

# COMPANY PERFORMANCE EVALUATION– GENERAL INFORMATION

EMILIA CLIPICI, MIHAELA GÂDOIU  
UNIVERSITATEA DIN PITEȘTI

emilia\_clipici@yahoo.com, mihaela\_gadoiu@yahoo.com

**Abstract:**

*The evaluation of the company performance represents an approach that requires careful analysis at the dual profitability – risk level, because, although the shareholders and managers of the company are certainly interested in the profitability of the company, more attention must be paid to the risks to which the company is exposed.*

**Key words:** *financial analysis, interim balances of administration, company performance, aggregation of the rate of returns*

**JEL classification:** *G00*

When we aim at evaluating the performance of a company, we look, in fact, for manners of measuring the economic and financial consequences of the decisions made by the company management, applied into operating, financing and investments activities. An important problem that must be solved by the financial analysis is related to the assessment of the company's efficiency in using its available resources, and of the extent to which the company profitability met the shareholders' expectations and of the prudence used for making financing decisions. The maximization of the company's value is indissolubly related to the positive results in all the above-mentioned areas<sup>1</sup>.

In relation to the analysis of a company's profitability, specialists unanimously agree that it plays an important role within the financial analysis. In fact, *the analysis of the company's profitability* represents a fundamental objective of the financial diagnosis, together with *the risk assessment and the measurement of the company value*, as the ratio between the profitability obtained and risk taken, which is made through *the market-to book- ratios*<sup>2</sup>.

Currently, the financial theory and practice use many indicators in order to evaluate a company's performance. It is important to note the fact that most of the instruments used are only relevant under certain specific and limitative conditions and that, generally, only a small part of them are truly useful to the financial analyst in his approach to assess the profitability of a company. It is also equally true that, given the advanced current computer technology level, many analysts are tempted to calculate a lot more indicators than necessary.

Before starting the company profitability analysis per se, we should first define the three following elements:

- The perspective from which the analysis is performed, which may be the company management's perspective, the point of view of its shareholders or its creditors;
- The specific objectives of the analysis;
- The potential standards used for comparison.

A relative measure of the economic efficiency of the company (a rate of return) is only relevant in relation to the chosen point of view and to the defined objectives. It is only under such circumstances that a rate of return can become a standard of

---

<sup>1</sup> See Helfert (2001), page 95.

<sup>2</sup> According to Stancu (2007), page 755.

comparison. Furthermore, as we will see hereunder, the rates of return of the company do not represent absolute evaluation criteria; they only supply valuable information when they are combined with other indicators that highlight changes in the company operating and financing conditions throughout several periods and as compared to other companies in the respective market.

From the perspective of a reliable analysis of the profitability of a company, we should remember the fact that the assessment of the company performance based on its financial statements uses data from the *past* with the help of which we intend to make estimates for the *future*, and this is not quite easy, because the conditions of the business environment in which the company operates are changing all the time. It is quite possible that, from one year to the next one, certain events unforeseen by the company occur and turn all its anticipations upside down. Even if the company's management makes decisions based on the company's past results, these decisions can only alter the future and this is why they must be analysed very carefully.

A delicate problem created by the analysis of the company performance is represented by the choice of the point of view of the analysis per se. There are many persons interested in the success (or failure) of business, who can be divided into two main categories: *internal groups and external groups*. The internal groups include the managers of the company, its owners, and its employees, and the external groups include the Government and its institution, the company's clients or customers and its suppliers, the potential investors, the creditors and others. In our opinion, from the above-mentioned, the most important categories are the company management, its shareholders and its creditors.

The management of a company manages the company's operations and is responsible for the efficient use of its available financial, technological or human resources, for the efficiency of its activity and for its current and long-term results. The analysis of the company's performance together with the other analytical elements of the financial assessment should be able to help the company's managers to anticipate the future conditions and especially to use them as a starting point for the development of the actions meant to optimize the future performance of the company.

The company's shareholders are especially interested in the current and the long-term return on the capital employed. The increase in the value of a company depends directly on its capacity to generate cash flows; consequently, it is only normal that shareholders should expect higher profits, cash flows and dividends contributing to the increase in the value of their property. At the same time, they are also affected by the way in which the profits of the company are distributed, and the financial analysis provides a reference for the anticipation of the future evolution of their company.

The creditors of the company, as fund suppliers, are directly interested in the profitability of the company and in its capacity to generate cash flows, because these elements have a direct influence on the liquidity and solvency of the company. We will see, in this chapter that the creditors of the company are more concerned with the structure of the company's financing and with the size of the financial lever, which allows them to assess the risk to which they are exposed by giving funds to the respective company.

Another important aspect, the performance of the company, is also a point of interest for other categories, such as its employees, who monitor the company's capacity to pay their wages and to provide for stable jobs, the suppliers of the company, who monitor the capacity of the company to pay its debts towards them, as well as to consolidate their business relations, and finally the Government bodies, who aim at obtaining the financial debts and the other claims they have in respect to the company.

The analysis of the interim balances of administration (accumulation margins) is an important step in the assessment of the company's performance on the three levels of

its activity: operation, financial, and extraordinary activity. The first interim balance of administration is the added value and constitutes an important indicator for the evaluation of the company's own contribution to the generation of its profit. The manufacturing companies, with substantial external costs, generate low added values, whilst service providing companies are clearly superior from this point of view. We identify, in this respect, a fundamental cause of the evolution of the shares issued by these categories of companies at the stock exchange: the higher the integration degree of a company, the lower the risk perceived by investors, because the company in question can ensure, all by itself, a higher number of phases of the production cycle, thus decreasing its dependence on its partners. Obviously, the stock exchange will provide advantages to these integrated companies to the detriment of those with low levels of integration, in relation to which a higher risk is perceived.

For the quantification of the operating performance, indicators such as the gross operating surplus or Earnings before Interest, Taxes, Depreciation, and Amortization (GOS sau EBITDA) and the result of the operation (EBIT - earnings before interest and taxes) are used, the latter being, in our opinion, the most relevant measure of the company performance, due to the fact that it reflects its economic efficiency in its core activities, i.e. manufacturing goods and/or providing services and the trading activity. Each of the two indicators have advantages and disadvantages: EBE has the advantage that it is not affected by the policy of the company on depreciations and provisions, and can be used at the same time as a basis for the comparison of various enterprises; on the other hand, EBIT takes into account the elements that have already been calculated (which can obviously have a significant influence on the perceived quality of the company profits). In some cases, the profit of the company has a significant accounting determination, which will generate distortions of the real image of the company's performance. A high variability of the above-mentioned indicators indicates a worrying situation, due to the fact that it generates reticence in the way investors perceive the company, which is reflected in the evolution of the market capitalization of the company. With the purpose of optimizing the financial analysis of the company, we recommend the use of the operating profitability together with the analysis of the situation of the main markets in which the company operates. The operating performance indicators may highlight some deficiencies at the level of the production and/or selling activity, which can be understood and eliminated only after a preliminary study of the mezo-economical situation and of the conditions of the demand and offer on the markets in which the company operates.

In its turn, the financial activity of the company may have a significant impact on its profitability. By a clever financial policy, due to which the maturity of financial investments are correlated with those of the due debts, and due to which the lowest financing costs are obtained, the company could have profits by which it could compensate the potential operating losses. However, it is obvious that the financial activity of the company must be planned very carefully, because it has considerable risks; the managers of companies with high performance may be tempted by investments with potentially high return, but with high associated risks as well, which could generate serious problems for the company in relation to the liquidity, and even to the solvability. This is why we recommend that a financial investment policy be developed with the purpose of ensuring the appropriate spreading of risks (and, in extenso, finding the optimum compromise between return and risk) and which may be based on good knowledge related to the situation of financial markets. At the same time, the financing decision should allow the company to obtain the lowest possible cost of the borrowed capital and a well-balanced structure of the borrowed capital in terms of exigibility.

We recommend that the financial result reported by the company be treated with reservations, with the purpose of optimizing the financial assessment of the company. Although the profit from the financial activity may have a significant impact on the profitability of the company, the basis of the company's incomes should be its operating activity, due to the fact that it includes the operations currently performed by the business entity with the purpose of obtaining profit. For this reason, we believe that a profit made from the corroboration of an operating loss with a significant profit from its financial activity has a lower quality as compared to the same profit resulted from a good operating profitability and a poorer financial result.

The last interim balance of administration, i.e. net profit, represents the most frequently used indicator (in absolute numbers) for the evaluation of the profitability of the company and at the same time constitutes the basic source of the company's self-financing capacity. The latter is an important indicator related to the company's ability to be financed from its own sources in the future and to increase its financial autonomy.

The evaluation of the performance of a company represents an approach that requires careful analysis at the dual return-risk level, because, although the company's shareholders and managers are undoubtedly interested in the profitability of the company, they should also pay increased attention to the risks to which the company is subjected.

## **BIBLIOGRAPHY**

1. \*\*\* – Order no. 3055/2009 of the Minister of Public Finance for the approval of Accounting Regulations in compliance with the European Directives, published in the Official Journal of Romania, Part I, no. 766 A from 10.11.2009
2. Dragotă, Victor (coord.) – “Management financiar, volumul II: politici financiare de întreprindere” (*Financial Management, Volume II: Company Financial Policies*), Economic Publishing House, Bucharest, 2002
3. Helfert, Erich – “Financial analysis tools and techniques – a guide for managers”, The McGraw-Hill Companies, 2001
4. Stancu, Ion – “Finanțe” (Finances), 4<sup>th</sup> edition, Economic Publishing House, Bucharest, 2007