Financial Performance – A Key Factor for Managerial Decisions

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Abstract. The study of economic performance has started by studying the economic efficiency, which treats analytically the links between costs, returns and risks for alternative ways of action proposed to achieve goals. Financial performance has a key-role in achieving performance by an enterprise and is based on a set of indicators that evaluates company's financial status. From these indicators may be identified factors that can be used to create a mathematical model for substantiation the managerial decisions.

Keywords: decision, financial balance, profitability, costs, risks.

1 Introduction

A high corporate financial performance determines the maximization of equity value or shareholder wealth, which leads to attracting new financial resources on the market. Thus, firms' financial performance is reflected in the evolution rate of the stock shares. The level of shareholder remuneration depends on degree of risk for which, in return, the market gives a rate of yield or profitability. The shareholder objective is to maximize the value of its securities, which depends on the economic characteristics of the enterprise, but also its ability to generate operating profit at least equal to the cost of financial resources employed.

Enterprise value can be assessed using specific criteria, such as: real estate and movable assets; a profitable activity; a loyal clientele, which is the basis for maintaining economic and financial performance in the future or a very good organization of work, qualified personnel, improved methods of work organization (Isfanescu, 2001). Thus, business evaluation requires a deep appreciation of enterprise performance and risks. The value to a business is given by its competitive situation, products and services quality, quality of management, staff competence and social climate.

Data on the quality and performance of operating activity shall be aggregated in useful measures that may be applied by top managers in strategic planning and decision making. Some companies develop an aggregate index of customer satisfaction by weighting the results of satisfaction, market division and customers' gains or losses.

However, mere aggregation of these data is not enough. Moreover, managers must to understand the links between quality and key measures of business performance. For example, a company must understand how the improvement of products and service quality is correlated to business indicators such as customer satisfaction, market division, operating costs, incomes and value added per employee, such employees satisfaction is linked to customers satisfaction and how solutions to these issues affect the costs and revenues (Evans, 1997).

The study of economic performance has started by studying the economic efficiency, which treats analytically the links between costs, returns and risks for alternative ways of action proposed to achieve goals. Universal principle for minimum action "desired effect with minimum effort" belonging to Maupertius lasted from the beginning of modern era and suggests one of the fundamental questions in effectiveness definition: "At what degree of concordance between result and purpose begins efficiency? (Andronic, 2000).

In the literature there are several definitions to economic efficiency: "maximum effect with minimum cost and in shortest time" (Strumlin), "degree of overlap the result actually obtained, with proposed effect" (V. Muresan), "is effective the action that ensures to achieve the goal in the minimum spending requirements" (T. Kotarbinski) or "the extent to which objectives and goals have been achieved" (P. Drucker), which gives a managerial approach to efficiency. Managerial performance is the point of confluence between results quality of managerial actions and goals quality of management system: to be effective means to do well what must be done.

V. Muresan enters the formula: Efficiency = Economy × Effectiveness. Each condition is necessary but not sufficient. Neither the wording "an activity is efficient if and only if it is economical and effective" is not fully adapted, because economic efficiency as the attribute of performance action of the company has two main antagonistic traits: cooperation and competition (Andronic, 2000).

Economic profitability is a quantitative indication of *managerial performance* and managerial performance (Table 1) means the conjugation of two factors: *effectiveness* (to do what must be done) and *efficiency* (to be productive).

Table 1. Du Pont factor

Financial indicator	Return on equity	Gross margin	Rotation rate of total assets
Significance in evaluation	***Managerial performance***	***Managerial efficacy***	***Managerial efficiency***
Factors definition	Quality of capital invested in the company	Management ability to achieve the proposed objective	Management ability to use resource better

Source: Pleter, O. T. (2005). Administrarea afacerilor. Bucharest. Cartea Universitara Publishing House.

Some authors define managerial effectiveness as improving revenue-cost relationship in the organization, reflected in increasing added value and profits.

Furthermore, performance can be defined as "a state of competitiveness of the company, reached by a level of efficiency and productivity that ensure a sustainable market presence" (Andronic, 2000). Thus, an efficient enterprise is and effective, and productive, these being effects or results. At the same time, effectiveness and productivity are the causes to performance. If effectiveness is understandable by the level of satisfaction of external demands (customers, state, suppliers, employees by motivating jobs and increasing job security), but also the internal (shareholder by value added market, economic value added), productivity is measurable by meeting the internal environment expectations of the company.

2 Background Literature on Enterprise Performance

An old and privileged theme of economic literature - the study of the relationship between enterprise performance and ownership - has its origins in the work of Berle and Means (1932) showing separation of ownership and decision-making. Most studies that comply with this sentence leads to superior performance for companies run by their owners, but often the difference is not statistically significant (Charreaux, 1997). Recognition of this separation has led to the development of enterprise management concepts by which drivers are prohibited from pursuing other goals than maximizing the market value of shareholders' wealth: Baumol (1959), Marris (1964), Williamson (1964), Galbraith (1967) and rise to a split in the relationship between the social function of private property and the optimal allocation of resources in the economy.

Traditional economic theory of managerial current argues that managers are subject to external or internal constraints which force them to drive in accordance with traditional objective. Lawriwsky's research (1980) starts from the initial management approach, but it substantially enhances by studying the efficiency and mode of action of the various constraints on the stock market (Charreaux, 1997). Also, he study the internal organization of the enterprise to which managers is subject. For Lawriwsky ownership unbundling and decision is not important.

Starting from these premises, Lawriwsky establish a distinction between managerial enterprises, private control enterprises and companies controlled by another company, each following a specific pattern of behaviour. Following tests on a sample of Australian companies, it was concluded that the internal organization and external constraints are important determinants of firm performance and that the distinction between types of property is relevant only insofar as it is associated with a particular set of incentive and constraints that bear upon managers.

In current literature there are three seemingly contradictory main views on the link between performance and ownership: the thesis of interests' convergence, thesis of neutrality and, ultimately, the roots thesis. After the first thesis, supported initially by Berle and Means (1932) and resumed especially by Jensen and Meckling (1976), as the share capital held by managers is more important than is more reporting to the traditional objective of maximizing value. Neutrality thesis in its purest form is that of Demsetz (1983), after which the ownership structure of capital is an endogenous response of the process of profit maximizing, depending on the operating characteristics of the company and pressure from the external environment, i.e., separation of ownership-decision leads to a drop of managers rights and there is no reason to believe that a company whose capital is wholly owned by its manager is better than a company whose capital is diffuse. Finally, the roots thesis argue, contrary, that managers who have most control beyond the capital, out of control the company and may also result in a spirit contrary to maximize value.

The organizations theory presented by Fama and Jensen (1983) consider organizations as a set of contracts and are based on the principle of natural selection, whereby long-lasting business are effective (Charreaux, 1997). Moreover, firms that survive are deemed to be those which enable to minimize agent costs associated with agent relation that establish the link between shareholders and managers, but also between all contractual relationships involved in the organization. Analysis of the arbitrations between advantages and disadvantages related to the separation of ownership and decision, have led Fama and Jensen to the enunciation of two fundamental results:

- separation of ownership and decision-making leads to separation of decision and control, i.e., for an enterprise to be viable, if managers are not owners, should have an independent body supervising managers;
- centralization of decision-making and control in the hands of a limited number of agents leads to concentration of ownership titles to these agents. There is normally separation of decision-control in opened businesses with a strong diffusion of securities and concentration in closed businesses with a weak diffusion.

Fama and Jensen's theory is interesting in that it proposes a typology of organizations and explains the origin and coexistence of different organizational forms, based on an interactive view of the firms behavior. Contracts that define the performance of these functions of ownership, decision-making and control evolves depending on the environment, the nature of work and organizational complexity. The structure of an organization is an equilibrium resulting from competitive pressures exerted on various foreign markets and domestic arrangements. This balance evolves according to changes in the market, but also with variations occurring in the legal, economic and technological. Fama and Jensen's thesis is confirmed therefore that of neutrality, however, but not excluding the existence of adjustment costs to the different structures of property-decision.

Fama and Jensen's analysis is still incomplete since it does not take into account only two extreme organizational forms, organizations with separation between ownership-decision (managerial companies) and organizations without separation property-decision (family businesses). In fact, empirical analysis of the agency relationship between shareholders and managers allow to identify a third category (already specified by Lawriwsky and recovered from Holderness and Sheehan), that of controlled companies, as highlighted by Charreaux and Pitol-Belin (1985). In this case, there is a separation of ownership-decision in the strict sense, since appointed managers are not personal owners of the capital and an agent relationship exists. Conversely, in the broad sense, taking into account the dependence of managers across the major shareholders, separation of property-decision is much less pronounced. The relevance of this typology is found to be established empirically.

This typology was used to study the influence of ownership structure on performance. It is more coherent, in terms of agent theory, to start with a typology based on the core element of the theory, that is agency relationship between managers and shareholders, rather than we focus the analyze on the share capital held by managers (or the Board of Directors), as do for example Morck, Shleifer and Vishny (1988).

Otherwise, this problematic allows avoiding consideration of the overall ownership structure-performance relationship as do Demsetz and Lehn. Finally, it allows considering other organizational elements, other than just the share capital held by managers or diffusion of capital, such as organizational management within the agency relationship between shareholders and managers on performance.

Demsetz and Lehn (1985) rejected any link between performance and ownership studying the relationship between accounting rate of return on equity and rate of concentration of capital held by major shareholders. This result confirms the neutrality thesis supported by Demsetz (1983), but this test and this conclusion have been criticized by Morck, Shleifer and Vishny (1988). The latter, making use of the Tobin's Q test as an indicator of performance, have identified a nonlinear relationship between performance and the share capital held by the Board of Directors, assumed to represent the capital owned by managers. Starting from an empirical study they conclude that depending on the area which lies to the share capital held by the Board, the effect of convergence of interests reflects the effect of roots and vice versa.

Finally, Holderness and Sheehan (1988) also using Tobin's Q test and the accounting return on equity, they find no significant difference in performance between enterprises with diffuse capital and those whose capital is owned by a majority shareholder. A distinction is made between companies in which majority shareholder is another company and those in which the majority shareholder is the manager, reveals the inferior performance of the latter, but insignificantly. Rooting hypothesis will therefore be rejected.

Most previous empirical studies are objectionable on two fundamental points:

- a concept of performance indicated inadequate theoretically, in which the measure is inadequate, especially for studies that relied only on accounting criteria;

- a problematic link between ownership and decision structures, on the one hand and performance on the other hand, which is in the most part insufficient depth.

Performance considered in terms of shareholders lead to organizational structures in favor of neutrality thesis. In contrast, the performance assessed in a wider angle of enterprise value corroborates the interests' convergence thesis. The divergence between the two critics confirms the important role of financing decision, as a means of managing the agency relationship between shareholders and managers.

On the other hand, empirical investigation of the relationship between ownership and control structures (Keasey et al., 1997), in terms of ownership structure and firm performance attempts, in particular, to test propositions of managerial or agent theory that advances the idea that different structures of ownership or control resulting in different performance (Short, 1994). It also assumes that if some shareholders act as monitors of managerial behaviour, performance will be improved to the companies that are not made to control managers.

3 Factors Affecting Business Performance

Studies on the relationship between ownership structure and performance have led to a large variety of performance indicators and finally to a greater confusion even about the concept of the performance. Studying the literature we concluded that the main factors affecting the company's performance are: the institutional framework, measures taken in the enterprise by employees and managers, cost and price.

Related to institutional framework, it is considered that if companies carry out non-productive activities, means that institutional constraints have provided a stimulating framework for such activities. Third World countries are poor because the institutional constraints define a set of inputs for the political/economic activities that not encourage productive activity. In socialist economies, the institutional foundation is appreciated the source of their current low performance and they are trying to fight on this way to restructure the institutional framework in order to redirect incentive measures so to lead businesses to increase productivity.

For developed countries it is not necessary to appreciate the importance given to the whole institutional framework, which was responsible for economic growth and led to performance in general, not just in certain sectors of the economy (North, 1990). Also, North (1990) considers that the structure of the tax system, regulations, judicial decisions and law statute are few formal constraints accompanying policy of companies and targeting specific aspects of economic performance.

Secondly, the company's performance is determined by measures taken by employees and managers. They should not cancel each other or lead to an overdose of actions. For this reason it is necessary to identify "critical measures" to help the other goals of the organization and that are fully compatible with the vision and business strategy. The essential conclusion is therefore to choose a small number of measures which we will publish and analyse, and we can be sure that we will lead to exceptional performance.

A crucial element in applying the effective performance measures is to ensure that there is a "repressive culture" in the enterprise. We start from the idea that the measure is to understand the problems of later trials, and then all attention centred on processes.

Performance measurement system had to support improvements in relevant fields. To do this, the company must determine its key objectives, communicate these goals to business staff and ultimately to develop measures for achieving performance in each task. These measures must announce how each activity contributes to global mission (Fahy et al., 2004).

Most companies focus on their financial measures (Clarke et al., 2004): turnover, costs, gross and net margins, working capital, liquidity and earnings per share. They are decisive indicators, key measures for external partners: investors, bank and suppliers. They allow comparison with other companies that have the same activity in the industry. In short, it is a good way to assess their performance on the market.

What is really fascinating in the "central" operational measures is that some of them have direct links with financial measures. They are true radar that helps to management team pilotage and of the overall company. This radar provides clarification on daily, weekly and monthly product quality, and how performance is directly related to operational and financial results, forecast future results.

Central operational measures can be connected with all financial indicators of a business. The following matrix shows direct links (Figure 1). Each central measure has a direct impact on the several financial factors - turnover, costs, working capital and investment. A performance improvement in any of these sectors will lead to financial improvement, provided that the lack of consistency measures does not lead to a deterioration of performance in another sector.

The key feature of this matrix is that the measures taken by the enterprise have an impact on operational processes. The items you usually measured in an array of performance based on financial measures (profit, turnover, stock levels etc.) are actually the results.

Figure 1. Influences between operational measures and financial results

Capital employed					√	√	√	√
Operational results	√	√	√	√	√			
Accounts Measure	Turnover	Procureme nt cost	Direct costs	Indirect costs	Depreciatio n	Customer accounts	Stocks	Suppliers accounts
Accuracy of demand	√				√		√	
Services to customers	√					√	√	
Reducing delays	√			√			√	
VAT rate	√						√	
Bonus for first attempt	√	√	√	√	√	√	√	
Compliance schedules		√	√	√			√	√
Launch on time	√			√			√	√

Source: Clarke, R., Crapart, P., Langa, G., Watkins, R. (2004). 7 mesures de performances. Pilotage et avenir de l`entreprise, Anfor.

A basic principle of Clarke's (2004) approach is that measure of financial performance not assists in understanding their use. In other words, financial measures are not able to give us information on their profound effects.

Thirdly, the joint influence of costs and prices on company profits, as a representative indicator of the performance varies depending on objectives of the pricing policy of firm and methods underlying the price based on cost (Andronic, 2000).

Businesses that are characterized by a high proportion of fixed costs, considers being vital to establish that price level to allow maximum use of capacities. If in the total cost structure, variable costs have a higher percentage, the objectives of price policy will follow to fixing that level of price enabling to maximize the contribution of each product to margin on variable costs. Cost is an endogenous factor, an element of price policy, perceived in permanent change in the indirect action of the market, often guiding the competitive struggle for the price level to the cost level.

4 Indicators of measurement and analyse of the financial performance

Analysis of company financial performance is based on three sets of indicators resulting from balance sheet analysis, analysis based on the profit and loss account and analysis based on the rates.

Since the balance sheet presents a series of distortions introduced by the application of accounting principles for a meaningful financial analysis are used two financial instruments: the financial balance and functional balance, both used to determine financial stability indicators.

Financial balance is achieved when the working capital is greater than the need of working capital, resulting positive net treasury. It follows that the main condition for financial equilibrium is financing of temporary needs renewable in successive operating cycles of the sources of permanent capital. *Working capital* is the effect of arbitrage between long-term financing and short-term financing. *The need for working capital* expresses the temporary needs of financing renewable permanent, and remaining uncovered by temporary sources and renewable in the same cycles of operation. This part left uncovered had to be equal or lower than working capital. Otherwise, the inefficiency of current activity can lead to financial imbalances involving risks to profitability of the future exercises and the integrity of equity. The need of working capital size is directly proportional with turnover.

The positive net treasury is the most eloquent illustration of the enterprise efficiency, the clearest expression of the enterprise to achieve financial balance. The existence of a net treasury positive reflects a cash surplus, found in the liability as net profit and a negative treasury reflects a financial imbalance, a financing gap that had to be covered on the new operating debt - discount loans or cash loans .

The increase in net treasury during the year represents the *net cash flow*, equal with the net profits and accumulated depreciation, representing the actual money opportunities for enterprise development. It expresses the increase in self-financing capacity and raising of the real asset, so the wealth of shareholders.

The Profit and loss account highlights the best known indicator of the company’s performance – *the profit*. “The profit is a consequence of risk”, a reward you can receive for risking the company’s capital. The main sources of the profits are considered: the uncertainty and innovation, both having in common the presence of entrepreneurship.

In the literature, it speaks about *super-profit*, which can be: innovation excessive profit (which comes from all economic and non-economic fields as effects of innovation: increasing production, reducing costs, improving products quality, acquisition of new products, etc.) excessive profit from initiatives with high risk based on a best estimate of it, excessive profits from the initiative in choosing more favorable natural conditions and position, excessive profits in the sphere of production and sales, excessive profits of initiatives to choose efficient capital loans, excessive profits as goodwill (Andronic, 2000).

Although performance of an enterprise has a multidimensional character, it is most often expressed and understood by financial indicators. In essence, analyze of the results account has as objective the appreciation of the company's strategic position, which directly determine the size of results and profitability. Thus, we can estimate that a company without a strategic force, sooner or later, will have weak or negative results, while a company that has an appropriate strategy will be more profitable than other companies in its sector of activity.

The appreciation of financial performance is based mainly on profit and loss account, on analysis of *interim management balances*. *Commercial margin* determines the commercial business performance or, in the case of non-commercial companies, the performance of trade activity. The margin measures the surplus of value obtained over the cost of goods sold and reflects the company positioning on the market taking into account: the type of product, type of distribution, sale price formation and intensity of competition. *Exercise production* measures the results of the production during the year. Value added allows the appreciation of enterprise contribution to increasing the national wealth and remunerates: the employees, the state, loan capital, technical and internal capital. Value added reflects the degree and means of integration the production as well as efficiency of production organization, shows how to finance the activities, particularly the use of loan capital.

Gross operating surplus measures the industrial and commercial effectiveness of enterprise and reflects the economic result released as a result of exploitation of production potential. This indicator is independent of firm financing policy, investment policy, provisions policy and hedging as well as extraordinary operations. Gross operating surplus allow generating a treasury needed for: financing of investments, borrowings, foreign equity compensation, equity compensation, maintaining the machinery and corporate income tax payment (Barbuta-Misu, 2009b).

Self-financing capacity is the prime source of financing the enterprise development. It includes both short-term resources that are not available for structural funding and sustainable resource that can be made available to repay loans, financing investment and current activities by increasing the working capital. Only a part of this monetary surplus will be affected for financing enterprise development. Thus, self-financing activity means the financial resources released by activity to finance future growth.

Also, the profit and loss account highlights the company's results. *Operating result* determines the industrial and commercial effectiveness of enterprise without the influence of structure and financial policy or exceptional items. Operating results measure the impact of investment policy and their dynamics in relation to the sectoral rules, taking account of the balance sheet structure.

Current result before tax measure overall operating results released by the company's financial policy. The *extraordinary result* corresponds to variations of enterprise wealth caused by exceptional factors. *Net result* represents the synthesis of industrial, financial and extraordinary operations. The net result takes into account the negative incidence of income tax and participation of employee to profit.

Undoubtedly, a good performance is to obtain profit, to maintain its position on competitive market, the wealth of the company to have an upward trend both in real form and in exchange quotation. Of the performance indicators that prints the state of financial balance and enabling business analysis and diagnosis is detached: profitability, liquidity, solvency and indebtedness.

Profitability is one of the synthetic forms of expression the efficiency of the entire economic-financial activity, respectively of all means of production and labour used in all stages of the economic cycle: purchasing, production and sales (Robu and Georgescu). The profitability increase reflected in obtaining additional profits has positively impact on funding investment projects and remuneration of production factors.

In practice, analysis and measurement of profitability must be limited to the calculation of some relevant rates, determined as the ratio between economic and financial effects obtained (the result of exploitation, gross operating surplus, net profit, self-financing capacity, dividends, etc.) and efforts to their production (turnover, total or economic asset, equity, etc.) depending on the profitability size that you want to be explored: financial, economic or commercial profitability (Stancu, 2002).

The profitability of an enterprise is influenced by profit tax and non-deductible expenses as the increase in non-deductible expenses lead to increase in total expenses, to reduce profit and hence the decrease in profitability since it does not benefit by the tax economy by lowering profit, deductible expenses decreasing only the accounting profit not on those taxable (Tatu, 2004). Rates of return highlight the economic and financial characteristics of firms, allowing comparison of their industrial and commercial performance.

Liquidity ratios measure the company's ability to pay that is short-term solvency. At any time, a financial manager's first concern is liquidity: will be able the company to honour their obligations with due date in the near future? In this regard, the analysis of rates results by comparing of all potential liquidity with potential chargeability is a quick and easy to use for assessing the degree to which the company copes with short-term obligations. However, characterizing the company's ability to pay, the liquidity rates illustrate the company's availability to access on cash loans.

The degree of debt as a ratio between debt and equity is the best appreciated when the rate is up to 60% for general indebtedness and up to 30% for financial leverage. To be considered satisfactory, these rates should have values between 60-100% (for general rate) and 30-70% (for financial leverage).

However, by analyzing these rates is characterized the situation of borrowing in relation to enterprise resources and sources of funding from its own activity. These sources are in fact the company's financial results, of which it can repay its debts (R. Stroe).

The analysis and measurement of financial performance with multivariate analysis, at company level, conducted on the conclusions drawn from interviews with key personnel of the enterprise as well as tests on the evolution of the industry and economic climate, underlying the practical application of forecasting methods that consisting in drawing of the general budget of the company, of the pro-forma profit and loss account and pro-forma balance sheet (Mazurencu-Marinescu and James, 2004).

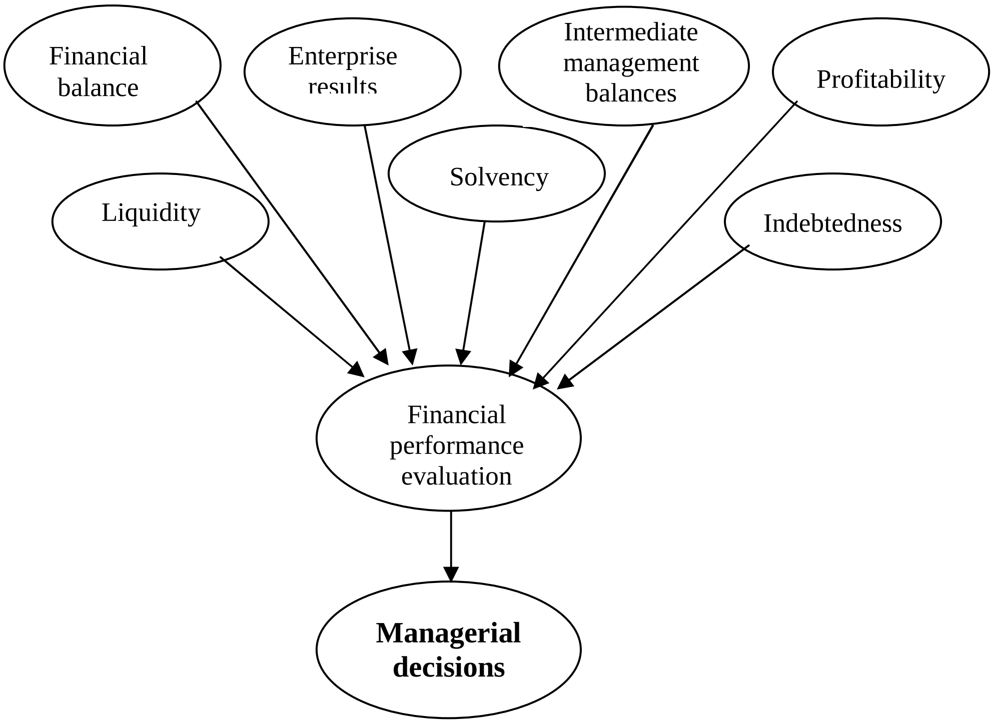

Figure 2. Financial indicators used in the substantiation of managerial decisions

Based on the indicators reviewed we propose variables that should be included in a model for predicting the financial performance of the enterprise. The indicators are shown in the Figure 2. After pooling of data from a sample of companies, it can crystallize the factors that have the most influence on financial performance and may be created a mathematical model for substantiation the managerial decisions.

Related to performance analysis in the literature was created many models for assessing the financial performance. Such a model was created in Romania by Barbuta-Misu (2009) on the building sector enterprises. She consider that modelling the financial performance offers the possibility of ranking at national level of enterprises acting the building sector in accordance with their financial performance, based on the financial-accountancy data in previous years, but also financial performance forecasting for an enterprise in the case when we can make a prediction as real as possible of the financial rates that constitute the model variables.

These models can offer some other benefits: listing enterprises in certain performance areas according to the value of the financial performance aggregated index; at a certain moment, the management of the enterprise can take decisions related to the activity, investments, financing etc., according to the values of the financial performance index; starting from a sought level of financing rates that constitute the model variables, the enterprise management can timely acknowledge the performance level their enterprise will take, and can take corresponding decisions (Barbuta-Misu, 2009a).

5 Conclusions

In conclusion, for manager, the aim for financial performance analysis is: understanding the performance achieved and the risks inherent in the business, as well as the prospects of future financial performance; adjusting the historical financial statements to assess the ability of the company to generate cash income for capital providers, and its prospects, comparisons with similar businesses to set risk parameters, profitability and value.

Appreciation of business performance results by the financial analysis. It discusses all aspects of business, their own characteristics and their specific contribution to the costs and to overall business results. It has an influence on monetary aspects of the operation, as well as qualitative aspects or characteristics that could be quantified, but only physically. Finally, the financial analysis involves work on globalizing business, considered as a whole which, by means of analytical approaches can be studied in terms of the impact of certain components, projects or products on the overall results.

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