Larissa-Margareta
Bătrâncea

Analysis of Financial Position

coursebook

RISOPRINT
Cluj-Napoca • 2023

LARISSA-MARGARETA BĂTRÂNCEA

Analysis of Financial Position Coursebook

Editura RISOPRINT
Cluj-Napoca ● 2023

© Editura RISOPRINT

*Editura **RISOPRINT** este recunoscută de **C.N.C.S.***
***(Consiliul Național al Cercetării Ştiințifice)**.*
www.risoprint.ro ***www.cncs-uefiscdi.ro***

ISBN 978-973-53-2744-6

ANALYSIS OF FINANCIAL POSITION
COURSEBOOK

Autor:
Larissa-Margareta BĂTRÂNCEA

Director editură: GHEORGHE POP

Table of Contents

Chapter 1. Theoretical aspects regardind the analysis of the financial performance

1.1. General aspects concerning the analysis of the company financial performance

This course scrutinizes the main categories of indicators used in the assessment of business performance based on the income statement corresponding to a fiscal year.

When one aims at assessing the performance of a business, it is necessary to identify ways to measure the financial and economic consequences of past management decisions that shaped investments, operations and financing over time. The fundamental questions to be answered are whether resources were used efficiently, whether company profitability met expectations, and whether financing choices were made prudently. The creation of shareholder value ultimately requires positive results in all theses areas in order to generate favorable cash flow patterns.

Before beginning any task, the analyst must define the following elements:

- General approach;
- Objectives of the analysis;
- Potential standards of comparison.

Any particular ratio is useful only in relation to the general approach and the specific objectives of the analysis. When there is a match among the three elements, the ratio can become a standard for comparison.

The type of analysis varies according to the specific interests of the party involved. Trade creditors are interested primarily in company liquidity. Their claims focus on the short run and the ability of a company to meet these claims is best judged by means of a thorough liquidity analysis.

On the other hand, the claims of bondholders are long-term oriented. Accordingly, they are more interested in the company ability og generating cash flow in order to meet long-term liabilities. The bondholder may evaluate this ability by analyzing the capital structure of the company, the major financing sources and use of funds, company profitability over time and projections of future profitability.

Investors who own common stocks in a company are mainly concerned with present and expected future earnings, the stability of these earnings, as well as how earing covariate with the earnings of other companies. As a result, investors might focus their analysis on company profitability. Hence, investors would be interested in the company fianncial state since this affects its ability of paying dividends and avoiding bankruptcy.

Keeping companies in business depends mainly on the development of rational and efficient economic activities. Within the market economy, rational economic activity is the one that generates profit. In this sense, profit or benefit is the monetary expression of the gain obtained through an operation, activity or action.

The general condition for generating profit is to perform an economic activity. The outcome of an economic activity is computed as a difference between the sales price and the cost of the product or service.

Company financial statements comprise specific links regarding the type of activity performed by the company, which can be emphasized via the financial analysis of individual components from every financial statement and via the computation of specific ratios of financial performance. For that matter, financial statements reflect the company field of activity and economy conditions. These statements are compiled in order to reflect decisions taken by the company management.

1.2. Performance analysis based on the income statement

The dimension of financial performance is emphasized by the income statement. This statement presents the results of the operating and financial activities of a company for a determined financial period (i.e., fiscal year). It provides information used in the evaluation of past company performance in order to estimate future financial results of the company.

In the process of assessing the financial state and performance of a company, the financial analyst needs certain benchmarks. The most frequently used benchmark is the **ratio** or the **index** that connects two pieces of financial information.

The analysis based on financial ratios involves two types of comparisons. First, the analyst can compare a present ratio with past and expected future ratios for the same company. The ratio for the current year end could be compared with the ratio for the preceding year end. When financial ratios are determined for a period of several years, the analyst can try to identify possible changes and determine whether the company has improved or not its financial state and performance across time. Financial ratios also can be computed using data from forecasted statements (i.e., pro forma) and compared with present and past ratios. In the case of comparisons across time, it is advisable not only to compare financial ratios but also raw data.

The second method involves comparing the ratios from one company with those of similar companies or with industry averages corresponding to the same point in time. Such comparison gives insights into the relative financial state and performance of the company. Sometimes a company will not fit neatly into an industry category. In such situations, one should try to develop a set (albeit usually small) of peer firms for comparison purposes.

The analysis must be connected to the type of business in which company firm is engaged and to the company itself.

For the purpose of this book, financial ratios can be grouped into five categories: **liquidity**, **debt**, **profitability**, **coverage** and **market-value ratios**. No single ratio provides sufficient information through which one could accurately assess the financial state and performance of the company. Only by analyzing a set of ratios is one able to make reasonable judgments. In addition, financial analysis should take into account any seasonal characteristic of a business.

1.3. Profitability, performance, return

Considering the new International Financial Reporting Standards (IFRS) officially enacted on January 1, 2020, the financial analysis that is stemming from financial statements has new stances. Hence, these standards emphasize indicators such as liquidity, solvency, operating efficieny, activity grow rate and *profitability*.

According to the specialty literature, **profitability** can be defined as "company ability of yielding gains" (Stefea, 2002: 261). The International Accounting Standard 1 (IAS1) called "Presentation of Financial Statements" within the new IRFS framework emphasizes that profitability indicators are "an indication of the manner in which company profit margin are associated with sales, average capital and own average capital". The IFRS approach to profitability/return is rather interesting. The standards do not specifically define the concept of return. Nevertheless, one can infer that return indicators are comprised in the set of indicators targeting profitability.

At the same time, the emphasis placed on indicators related to growth and the link profitability–growth is also notable.

*Defining elements of **financial performance***

❖ According to IAS, expenses represent "decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, others than those relating to distributions to equity participants". In essence, an expense represents an element of deprivation of the company, which is generated by a decrease in some assets, or an increase in some elements of liabilities or owner's equity.

❖ According to IAS, income represents "increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants". In essence, an income represents an element though which a company becomes "richer", namely via an increase in assets or a decrease in either liabilities or owner's equity.

By means of a synthetical view, it can be stated that **financial performance** includes income, expenses and financial results of a company. Information on these financial aspects are provided mainly by the income statement, but the explanatory notes also come to complete the information regarding company performance. In addition, similar to explanatory notes, legal proceedings also bring additional details on the reconciliation of cost and financial accounts in terms of the current income tax and the deferred tax.

Performance is the qualitative improvement of a company that is measured via financial indicators such as liquidity, solvency, activity (labor productivity, efficiency of asset use, etc.), profitability (profit ratio, absolute and relative return). According to Niculescu (1999: 189), performance can be defined as "a state of company competition that is reached via a level of efficiency and productivity that ensures a sustainable market presence of the company".

Hence, from the abovementioned definition, it can be stated that performance requires the simultaneous and complementary presence of two "ingredients" that are necessary but not sufficient conditions. This request is very important since a global look on performance is possible only by correlating the two indicators.

Company **performance** assumes knowing the following:

a) objectives, strategies and current policies of the company;

b) the degree to which economic objectives set by the company have been accomplished, namely the degree of economic efficiency;

c) the productivity level of production factors, especially labor productivity;

d) performance elicited by the main financial indicators: profitabilility, liquidity, solvency, profit/share, return on investment, market share etc.

Performance is an economic category that assesses the quality of the activities performed by economic agents with the help o certain indicators such as: turnover, value added, return, labor productivity, gross profit etc.

Profit should not be the ultimate goal of the company, yet it is necessary for attaining objectives. generaly, the most powerful competitors:

- generate value;

- obtain competitive benefits and optimally distribute created value;

- improves the ratio of effects/efforts.

Obtaining a superior performance is conditioned by meeting all three conditioned previously mentioned. It it possible that a company registers efficient activities without having a competitive advantage or that certain produts/services to have a competitive advantage even though these products/ services are provided by an inefficient company. In other words, a company can be efficient yet not be market competitive. In this case, one cannot tackle the concept of financial performance at global level. Or if the topic of competitiveness at company level is addressed, efficiency cannot be tackled. Hence, this will lead again to lack in performance.

The following paragraphs are dedicated to the concept of return.

- **Return** ca be defined as the capacity of a company to generate profit by using production factors and different capital sources;
- A more concise definition of **return** would be the company capacity of generating profit, which is necessary for company development and equity remuneration (Işfănescu, Stănescu & Băicuşi, 2000: 203);
- Favorable result (from a financial standpoint) of an economic activity, materialized in an income increase as compared to the expenses incurred, which generated a surplus value called profit.
- Economic indicator that expresses quantitatively and synthetically positive economic results that have been generated by social work input with the purpose of redirecting goods from the manufacturing domain to the trading domain.
- Economic yeld of a company, which stems from reporting results at the value of invested capital. It is also the capacity of economic agents to generate profit.
- Return is one of the most synthetic ways of eliciting the efficiency of economic activities within a company and the efficiency of all means of production and workforce from all stages of the economic cycle: acquisition, manufacturing, sale.
- It is a matter that interest the economic agent since the scope of economic activity is to generate profit and have a profitable business;
- *Return* provides a synthesis of all factors within the production process, thus being a key indicator among the set of indicators concerning economic efficiency at a microeconomic level. Hence, the element defining the result of economic activities is in fact the supplementary