# STANDING'S PLACE AND ROLE IN THE FINANCIAL ANALYSIS OF THE ECONOMIC ENTITY

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*In this paper, the authors present the methods of determining the company's financial standing, based on its financial reporting. Hence, in the debate are included concepts commonly used in financial literature and banking practice such as credit worthiness, credit rating and standing.*

*Keywords: financial standing, creditworthiness, rating, credit-standing*

JEL Classification: G32

**1. Introduction**
Modern and efficient management of an entity must be evaluated using financial performance criteria, covering on one side operational activity and on the other side the actual financial activity conducted over a period of time determined usually by the financial exercise.
With respect to this, many analysts have designed and developed an assessment model of the entity's business based on score, a model that highlights the financial standing of the entity at some point in time. They consider that in between two successive moments of the financial position, reflected by the balance sheet, respectively the beginning and end of the financial exercise, intercedes the work carried out by the firm whose efficiency or inefficiency is reflected in the results, that is the profit and loss account.

**2. The Importance of Financial Standing in the Current Financial Crisis**
With the help of financial standing, managers can always find out why a company has not paid its debts to suppliers, budgetary obligations, why customers have not been asked to pay for services they received and what are the causes that led to a lack of cash resources. The reason for designing and making some models of standing is that from the beginning of 2010 nearly 16,000 entities have entered into insolvency, twice compared to the entire year 2007. The value of checks and promissory notes issued without coverage reached almost 450 million Lei in September 2010. Analysts stated that this fast growth in the number and amount of payment incidents is due to the economic crisis, which led to financial blockage. Therefore, now more than ever, managers must find out the financial situation of their business partners.
The National Bank of Romania has a database with information about all entities that generated payment incidents, entities that have issued checks and promissory notes without coverage. In order to find out information about an entity, one must seek the services of a bank, which charges a fee to query the CIP database. By consulting this database, one can find out both the payment incidents in which a business partner was involved and also if the serial number of the check the business partner has issued is part of a set of payment instruments approved by The National Bank of Romania or whether this check was previously declared to CIP as lost, stolen, destroyed or withdrawn from circulation.

Specialized Romanian sites can be used to find out financial information about companies, namely from “bonitate.ro” or “vrajitorul.eu”. Moreover, information is also obtained from the databases of the Official Gazette, the Securities Guarantees Archive, the Trade Register or the Insolvency Report. Another solution for a brief check of a business partner is checking public databases. On the website of the Ministry of Finance, financial information of all Romanian companies can be found, both regarding the balance sheets and the profit and loss account.
The data provided by the Ministry of Finance must be analyzed and interpreted, in other words a score that reflects the entity’s financial standing must be set.

**3. Method and Results**

Economists generally believe that is ideal for a business to have had a profit in the last three years of activity. Another important indicator is the degree of indebtedness, calculated as the ratio between equity capital and permanent capital (medium and long term debt plus equity). A share below 30% of equity in total resources available to a company, medium and long term is considered unhealthy. Also, some economists believe that a business with no financial problems is one with general solvency (measured as the ratio between current assets and fixed assets on the one hand and total debt of the other hand) above 1,2.
Financial data in raw form is not always useful. This is why it’s easier to call upon the services of consultants specialized in analysis of standing. In Romania, there are consulting companies that provide more comprehensive reports on companies, including a “credit rating” which assesses the risk of insolvency of a business, based on a scale from 0 (insolvency proceedings pending) to 10 (non-existent risk).
The rating of a company takes into account both the company’s financial indicators (standing indicators, in our view) and qualitative factors such as company’s development, payment system, changes in the number of employees, etc. The way the company has met its payment obligations is also considered. A model of the entity’s standing takes into account the financial performance indicators to be used for estimating the economic value, value creation and future earnings potential in that business.
Most often, some of the following indicators are used in assessing a business performance: net result; operating result; operating cash flows; residual result; value added.
Out of the profitability indicators, the *net result* is the best known. Because of its normative character, it has a limited utility for investors. Analysts generally prefer performance indicators that are not bound to the results.
*Operating result* is the result before tax and financial expenses, which refers to the ability of managers and employees to create value whatever the tax rate and capital structure is. Operating result is often used as a performance indicator in the analysis of financial statements.
*Operating cash flow* provides investors with additional information beside the net income. In the U.S., operating cash flow has significantly changed with the introduction of SFAS 95 in 1987. In Europe, the International Standard IAS 7 is according to SFAS 95. This standard has specific rules for calculating treasury cash flow, which is nothing more than the reconciliation between the profit and loss account and balance sheet modifications. For countries that do not adopt these rules, operating cash flow remains an estimated number.
*Residual result* is the net result less invested capital cost. In recent years, this indicator has gained increased interest. A small but growing number of businesses select this indicator for determining the remuneration of managers.
*Value added* is the measure of overall performance which is distributed to all partners of the business. The concept of value added aims to provide an indication of the business contribution to national wealth creation.

In the specialty literature, there are opinions (Turliuc and Cocriş 1997: 294) that in the analysis and evaluation of the borrowers performance based on data from the balance sheet and income statement, banks can determine the creditworthiness of customers situation, using for this purpose a system of structure and performance indicators:
- *structural indicators*: turnover; equity; working capital, working capital requirements; net treasury; liquidity (as a milestone, it can be immediate, current and at a future date); solvency; the degree of indebtedness (it is taken into account an overall level of debt and a financial leverage); rotation speed (is determined as index or duration of specific balance sheet items);
- *performance indicators*: profitability can be expressed as the rate of operating return (gross or net), rate of economic return and rate of financial return; financial risk expressed as a degree of covering interest; the rate of value added; share of dividends from the net result.
By corroborating the results of creditworthiness' indicators, the bank can highlight the trader's financial situation marked by "strengths" and "weaknesses", which will make the credit decision to be well reasoned. (Turliuc and Cocriş 1997: 294) As it can be observed, in the banking environment, the *creditworthiness* of the company is of high importance and in the business environment the focus is on the company's *financial standing*, namely on its *rating*.
In their book, Costin Kirițescu and Emilian Dobrescu state that creditworthiness is "a form of trust that a person or legal entity has upon completion an economic and financial transactions, especially credit-based" (Kirițescu şi Dobrescu 1998: 43). As a result, *creditworthiness* endorses first of all accessing a credit. This way, bank management specialists believe that the *analysis of the borrower's creditworthiness* represents an important step in the process of bank lending. (Trenca 2004: 179) At this stage, based on documents provided by the client, the bank reviews the documentation for the credit. The need to analyze the economic and financial situation of the client is generated by the bank's need to know all the elements necessary for the credit decision. (Trenca 2004: 179)
In this analysis, a very important aspect represents establishing the creditworthiness of the borrower. Banks, in general must make sure the customer is creditworthy, *which defines, in fact, his ability to support debt service, respectively to repay that loan at maturity and pay interest, and also to prove the existence of insuring guarantees.* (Trenca 2004: 179)
In the context of economic and financial analysis of customers, banks often encounter a question that experts have tried to answer to, namely that if the *client's creditworthiness* established historically can be a compelling argument for future lending. (Trenca 2004: 179) Often it is argued that, in the lending process, excessive reliance that banks show towards *indicators of creditworthiness* resulting from past activities makes the decision of granting or refusing future loans not to be always correct. From this point of view, it would seem that in the process of assessing the credibility of the customers through the *past (historical) creditworthiness*, the ex-post analysis should be given less importance. Analysts should insist on the future, projected work, which otherwise is the purpose of the requested loan, in order to maximize certainty in drawing conclusions. (Trenca 2004: 179)
Other experts believe that creditworthiness can be evaluated (credit rating = *evaluating creditworthiness*) often in the form of a numeric or alphanumeric score (for entities or individuals), so that entities can decide whether to trade with that company or grant a loan to a person. (Koch 2001: 84)
In the Explanatory Dictionary of Romanian Language, creditworthiness is explained either by "credit and payment capacity of a person or an institution" or by "solvency". The term comes from the German word "*Bonität*". (Coteanu, Seche and Seche 1998: 107) In other words, creditworthiness can be characterized by these qualities of the entity. By creditworthiness, other specialists understand "the confidence that some people inspire when applying for a credit;

solvency (being creditworthy is derived from the French *solvabilité*)”. In the same time, specialists state that creditworthiness and “*good standing”* have the same meaning.

In other papers, the term *creditworthiness* is translated as *financial solvency*, solvency, funding capacity. Therefore, some authors regard the three concepts as equal. Also, the word solvency is translated as “credit – standing”. In our view, creditworthiness is the degree of confidence that can be drawn between two subjects. Financial standing concept is used in different papers with no explanation of its scientific content. That is why we will focus on it in the following paragraphs.

Romanian financial banking regulators have established for all credit institutions level a number of regulations based on which they periodically assess the performance of borrowers in order to build up reserves in the banks. (Romanian National Bank Regulation No.5/22.07.2002 on the classification of loans and deposits, and the establishment, adjustment and use of credit risk provisions, published in the Official Gazette No.626/ 23/08/2002). Financial performance represents the reflected economic potential and financial strength of an economic entity, obtained after analyzing a set of *quantitative* factors (financial and economic indicators calculated based on compiled data from annual and periodic financial statements, referred to as financial statements) and *qualitative* ones.

The assessment of financial performance of an economic entity will lead to its inclusion in one of the five categories of financial performance (A-E). This assessment is done according to internal rules of credit institutions, based on scores assigned to quantitative and qualitative factors. *Quantitative* factors relate mainly to the following indicators: liquidity, solvency, profitability and risk, including currency risk.

*Qualitative* factors include at least aspects of the way the analyzed economic entity is administrated: the quality of ownership, collateral received (other than those which are to reduce the exposure to the debtor), the market conditions in which it operates.

The above indicators are determined based on data contained in the company’s financial statements, elaborated according to regulations issued by the Ministry of Public Finance or the authorities of other countries with similar competences. The category of financial performance contributes to establishing the category of classification of loans in the month following the one when respective reports are submitted to the bank. If banks are unable to assess the financial performance of a client, this client will be assigned directly in the category E.

Loans and investments are classified into the following categories: standard; under observation; substandard; questionable; loss. Classification of loans and investments is made by the simultaneous implementation of the following criteria, when possible: for *credit institutions*: debt service; financial performance; initiation of legal proceedings; for *non-banking financial institutions*: debt service; starting legal proceedings.

***Table no.1 Classification criteria for loans granted to customers outside the credit institutions***

<table>
<tr><td colspan="2" rowspan="2"></td><td colspan="5">Financial Performance</td><td rowspan="2"></td></tr>
<tr><td>A</td><td>B</td><td>C</td><td>D</td><td>E</td></tr>
<tr><td rowspan="10"></td><td rowspan="2">0–15 Days</td><td>Standard</td><td>Under observation</td><td>Substandard</td><td>Questionable</td><td>Loss</td><td rowspan="4">No legal procedure initiated</td></tr>
<tr><td>Loss</td><td>Loss</td><td>Loss</td><td>Loss</td><td>Loss</td></tr>
<tr><td rowspan="2">16–30 Days</td><td>Under observation</td><td>Substandard</td><td>Questionable</td><td>Loss</td><td>Loss</td></tr>
<tr><td>Loss</td><td>Loss</td><td>Loss</td><td>Loss</td><td>Loss</td></tr>
<tr><td rowspan="2">31–60 Days</td><td>Substandard</td><td>Questionable</td><td>Loss</td><td>Loss</td><td>Loss</td><td rowspan="6">Legal procedure initiated</td></tr>
<tr><td>Loss</td><td>Loss</td><td>Loss</td><td>Loss</td><td>Loss</td></tr>
<tr><td rowspan="2">61–90 Days</td><td>Questionable</td><td>Loss</td><td>Loss</td><td>Loss</td><td>Loss</td></tr>
<tr><td>Loss</td><td>Loss</td><td>Loss</td><td>Loss</td><td>Loss</td></tr>
<tr><td rowspan="2">min. 90 Days</td><td>Loss</td><td>Loss</td><td>Loss</td><td>Loss</td><td>Loss</td></tr>
<tr><td>Loss</td><td>Loss</td><td>Loss</td><td>Loss</td><td>Loss</td></tr>
</table>

Source: www.wall-street.ro

As can be seen from Table no.1, according to recent regulations of the National Bank of Romania, credit institutions must include borrowers outside the credit institutions sector into financial performance categories, which are marked from A to E, in decreasing order according to quality. (Romanian National Bank Regulation No.3/19.03.2009, on classification of loans and deposits, and the establishment, adjustment and use of credit risk provisions, published in the Official Gazette No.200/03/30/2009)

Therefore, financial standing is focused more on the quantitative side of the entity, which is based solely on financial indicators. This standing has the goal of establishing a score, which classifies the economic entity in a particular *financial performance class* or a *class rating*.

Regarding rating, there is also the issue of the *country rating*, an index which estimates the ability and willingness of a country to repay external debt using foreign currency. Based on these understandings and other sources of information, we consider that *rating* is an evaluation process (assessment) of a system's status, evaluation after which the entity is granted a *mark* (number and/or letter(s) or a score). Hence, the classification of an entity in a *performance class* marked from "A" to "E", based on a *score*, is no more than the *rating* given to that entity.

## 4. Conclusions

Based on the above aspects, we can state the following.

- an economic entity's financial condition must be the main business target for every manager;
- the assessment of the financial condition can be done with the help of a system of linked financial and non-financial indicators, where the most important are the financial indicators;
- the creditworthiness of a company that involves accessing a loan from a credit institution is subject to banking regulations in Romania, customized at microeconomic level;
- determining the level of each financial indicator ultimately involves determining the financial standing and classification of the entity in a certain group of rating involves the design of a unitary pattern of aggregation of individual scores set for each financial ratio.

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