THE RELEVANCE OF THE PERFORMANCE INDICATORS IN ECONOMIC AND FINANCIAL DIAGNOSIS

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ABSTRACT: *Each company must achieve the objectives to reach performance in order to survive on the market. The paper aims to present the concept of performance as is seen in economic literature, to discuss the relevance of the main performances indicators on economic and financial diagnosis, to answer the question what are the main indicators which reflect economic or financial performances: profit, profitability ratios, economic added value, investments return, liquidity, cash-flows, resources efficiency, productivity, others.*

KEY WORDS: *performance, efficiency, value added, profitability, competitiveness, relevance.*

JEL CLASSIFICATION: *M21, M10, M41*

1. ENTITY'S PERFORMANCE – CONCEPTUAL APPROACH

Performance is a major objective of each company because only achieving performances is possible to obtain growth and progress. Starting from the concept of performances from literature review we can say that the most important ways to measure any company's success are their performances. In economic and financial diagnosis there are indicators which reflect results of different activities being relevant in a way or another. We have to make a distinction between the concept of performance and the ways of measuring performances.

In the economic field are known a variety of definitions given to the concept of performance due to the fact that this concept is defined differently depending on the user of the information about performance. Thus the current and potential investors perceive their performance in terms of investment profitability, managers are oriented on the overall performance of the organization they lead, employee understand

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performance through profitability and stability of their job and creditors manifest interest towards organization's stability (Pintea & Achim, 2010).

Performance of a company is linked to competitiveness. Competitiveness means efficiency and future development, a necessary business purpose. It is a challenge for company management and financial analysts to find the best way to measure performance related to industry and company profile. (Robu, 2010).

An obstacle and also a challenge in evaluating the performance of a business from the outside are to interpret the results as expressed in financial statements (Helfert, 2001).

The relevance of the measures to the goals set, and the need to establish not only indicators of deviation from desired norms, but also to interpret these indicators so they can be used to reinforce value creation (Helfert, 2001).

The information about company's performance are necessary to evaluate the changes of the economic resources that the company will control in the future, to anticipate the company capacity to generate cash flows, and the efficiency to use the assets and resources.

An important position within the financial diagnosis and the main instruments for measuring performance are financial indicators. An indicator is "a measure which expresses numerically one aspect or a group of aspects which characterize a phenomenon, a process or an economic activity, defined in time, space or organizational structure" (Buglea, 2004).

Also, in financial diagnosis the performance of a company is associated to its capacity of obtaining profit, or generally is mostly associated to its profitability, so that profitability indicators are widely accepted to measure performances. Profitability indicators may be expressed through their absolute values under the form of results, or through their relative values under the form of a ratio.

The ratios and relationships used as measures are easy to derive, but their effective use depends on the skill of the analyst in interpreting trends and recognizing exceptions and changes due to management actions or accounting policies (Helfert, 2001).

In economic literature authors define the concept of entity's performance in different ways:

- "The issue of enterprise performance has been central in strategy research for decades and encompasses most other questions that have been raised in the field; enterprise performance depends on its ability to create value for its clients, depends how they behave, choose strategy and how are managed" (Porter, 1986, 1991);
- The word performance has three basic meanings: success, action, the result of the action, (Bourguignon, 1995 – cited by Pintea & Achim, 2010):
  - Performance means success: performance does not exist by itself, is in fact a dependent representation of the success of the different categories of users of accounting information;
  - Performance is action: in this sense, performance is a process and not a result that appears at a time; performance is not a state but a process and its content became almost secondary in relation to its own dynamics.

- Performance is the result of the action: performance measurement is understood as "ex post assessment the results”.

- "Performance is a state of competitiveness of the economic entity, reached by a level of efficiency and productivity that assures a sustainable presence on the market" (Niculescu & Lavalette, 1999);
- There are authors who define performance in terms of profitability appreciating that like the ability of an economic activity to generate revenues higher than expenses involved. The profitability indicators are known as profitability ratio or accumulation margin (Ștefea, 2002);
- Performance of an entity could be define through other concepts: performance means to achieve the strategic objectives, and as an economic concept implies the creation of wealth and value in the enterprise (Albu, 2005);
- Performance is a function of two variables, efficiency and efficacy; efficacy reflects the achievement of external expectations, and efficiency is measured by the achievement of internal environment of a company (Siminică, 2008),
- The word performance is frequently used and express different terms such us: growth, return, profitability, productivity, competitiveness; also the author use the concept of "performativity" with these different financial approaches (Colasse, 2009);
- A common criterion for measuring performance since the 90's is to value creation. Starting from value creation, a series of economic indicators was developed for measurement: the economic value added, market value added, total shareholders return, cash-flow return on investment, return on capital employed, cost of capital (Robu, 2010).

2. RELEVANCE OF THE PERFORMANCE INDICATORS

To be relevant and useful performance indicators must to be understood having different meanings and some limitations for different individuals, interest groups, and users of various information, the most important being managers, investors, lenders and creditors. Performance assessment depends mainly of the following elements (Helfert, 2006): the viewpoint taken; the objectives of the analysis; the potential standards of comparison.

More and more the financial analysts use a new type of indicators, non-financial indicators, considering those to characterize better business performance.

Robu & Vasilescu presents a list of non-financial criteria used by investors to assess company performance related to Corporate Governance practice, related to: management quality (corporate strategy quality, leadership, managerial experience); corporate culture (employee skills, staff training programs quality, social policies, environmental policies, teamwork); effectiveness of executive management remuneration, communication quality with shareholders, leaders credibility.

Also, Achim & Borlea (2010) highlight the financial and nonfinancial performances. They refer especially to the financial performance highlighted by financial analysis, especially with reference to issues of profitability / return / growth and to the correlations that are interposed between these categories. Extra financial analysis finally comes to complete supplement the main picture of the entity in terms of global performance by increasing the value for stakeholders.

But there are many critics related to these non-financial indicators mainly their lack of relevance, opacity, or lack of continuity from one year to another, so that financial indicators remain the most relevant for all interest groups.

Different financial indicators measure different dimensions of financial performances (such as profitability and liquidity), and all this information is needed to make an informed judgment about the financial health of an organization.

Most the ratio analysis represents a diagnostic tool in order to help the users to understand financial situation, to identify weaknesses and opportunities within a company.

The analysis of financial indicators reflects into a synthetically manner economic and financial situation of a company, reflects the correlation between all the company's functions and also allow to make comparisons in time, space, with standards, or optimal values.

Users of financial statement need to be familiar with the analytical tools and techniques used in performance measurement and the assumptions that underlie them. (Needles et al., 2007).

Anghel (2002) consider that the most representative indicators used in financial diagnosis are the financial ratios, and presented a synthetic set of ratios:

Relevant financial ratios in financial diagnosis	
Return on investment	$\frac{Net\ Profit}{Total\ Assets}$; $\frac{Net\ Profit}{Equity}$
Debt	$\frac{Liabilities}{Equity}$; $\frac{Liabilities}{Assets}$
Assets efficiency	$\frac{Turnover}{Assets}$
Liquidity	$\frac{Current\ Assets}{Current\ Liabilities}$
Cash-flow	$\frac{Cash}{Assets}$;
Inventory turnover	$\frac{Inventory}{Turnover}$; $\frac{Cost\ of\ Sales}{Inventory}$
Receivable turnover	$\frac{Receivable}{Turnover}$; $\frac{Sales}{Receivable}$

Source: Anghel, 2002

Financial ratios are useful to indicate company's performance and financial situation. To be significant most of the financial ratios must to be compared to company's forecast, to historical values of the same company, to a value which is considered an optimum value for the company's activity sector, or ratios of similar companies. (Monea, 2009).

The principal financial performance areas of interest to management, owners, and creditors are shown below, along with the most common ratios and measures relevant to these areas (Helfert, 2006).

Managers	***Operational analysis:*** - Gross margin; - Profit margin; - Operating expense analysis; - Contribution analysis; - Operating leverage; - Comparative analysis;	***Resource management:*** - Asset turnover; - Working capital management; - Inventory turnover; - Accounts receivable patterns; - Accounts payable patterns; - Human resource effectiveness;	***Profitability:*** - Return on assets (after taxes); - Return before interest and taxes; - Return on current value basis; - EVA and economic profit; - Cash flow return on investment; - Free cash flow;
Owners	***Investment return:*** - Return on total net worth; - Return on common equity; - Earnings per share; - Cash flow per share; - Share price appreciation; - Total shareholder return;	***Disposition of earnings:*** -Dividends per share; - Dividend yield; - Payout/retention of earnings; - Dividend coverage; - Dividends to assets;	***Market Performance:*** - Price/earnings ratio; - Cash flow multiples; - Market to book value; - Relative price movements; - Value drivers; - Value of the firm;
Creditors	***Liquidity:*** - Current ratio; - Acid test; - Quick sale value;	***Financial Leverage:*** - Debt to assets; - Debt to capitalization; - Debt to equity;	***Debt Service:*** - Interest coverage; - Burden coverage; - Fixed changes coverage; - Cash flow analysis;

Source: Helfert (2006), Financial Analysis Tools and Techniques. A guide for Managers, pp.113

The persons having a strong interest in measuring company's performance are mainly the managers who strive to achieve performance objectives, creditors, investors and customers who have agreements with the company.

All the strategic and operating plans that management formulates to achieve a company's goals must be stated in terms of financial objectives in order to increase the wealth of the company (Needles et al., 2007).

We are presented the main categories of performance indicators on which managers need to focus in order to achieve key business objectives, and also which have interest for investors or creditors. We consider that the most important economic and financial objectives for a company are:

- business growth;
- growth of revenues and costs control in order to improve profitability;
- growth in earnings per share;
- assets management;
- human resources effectiveness;
- liquidity;
- solvency;
- working capital management;
- cash flow adequacy;
- financial leverage;
- debt management;
- investment return;
- market strength.

Business growth refers to company's ability to increase its size and could be measured through *turnover*, *added value* or *total assets*.

Investors and creditors are interested in company's profitability that means its ability to earn a satisfactory income. With this aim important we consider relevant: *profit margin, gross margin, assets turnover, return on assets* and *return on equity*. *Profit margin* shows how much of a company's revenue remains after paying off all operating expenses. A low operating margin is a sign that a business might not have enough revenue to pay off debt and other non-operating costs. *Gross margin* shows how much revenue is left company pays all of the direct costs associated with generating that revenue. The higher this ratio is, the more revenue the company has to pay off other expenses. *Return on assets* show how company's assets are being used to generate profit, being useful to take into consideration the idea of trying to convert assets into profit. *Return on equity* show how well a company uses investments to generate earnings growth, measuring company's efficiency to generate profits from each monetary unit or net assets.

Liquidity measure the ability of a company to pay its short-term obligations and to meet unexpected needs for cash. The most common liquidity ratios are: *current ratio*, *quick ratio*, *working capital ratio* (liquidity ratio measure the balance between current assets and current liabilities), *cash flow ratios* (which is closely related to liquidity), and also *receivable turnover, inventory turnover, payables turnover*.

Solvency shows company's ability to survive over time, to face with medium and long term liabilities. Solvency measure financial security of a company relative to its creditors and financial institutions, and the aim of measuring solvency is to detect earlier signs of company's financial difficulties. To appreciate long-term solvency most relevant indicator we consider: *solvency ratio*, *debt to equity ratio* and *interest coverage ratio*.

Cash flows are closely related to liquidity and long term solvency, measuring company's ability to generate cash from their operations, the main ratios are: *cash flow yield* (ability to generate operating cash flows in relation to net income)*, cash flow to sales* (ability of sales to generate cash)*, cash flow to assets* (ability of assets to generate cash).

For a company market price is the price at which their stocks are bought and sold, but the information regarding market price of a company is not so relevant by itself; for owners and investors market price show the potential return and the risk, so to be more relevant this information must to be related to earnings through: *price to earnings ratio* (measures the confidence of the investors, and is useful if it is compared with earnings of different companies or by comparing the value of shares in relation with the values in the overall market) and *dividends yield* (measures current stock to an investor in terms of dividends).

In order to determine those indicators that facilitate the interpretation of different situations, the accounting information has to meet qualitative characteristics, most important being understandability and usefulness.

Qualitative characteristics		
Understandability: - decision makers must be able to interpret accounting information	***Usefulness:*** - accountants must provide information that is useful in making decisions	
ACCOUNTING CONVENTIONS: • comparability; • consistency; • materiality; • conservatism; • full disclosure; • cost-benefit;	RELEVANCE: • feedback value; • predictive value; • timeliness;	RELIABILITY: • faithful representation; • verifiability; • neutrality;

Source: Needles et al., (2007), Financial and Managerial Accounting, pp.233

3. CONCLUSIONS

Relevance in accounting means a qualitative characteristic, mainly associated with information that is timely, useful, has predictive value and makes a difference to a decision maker.

A key business skill for any manager, owner or creditor is to understand the economic and financial indicators which reveal performance and illustrate the strengths and weaknesses of a business. Through their overtime analysis it is possible to observe the unusual fluctuations and to conclude if a business is performing over time.

It is important to choose from hundreds of indicators available those which could be apply to all type of business and those which are specific for a business in order to improve business performance.

The performance indicators based on information from financial reporting helps in establishing the strengths, weaknesses, opportunities and threats relative to a business, their main objectives are as follows:

- to provide useful information in investment and credit decisions;
- to provide useful information in assessing cash flow;
- to provide useful information about business resources management;

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