

## THE FINANCIAL PROFILE OF THE COMPANY AND OF ITS FIELD OF ACTIVITY

**Melania Elena MICULEAC**  
„Drăgan” European University in Lugoj  
Faculty of Economics Sciences  
Lugoj, Romania  
*miculeacmelly@yahoo.com*

**Abstract:** *The essential characteristics of the company from a financial point of view represent the financial profile of that company. When analyzing the financial situation, these characteristics help understand a certain behavior in investments, financing and operation. These characteristics are mainly defined by the following factors: the business that company deals with; the groups of interests which revolve around the company; the financial flows which take place between the company and the environment; the management's attitude towards the financial reports. If the first three categories have an objective character, the last one has a subjective character.*

**Keywords:** *the financial profile, the stakeholders, financial flows*

### 1. THE FINANCIAL PROFILE OF THE COMPANY

#### 1.1. The company's lifecycle and financial profile

One of the most modern techniques used to define the financial profile results from the strategic analysis. The method is based on the lifecycle of the business, being the consequence of statistic observations and studies made in different sectors of activity. This method was taken by the financial analysts and correlated with Du-Pont system of rates for companies and with the averages on the fields of activity. From the point of view of the financial analysis, the characterization of the four main stages of the business lifecycle reveals the following conclusions with a general character. (Van Horne & Wachowicz, 2005).

a) *The startup stage* is characterized by a slow rhythm of growth of the turnover. The liquidity rates are reduced while the rotation speed of the management rates of the current activity (the rotation of stocks, the rotation of clients and the rotation of suppliers) is high. This fact, apparently contradictory, is due to the fact that at this stage the level of stocks and debts to clients is reduced. At this stage the company has a negative treasury and an acute need of liquidities necessary for investments. This fact is due to its incapacity to build a substantial working capital. The profits and the operation cash flows are much reduced or even negative. The global debt, respectively the long, medium and inclusively short-term global debt is usually very high. In consequence, the profitability and reliability indicators have satisfying levels.

b) *The expansion stage* has other characteristics. The accelerated rhythm of growth of the turnover is followed by the increase of the profit. Nevertheless the operational treasury

flows remain below the profits, the company starting to give more substantial client credits as value and duration in time in order to stimulate the sales. Thus the indicators which have as a basis of calculation the turnover and the profit improves in a more accelerated rhythm compared to those which have as a basis of calculation the cash flows. The company's capacity to invest increases too, generating the reduction of the fixed assets' rotation. The margin rates based on profit do not reach the highest levels (due to the gap between the dynamics of the turnover and the profits). At this stage, although the operation risk reduces substantially, the operation doesn't act at its full power, the level of fixed costs (resulted on the basis of the growth of the depreciation resulted from the increased volume of investments materialized in fixed assets) still being high compared to the level of the turnover. The economic profitability of the assets is reduced as a consequence. The debt rates, although they have a tendency to get reduced, still present pretty high levels.

c) *The maturity stage* is characterized by the maintenance or the growth with a slow rhythm of the turnover. The company reaches constant and normal levels of the operation indicators. The financial rates tend to get close to the average rates in the field of activity. The profitability rates and the rotation speed of the assets are high, generating high levels of the productivity rates. The debt on term reduces to minimum levels or it disappears. The global debt degree is much reduced. The liquidity and solvency are high. The cash flows are also very high, much above the company's needs, at this stage the level of the investments being minimum.

d) *The decline stage* is characterized by a low rhythm of decrease of the turnover. The company orientates the liquidities to other investments. A large process of disinvestment of old technologies takes place.

The concept of company's lifecycle, although it is very useful in the evaluation, is not applicable in the case of the companies that have a multiple object of activity, in several fields of activity. Although it assumes the existence of a large range of products, they must belong to the same field of activity.

## **1.2. The groups of interests which revolve around the company**

The company's stakeholders are represented by those individuals or groups who in carrying out their interests and objectives depend on the company, and on whom the company depends at its turn. The notion of stakeholder in free translation means the owner of a part (a piece) of the company.

In every sense, the stakeholders represent the groups of interests whose satisfaction of needs and interests depends on the company, and the company at its turn depends on them. In a large meaning, they are represented by shareholders, employees, managers, clients, suppliers, banks and the community understood in a large meaning. Strictly speaking, the stakeholders represent the groups of interests who have a direct contact with the company in order to satisfy their needs. The company depends on the way their needs are satisfied. Given the pecuniary nature of their interests and needs, the majority of relations between these groups are regulated legally.

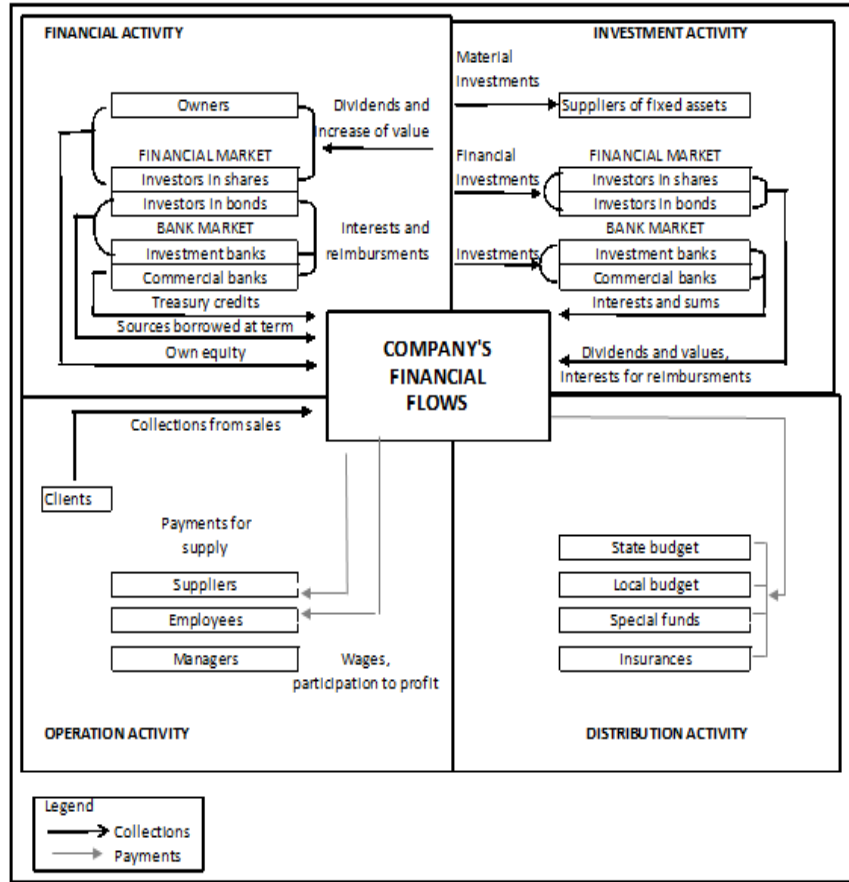
There are two perspectives regarding the meaning of having a part (a piece) of the company: strategic and financial. (Palepu, et al., 2010)

1. The strategic perspective has the advantage it offers a large vision, because it focuses on the company's vision from the point of view of the market orientation. In this sense, the stakeholders are represented by the groups of interests from the external environment of the company: shareholders, final consumers (not clients), suppliers, partner banks and the community in a large sense. Each of them depends on the satisfaction of their needs by the company and, at their turn, they satisfy the company's needs. The needs are not understood only with a pecuniary meaning, they also have ethical, moral, social and ecologic components. The disadvantage of this perspective is that it enlarges too much the sphere to groups that sometimes have interests too vaguely defined, and the company depends too little on them. Also it ignores other groups of interests that have a direct impact on the company, but come from the internal environment, such as the employees or the managers.

2. The financial perspective has as a starting point the bankruptcy law and the priorities to satisfy the needs. This criterion limits the group of stakeholders from the external environment to the groups of interests that have direct relations with the company and to the groups of interests from the company's internal environment, relations which are well regulated legally and have a pecuniary goal. This perspective makes possible the clear delimitation, from a financial and legal point of view, of those who are interested by the good development of the company.

In order to work accordingly on long term, the company's strategies must take into account the main interests of the stakeholders and correlate them with the company's interests. The encouragement of an interest specific to a specified stakeholder, to the prejudice of another or of the company, respectively the failure to harmonize the company's objectives with those of the groups of interests, endangers the relation of mutual dependency, existing the possibility to emphasize the already existing conflicts of interests (however normal) and to influence in a negative way both parts.

Each stakeholder comes from an organized environment. The company has financial relations with each of these environments, being suppliers and users of financial resources just as the company. The company's relations with the stakeholders are complex, but they can be grouped on categories of relations of a financial nature which come from the operation, financing, investment and distribution activity. At its turn, the company also acquires the quality of stakeholder to certain actors from these organized business environments.



**Chart 1. The positioning of the stakeholders' financial interests to the company's activity**

Each category of stakeholders has different informational needs regarding the company's financial situation. These informational needs are formed depending on the positioning of the stakeholders' financial interests to the company's activity. They are specific to each category, being different according to the area of interest they come from and the asked detailed level.

### THE COMPANY'S FINANCIAL FLOWS

Within the company, like in the relations with the external environment, a series of economic flows, of a complex nature, take place. Being in a continuous activity and in permanent contact with the environment, the company has permanently flows inside and outside it. Among these flows, the most important are those with the company's stakeholders.

From the point of view of the economic nature of the flows, we have:

- real flows, which include the goods and services which circulate in the company as well as in the relation with the environment;

- financial flows, which include the value circuit in the company as well as in its relations with the environment.

From the perspective of the financial analysis, the financial flows present a special importance.

*The financial flows* represent the set of movements which have an immediate or future impact on the company's results and liquidities. They are diverse, heterogeneous, being generated by the operation, financial and investment activities.

From the point of view of the financial management, there are (Lala-Popa & Miculeac, 2012):

- financial flows from the operation activity, which reflect the essence of the company's object of activity;
- financial flows from the financing activity;
- financial flows from the investment activity;
- financial flows from the distribution activity;
- extraordinary flows, which result from situations which are not usually assignable to the company's activity.

The totality of the financial flows, their volume, dynamics and structure define, at last, in a defining way, the company's financial profile.

#### **1.4. THE POSITIONING OF THE MANAGEMENT TOWARDS THE FINANCIAL REPORTS**

The management must report to the General Meeting of the Shareholders the way it managed the patrimony within a financial year. The company's financial situation is reflected synthetically in the forms of accounting report. The goal of the financial analysis is to evaluate the company's financial situation and performances, to show on the basis of a diagnosis which is the strong and weak points, and to decide on the financial potential. The shareholders are essentially interested in this situation. Also, the managers are very interested, because on their basis is evaluated the performance of the management, respectively the persons in charge for the possible unfavorable situations.

There are two behavioral attitudes of the management towards the financial situation (Brealey, et al., 2006):

- the passive attitude, which let the things follow their normal way;
- the active attitude, which allows in a certain measure the "make-up" of the situation.

In the practice of developed countries, it was noticed an active attitude of the managers to the possibilities offered by the accounting system. The temptation of "changing a little the truth" (within the legal limits) is already a common practice to companies no matter their size. This managerial practice is called the technique of arranging the window. That is why the financial analyst must pay a lot of attention to the way they approach the situation.

*The manipulation of rates in the annual reports* is possible if there is no standard system of rates at the level of the company or sector, or if the reports are not drafted by consulting companies. This thing allows the use of the most advantageous rates or the change of their calculation basis. The managers transform the limits of using the rates to

their advantage. For example, to rotations of the active elements are more favorable if correlated with the total revenues instead of the turnover which is more reduced, especially in the case of companies with serious dysfunctions in operation, but with substantial financial revenues as result of treasury maneuvers, or with exceptionally substantial revenues as result of assets cession. In this case can also be used the profitability rate which has as a basis the result of the exercise, which in these conditions can be substantial, hiding the losses from the operation activity. This technique can be counteracted in the easiest way by detailing the situation on the operation activity.

*The managerial effect on the treasury* is practiced in the case of companies which have long-term credit lines to banks, where the credit is done through drawing, and if the sum is paid back within a month, there are no interests or they are minimum. In order to improve the treasury, the managers draw a rate from the credit at the end of the last month of the financial exercise, which they pay back within the first days of the first month of the following exercise. Because the balance reflects the situation of the patrimony at the moment of the last day of the financial exercise, it presents a better situation, because the working capital increases with the sum from the long-term credit.

*The managerial effect on the solvency* is practiced in the case of companies which benefit of special credit lines, from which they draw the needed sum and they pay it back in less than a year. In this case, given the specific legal nature of the contractual relation of the company with the credit bank, these credits are in the category of those on short term, changing substantially the debt rates on term and the solvency of the company.

The managerial effect on the liquidity is practiced through the changes brought to the elements of the current assets and current liabilities. In this case the managers try to postpone a little bit forcedly the payments and they try to accelerate a little bit forcedly the receipts, sometime appealing to the opportunist liquidation of stocks. Another solution is the payment of some debts, but only in a certain proportion, so that the reduction of the current assets in relative values is less than the one of credits.

*The leasing effect on the debt* is practiced by omitting to mention in the different reports (if they are not required clearly) if the company benefits or not of the leasing. The leasing is a special form of debt, being reflected in the accounts outside the balance. The drawing up of the functional balance, which incorporates the leasing, may emphasize the real degree of debt which, in this case, increases.

*Managerial techniques to bring up-to-date the inflation* refers to the possibility to use in reports the different techniques of bringing up-to-date. If the bringing up-to-date to the general rate of inflation is unanimously accepted, it doesn't mean that it is the most correct one, it being an average made up on those from the activity sector (which can be superior or inferior). It can be noticed that in the reports of the managers, the rates which favor them most are used.

In practice there are very many possibilities to alter the true reflection of the financial situation without breaking the law. These accounting tricks alter substantially the evaluation of the financial situation. It is up to the financial analyst to identify them. On the contrary, wrong conclusions can be drawn regarding the real performances of the companies and the contribution of the managers to these results.

## 2. THE FINANCIAL PROFILE OF THE FIELD OF ACTIVITY

The financial profile of a field of activity is given by the combination of the financial profiles of all the companies which work in that field of activity.

The use of the financial rates allows the analysis of the features of the different fields of activity. On their basis, the profile of that field of activity can be defined. The essence of building the average financial rates on the sector consists in emphasizing the differences between the sectors. There were several specialized studies which emphasized the differences of rates on fields of activity. In the U.S.A. each year the annual report of the average rates of fields of activity is published, which in essence includes the Du-Pont system of rates. The annual report includes data on the last 10 years, on sectors of activity, and within them on subsectors, there being a differentiation depending on the dimension of the companies.

*These average rates evaluate the financial profile of a certain sector of activity.* However, these rates are not relevant in the case of multinational corporations (due to the specificity of the business within each economy of the branches) and of the companies that have a multiple object of activity, belonging to several sectors of activity. Although they are very useful in the comparisons used by the financial analysis, there still are specific criteria to evaluate the average rates on sector, which must be taken into account because of precaution reasons, which can be materialized in the following aspects: (Brealey, et al., 2006)

- the proportionality hypothesis which implies that the report of the values at numerator and denominator would lead to the minimization of the differences related to the business dimension and the reporting period, but there are different dimensions (such as scale economies) which cannot be eliminated, and some elements do not evolve proportionally to the reality (the stocks compared to the turnover);
- the basis of comparison must be unitary, while the interests of the analysis users are different (the high liquidity is favorable to the creditors on short term, but for the shareholders it may represent a precarious management of liquidities);
- the analyzed period must be unitary, the beginning and the ending of the exercise is standardized at the level of the entire economy, giving not only a strong static character to the rates, but also a certain level of irrelevance (some activities are strongly seasonal, which means that the calculated rates are not relevant for the operation activity, implicitly endangering the relevance of the sector average);
- the accounting methods, whose periodical change cumulated with financial techniques such as revaluations of the patrimony elements may alter the relevance of the rates at the company's level as well as at the sector's level;
- the unitary basket, which means that the average is made by all the members of the population, fact which can alter the average value through the presence of negative numbers (some companies have profit, and other companies register losses).

The financial profile of the sector also depends on the following specific aspects which are essential:

- the different informational power of the rates, certified by specialty studies;
- the different practices of the suppliers of economic and financial information;

- complications when too many rates are used;
- the specific of the economy and sectors, respectively of the accounting system.

In Romania, the main supplier of financial rates on sectors is the National Trade Register Office. The offered set includes 18 rates.

The comparisons are made depending on values delimited on intervals. The statistic technique splits the interval of comparison in four subintervals: interval 1 (maximum rare - superior quartile); interval 2 (superior quartile-median); interval 3 (median - inferior quartile); interval 4 (inferior quartile - minimum rate). The use of interquartile intervals and median instead of average is based on the following statistic grounds. The median is the value which has the highest possibility to appear, eliminating the influences due to exceptional values. The interquartile range takes into account the variation of the phenomenon, being more precise than the one made on the basis of the median. The delimitation presents the advantage of inclusion in several subintervals (4), compared to those offered by the average (2 subintervals). The difference between the inferior and superior quartile covers 50% of the companies.

### **3. CONCLUSIONS**

The utility of the financial profile is represented by the evaluation of the sector's activity and the comparisons that can be made. The studies concluded that the individual results converge to the average of the sector, because the companies' managers tend to report permanently to them. It allows the evaluation of the financial profile and the general efficiency of a sector. It also makes possible comparisons between different sectors of activity, emphasizing clearly the differences and the elements specific to each sector, the identification of main tendencies at this level.

Still there is a series of risks which result from the abusive use of the average rates on the sector of activity. The different informational power of the rates may alter the global evaluation of the situation. The managers' tendency to correct the deviations from the average of the sector they compare themselves permanently may lead to the renunciation to some solutions which are more effective to those companies, the effect being known under the name of management to the average. The financial profile does not reflect the strategic alliances in the sector of activity. Also, the average of an industry where the majority of the companies is in decline is from the beginning irrelevant. The majority of the rates have a static character.

The main users of the average rates on sector are the banks, the consulting companies, the brokerage companies and the profile professional organizations. The managers of the companies frequently appeal to comparisons based on the average of the sector in order to evaluate the positioning of their own performances.

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