with different "ages" must be treated very carefully.
Most of the companies aim to achieve some better performances than the industry's average, so that achieving the industry's average performance is not necessarily something good. For these firms it may be more relevant to comparison with the financial rates of that sector's financial leaders.
It is difficult to generalize when we estimate whether the value of some financial rates is good or bad. For example, a current financial rate with high value can indicate a very liquid position, which is a positive thing, but may also indicate the existence of some funds in excess, which is a negative thing, because the funds in a current bank account is an asset which brings no gain.
The financial analysis can be distorted by seasonal factors as well, and this problem can be solved if we refer to the annual averages of the elements such as stocks or receivable / payable trade goods).
Some financial rates may look good, while others may look bad. This way it becomes more difficult to judge whether the whole company has a strong position, or a weak one. We may, however, use statistical procedures, which can analyze the net effects of a particular group of financial rates. Many banks and other credit institutions use statistical methods to analyze the companies' financial rates and based on such analysis we can classify the companies by their likelihood of being found in situations of financial difficulty.
Conclusions. I presented in this article the most important financial rates that companies use when they want to communicate information about their financial status. This does not mean that this type of evaluation based on financial rates is enough, sometimes we need more. I tis necessary tol ook beyond these calculations to establish whether the status of a company is bad or good. It requires a deep knowledge of the main forms of risk: business risk, liquidity risk, termination of payment risk, market risk, interest rate risk, and finally, the appliance of an advanced form of the firm's economic analysis, and the discriminant analysis, which proposes mathematical models, predictive functions of a firm's bankruptcy.

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