Indispensable Financial Statements for Performance Analysis of Business Activity

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ABSTRACT

The basic idea of the research focuses towards a synthetic analysis regarding the risk of bankruptcy of firms in terms of current realities that characterize the competitive environment of global business. In essence, the research outlines the types of risks that inevitably threaten any company in its evolution during "n" years (macroeconomic vision and microeconomic vision respectively), focusing on accounting data at the level of economic entities. To support the theory put forward in the structure of the research, we included in the analysis the economic situation of the companies Antibiotics Iasi and Pharmaceutical Remedia. The statistics for the two companies show clearly the complexity of the problem on estimating the risk of failure of any company (for instance in the two cases it is shown that turnover follows a permanent upward trend for a decade or more, but profitability approaches zero, and yet the two companies have not gone bankrupt and have subsequently favorable periods of evolution). In other words, it takes several financial indicators accountants to diagnose the situation of the company at a time. Today, the knowledge society and / or the knowledge economy have become a kind of reporting vector for both business organizations and policy makers, opinion leaders and even every citizen. The so-called intangible assets of a company determine in an increasingly measure the market value of the company but are hardly reflected in the accounting entity.

Keywords: Risk of Bankruptcy, Financial Statements, Economic Models, Knowledge Management, Forecasting Mode

INTRODUCTION

Today in all countries, both in the developed as well as in the less developed, companies operate in a competitive environment extremely complex and volatile. Their reactions will have an adaptive character and they could survive and possibly obtain the indispensable profit rewarding shareholders if they get to know the environment, to dominate it or at least use it. Otherwise, analysis and use of opportunities will suffer as the management of resources and available time and adversity and factors able to generate positive effects will not be noticed.

A primary concern for companies is information on the rules and practices of competition in the market segment the company is working, or aspiring to, those relating to competitors such as weakness or their force support as the ratio between supply and demand on that market. Or, to this dynamic environment firms must respond by targeting the processes occurring within them. For example, through size and selecting the relationships with suppliers and customers, through choosing products or services and marketing strategies.

Although socio-economic effects of bankruptcies are directly proportional to the size of companies, the causes that lead to failure are often the same. The economic theory is not able to provide a specific model for decision makers in the real economy, based on which it can be

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prevented/avoided bankruptcy. Every business needs to build and to apply its own business strategy in the competitive environment, both in boom periods and in times of economic crisis. So, top management of each business organization is called upon to examine the entity's evolution in the past and to build scenarios for the future; this means strategic thinking/vision based on market realities and practices of other competitors [12].

Applying strategic thinking in business does not automatically equate to a future without worry for companies, but it is likely that the total lack of management strategies to equate to the lack of any future for the company.

Drucker's seemingly simple statements emphasize that *rarely attempts to predict future events could be successful*, but we have a duty to try to predict "the future effects of events that have already occurred irrevocably" [4].

Accepting the idea that the linear growth of a company it is not possible, questions such as arise: What should managers do to prevent and mitigate crisis manifesting in doing business? What are the changes that appear in business strategy to mitigate the crisis and recover quickly?

The source of financial failure *of a company* can be summarized in a few words that are commonly known in various social contexts; often, society and various economic analysts sanctioned nonperformance of managers and believe/conclude that they can behave irresponsibly, they demonstrate greed, they engage in excessively risky/speculative activities etc. Through such phrases the society characterizes poor management applied by firms that have been brought in bankruptcy.

Managers can use a *number of indicators* that can be alarm signals for the likelihood of bankruptcy of the company. The manager can begin this analysis with evaluation of liquidity indicators that measure the ability of the society to honor its obligations in the short term, for the calculations being used current assets (the most liquid; cash in bank and house, receivables, inventory) and liabilities with a maturity of less than one year, the necessary data being included in the balance sheet [1].

LITERATURE REVIEW

The two fundamental issues on the one hand, the mandatory necessities of human life and on the other hand, the existing resources (which always are and remain limited) induced / generated the emergence of economic theory about two and a half centuries ago; Typically economic theory (economics) remains associated with the name of Adam Smith and the work *The wealth of nations* [11]. The economic and social reality in which we live and operate daily, either as individuals or as business entities, is increasingly influenced by globalization. Information technology and knowledge revolution of recent decades shows that ownership of information/knowledge is essential in decision making at the level of individuals, families and/or business organizations.

The increasing complexity of economic activity of businesses, due to the evolution of market mechanisms has major implications in adopting managerial decisions.

The evolution of the management as practice and science has strengthened over time through contributions made by the founders and supporters of the school of management from FW Taylor, H. Fayol, and later by the contribution of P. Drucker, Th. Peters, R. Waterman, etc [1]. Alongside, other analysts and thinkers from different fields (economic analysis, statistics, mathematics, computer science, sociology, psychology, finance, law, logic, etc.) have made significant contributions to strengthening management institutions in modern society [8].

Diversity of problems concerning financial accounting and economic activities of the entity in terms of cause-effect relationship requires research, analysis and interpretation of financial accounting and economic diagnosis [2][5][6][7].

Diagnosis of external environment of the entity aims to get to know the audience, information user, whether economic, social, financial or tax. Most often are analyzed in the external environment of unity, economic agent-actors, which we consider competitors on the market of products made by the entity.

Diagnosis of internal environment involves determining the financial health of the company at a time, any threats that may occur and instructions for correcting the course of further economic activity.

In this analysis there are usually checked a number of issues, such as: market position, growth trend, competition structure, features and loyalty of customers, organization and distribution, location etc. Adjusting the information must be obtained and processed by the entity making the inquiry and consists in valuing of the opportunities available, further valuing of strengths, correcting weaknesses and avoiding threats identified.

Diagnosis of internal environment includes financial-accounting diagnosis as a modern approach to economic and financial situation of the company that has established the basic methodology of financial-economic analysis of the firm, and knowledge of concepts and literature terms. Financial accounting diagnosis results, whether it is a preventive one or a crisis one consists in exposing some original opinions and viewpoints that are based on professional judgment of the analyst. Among other theorists, Drucker tries to outline a theory of business organization, in his optics the mission proposed and the distinct skills that can be offered to the market come two essential conditions for the survival of the company in a competitive environment [3].

The innovation process has incited over time in many reflections. The Austrian economist *Joseph Schumpeter* addressed for the first time the mechanisms and factors of the *innovation process* arguing *that entrepreneurship spirit and the possibility of obtaining a temporary monopoly profits may stimulate the introduction of new products on the market or the reduction of production costs* [9].

We can now state that the contribution of *J. Schumpeter's* in the *innovation theory* is current and the concepts of *"innovation" and "technological development"* that constitute the core of its work, *have contributed and influenced the economic theory of innovation [10]*.

Based on the concepts of *J. Schumpeter*, some authors of the neoclassical theory have combined in an effective way *elements of creative destruction in economic growth model*. The promoters of this incorporation include *Philippe Aghion, Peter Howitt, G. Grossman and E.Helpman,* economists that have developed a model in which *economic growth is generated by a random sequence of innovations derived from research.*

However, *Peter Drucker "sees" innovation as a specific instrument of entrepreneurship, means through which he uses change as an opportunity for a different business or service [10].*

METHODOLOGY

In theory and in business practice there are discussed the various types of risks that inevitably threatens any company in its evolution of n years; There are several tools that formalize somewhat the evaluation of the market context and the type of predominant risk to a company's specific situation (consider that each firm has only a market share and has no monopoly). Between these existing tools available to the decision maker in the company we remember the following:

a) applying a SWOT analysis on the situation of the company at a time on the market and identifying courses of action to mitigate risks / threats or to exploit certain opportunities;

b) applying the PESTLE model that attempts to delineate/group politic, economic, social, technical, legal and environmental factors and later to decide the best course of action for the firm (relative to restrictions/opportunities that gives each group of factors);

c) use of other models and/or tools that attempt to describe and quantify the main categories of risks that threaten the normal development of the business organization. From this theoretical point of view there are distinguished the following types of risks:

Market Risk

Any market study should a firm make it cannot find precisely find out what will occur if everything that would be produced would sell. Demand for the products of a company is usually more elastic than stable because consumer preferences and orientations, the price and size of competitors' offer are unpredictable. So volatility of demand, of sales, price, make business risk always present in the life of businesses.

Operational Risk

The activity of economic agents varies from one branch to another and even within the same area firms face different situations due to the interaction of factors such as:

a) The variability of demand, which is makes revenues uncertain as well as opportunities of payment of suppliers and business expansion. Uncertainties are higher for those who plan to undertake a new course of action because it could be that their new product is not appreciated. As the opposite may happen, consumer preferences undergo a radical mutation so that supply can meet demand.

b) The purchase price fluctuation of production factors used influence the cost and subsequently the size of the profit of the company. The more pronounced the share of fixed costs is in the total cost the higher is required a volume of sales to reach the return level.

c) Quality of marketing activities that may or may not influence the firm to adopt the changes required by market conditions.

d) The competence of managers reflected in the opportunity of decisions taken on which subsequently depends the success or failure of the business. Often, managers are not able to perceive in time the fundamental changes of the competitive environment as and to imagine alternatives to mitigate their undesirable consequences.

The Risk Due to Changes in Technology

The risk due to changes in technology of which the competitors take advantage in varying degrees. Since the evolution of technology is so important role in competitive activity, anticipating changes in this area may improve a firm's market position.

Financial Risk

The financial situation of economic operators, seen through extent, variability and direction of money flows and mass benefit is normally under the influence of many factors. The most important of them are market fluctuations, which determine the variability of sales and payments for purchase of necessary factors, incidents of labor and production. As a result businesses are constantly facing economic risk because they do not have a satisfactory control over future revenues. So, to prevent financial risk companies must calculate and secure from all activities developed a return stage configured as a confidence interval rather than a predetermined reference value.

Currency Risk

At the origin of this risk there are foreign currency bank operations: external assets and liabilities. These items are included in the balance sheet of banks through conversion in national currency at the course of the day; the variation of this course may involve gains or losses independent of the bank efforts or the quality of its management.

The Risk of Cash-Flow "Dropping"

if the payment obligations of the entity tend to exceed for n months the normal revenue and the firm has no other assets that can be immediately converted into cash (in some models this risk is measured by the solvency ratio).

Finally, to illustrate the complexity of issues related to estimating the risk of bankruptcy of the company (whether we take into account or not the economic dynamics) we point out that the data from the balance sheet of a company are usually more difficult to interpret and brought to a common denominator. In other words there are needed more accounting-financial indicators to diagnose the situation of the company at a time, and on this basis to draw a BCC (business cycle of the company) hypothetical under the form of prediction of the next n years. In addition, the difference between the accounting systems between countries, the difference between the accounting practices and usages between economic sectors in the same country, the size of firms and the socio-economic situation of the country will complicate trying to predict the bankruptcy risk of a firm. For example, based on actual accounting data for two pharmaceutical companies (ATB and RMAH), each with a significant segment of the market, we can trace synthetically the development of core indicators for these entities for the period 2004-2013 (Figure no. 1 for ATB and Figure no.2 for RMAH).

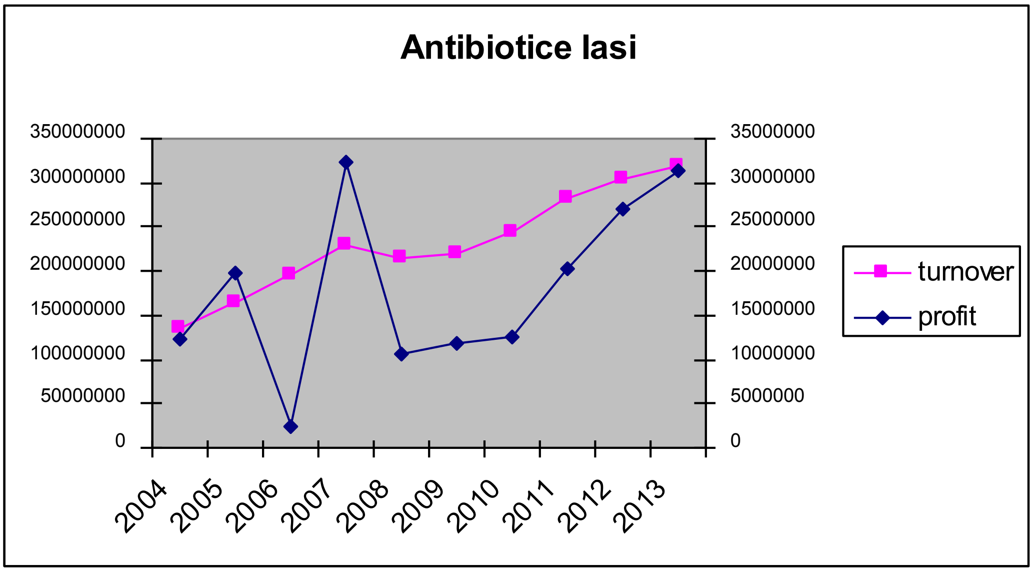

Figure 1. Evolution of turnover and profit for ATB

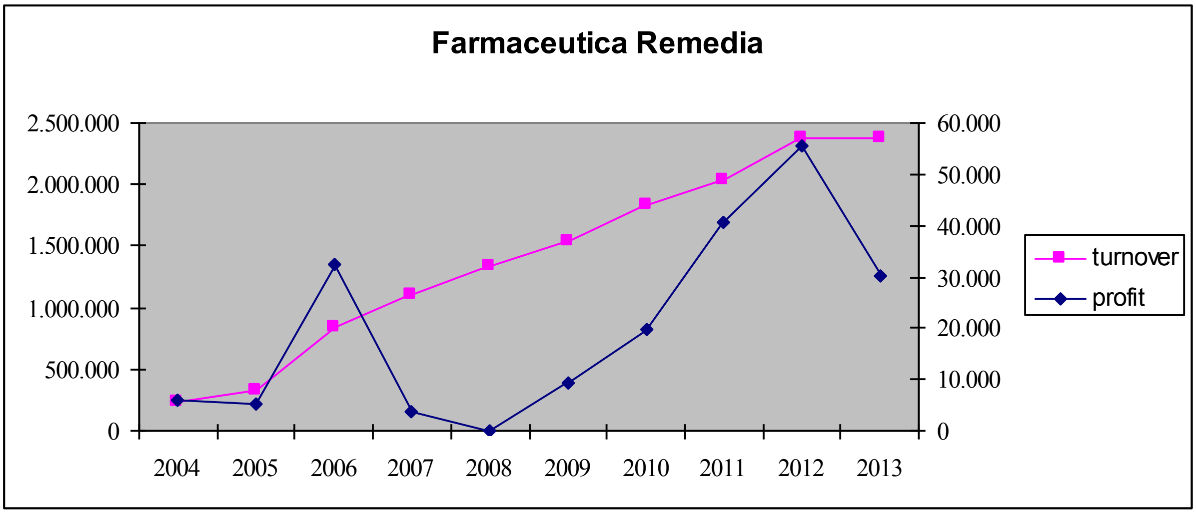

Figure 2. Evolution of turnover and profit for RMAH

Analyzing financial and accounting data for various companies (ie those listed on BSE - Bucharest Stock Exchange) for n years we find that a firm's business evolve tortuous, unpredictable and not in a linear trend. In other words, any business organization is constantly faced as reality/consequence of the competition battle and of the market mechanism given, with the hypothesis of market exit or the hypothesis of reaching bankruptcy. How and through what tools the top company management can anticipate/prevent the risk of bankruptcy? What are the main models and recommendations that theory provides for the decision makers in the real economy?

In our opinion, there is not only one single descriptive model through which it can be captured the cyclical movement of business at level companies, as reality in any country is extremely diverse in the number of economic actors, size, economic sectors and period in its own development of each organizations. Theoretically, the graphical pattern after which evolves the business of a firm for n years shows a sinuous, oscillating motion, as suggested in Figure no.3.

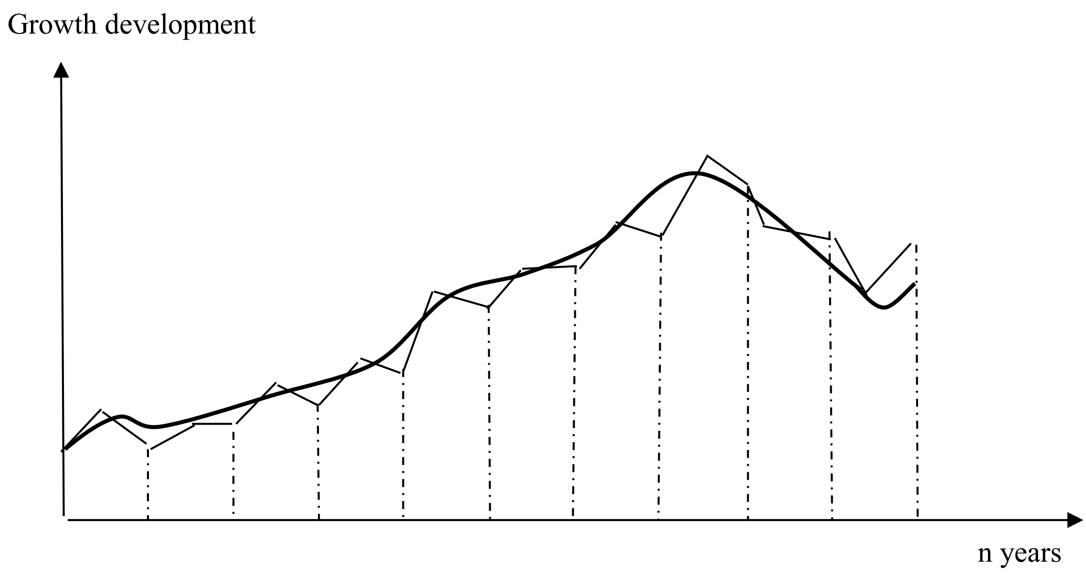

Figure 3 Business cycle at the company level (BCC) for n years

In the graphic sketch suggested is included in the analysis an indicator such as "growth/development" but it's difficult to say which of the accounting indicators of a firm's (turnover evolution, evolution of gross/net profit, labor productivity, cash flow, the evolution in the number of employees, etc.) would give content to this indicator. In fact, the analysis of past business organizations requires direct experience, vision and intuition of the decision maker in order to aggregate informally accounting indicators of different nature so that later to be able to predict the desired/feasible future for the organization.

CONCLUSIONS

A general conclusion that can be expressed is that *default risk* was and is a sensitive area where experts have proposed to investigate and develop a mathematical model to answer the question "An economic entity is going/or not towards bankruptcy?. Developing a *predictive model of bankruptcy risk* that meets both global and national (Romanian) economic requests is quite difficult to achieve given that part of bankrupt firms restrict their activity without declaring the state of bankruptcy in court, something that makes research very difficult.

Although the emergence of mathematical models to predict the bankruptcy risk is not recent, the increasing complexity of firms and commercial transactions, as well as new tools emerging determine the development of new score function appropriate to the current economic and financial context, in which the situation of many companies is uncertain. Thus, the famous bankruptcies, especially in recent years have highlighted the ineffectiveness of previous models, but especially of classical methods in identifying the likelihood of bankruptcy risk.

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