

Empirical Study on the Example of an Economic Entity in Romania About Financial Performance Indicators

Ilie Răscolean
Ileana - Sorina Rakos
University of Petroșani, Romania
ilierascolean@yahoo.com
nihilsinedeo_68@yahoo.com

Abstract

Today, the business environment faces many challenges, which have a major impact on the performance of economic entities, financial markets being influenced by vectors of change, such as: fierce competition, high costs, deregulation with not only financial but also social impact, the exchange rate and last but not least, globalization. This study presents the financial and non-financial indicators used to measure the performance of a Romanian economic entity, associates the concept of performance - profit, income and expenditure as elements directly related to measuring profit, so performance. It also presents aspects of profitability - a fundamental criterion for assessing the efficiency of the activity of an economic entity. The purpose of this paper is to demonstrate that profitability indicators are particularly important, indicating the effectiveness of an economic entity. This aspect is highlighted by an empirical study, on the example of an economic entity. The article concludes with the author's conclusion.

Key words: economic entity, performance analysis, performance indicators, profitability, value
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1. Introduction

The globalization of the economy makes the external competitive environment of any economic entity become approximately the same for all countries, and the characteristics of the economic environment of developed countries are valid for the rest of the economies in transition or developing. The goal of any economic entity is value creation - investments for which the resulting efficiency is higher than the rate of return required by shareholders. This challenge has led managers to focus on value creation and differentiation from other parameters - earnings. Therefore, the competitiveness of economic entities is closely linked to performance, and the knowledge of the best methods of measuring performance and value creation leads to its increase. In order to be able to measure performance, the information needs to be presented correctly. Thus, the role of information provided by accounting should not be neglected. By using information that accurately expresses the financial situation of an economic entity, performance measurement indicators can be calculated and economic models developed. Financial performance provides a true and relevant picture for choosing an optimal financial structure, by establishing the most appropriate asset management strategies for adopting those investment and dividend decisions that will serve to improve the performance of economic entities. From a financial point of view, a profitable investment increases the value of the economic asset. Modern financial indicators are based on the concept of value creation, representing a benchmark for expressing real financial performance. Indicators such as the rate of economic return on assets and net profit per share are used as measures of performance in a large number of economic entities, although these indicators are not theoretically correlated with value creation. In order to highlight value creation within economic entities, a wide range of indicators is used that can be grouped into three broad categories: accountants, economists and stockbrokers.

2. Literature review

In the literature, the concept of performance has been assigned various meanings, such as: competitiveness, the positive result of an activity, profitability, efficiency, success, outstanding achievements in a field, satisfaction, productivity, etc. In the national literature, an important contribution was made by specialists such as: Neghină (2012) which supports the idea of a negative influence of the effective tax rate on performance, using economic profitability (ROA) and financial profitability (ROE); Pântea M, Gligor D and Anis C. (2014) who, in the light of a long-term study, found that the size of the economic entity, the intensity of capital and the number of employees positively influence the performance. Bolboroş (2014) also argues that an increase in debt, although it contributes to increasing risk, also determines an increase in performance. Externally, Chinaemerem, Anthony and Erdogan (2015) made a significant contribution to the literature, demonstrating that there is a positive correlation between company size and financial performance. A more recent study by specialist G.Kokins (2017) indicates that, "the performance of current organizations is a multivalent concept that incorporates the overall satisfaction perceived both by the organization, by entrepreneurs and employees, and that perceived in its external environment, by third parties such as: suppliers, customers, the state and civil society in general".

3. Research methodology

The research involved the observance of principles and rules specific to the research methodology: the review of the literature, the collection and processing of data, the synthesis of theoretical aspects and results obtained. Theoretical research analyses and describes the current state of knowledge as a result of specialized theoretical documentation, in the context of national and international references. The idea of the research is due to the concepts of profitability / return and growth that together give the measure of the profitability of an economic entity. The central question of the research is: *Is any profitable activity also rewarding? And vice versa: Is any rewarding entity also profitable? And in the alternative: Are there entities that are profitable but not rewarding?*

4. Semantic analysis of performance

The answer to the question: *What is the performance of an economic entity?* it is far from as simple as one might think. Although there are many definitions of performance in the literature, there is still no consensus on the definition of the concept or how to measure it. Performance, success and development, these three elements became at the beginning of the 21st century a truly obsessive motivation of economic entities, in an attempt to enter and maintain themselves sustainably, in a competitive market.

Transposed into the business environment, the term performance is interpreted as a good success or as development, both in general and in specific areas of activity of economic entities (commercial, technical, financial, social, etc.) that can be quantified with the help of a set of indicators or criteria of quantitative and qualitative nature (profit, profitability, turnover, cash flow, market share, cost of externality, brand image, social climate, reputation of the management team, etc.) constituting the expression of management an entity. Managers are interested in the overall performance of economic entities, investors will perceive performance through return on investment, employees and the customer are interested in the stability of the entity, while creditors consider solvency and liquidity.

4.1. Performance measurement

Performance measurement is essential for economic entities, i.e. the presence of an efficiency measurement system is a necessary condition for the proper management of an entity. In this regard, the best indicators should be chosen to reflect and make a major contribution to measuring the performance of an economic entity.

4.1.1. Relevance of the performance measurement system

The performance measurement system of an economic entity must include a set of equitable indicators, related to the strategy of the entity and to assist managers in their actions. Performance indicators must be able to assess the current state of an entity in relation to the degree of achievement of the assumed objectives. These practical indicators send a message to the entire entity about what is important to be known by all employees, namely: communicate the strategy defined by management including lower hierarchical levels; provides feedback on the performance of the management team; reflect the outcome of controls and improvements in a process; expresses in quantitative terms the results of the various activities of a process or of the process itself, in accordance with a specific objective.

4.1.2. Problems that may arise in measuring performance

Problems can arise in measuring performance when specialists choose performance criteria that seem appropriate, but without trying to place them in a coherent overall structure. Problems in measuring performance may arise when evaluating it, as, due to the lack of consensus around the notion of performance, specialists may use different performance indicators. In measuring performance, various problems may arise, among which we mention: (1) the organizational or environmental aspect of the selected criteria; (2) the particularity or universality of the criteria; (3) the normative or descriptive nature of the criteria; (4) the static or dynamic aspect of the criteria.

4.1.2.1. The organizational aspect of the performance criteria

Achieving the set objectives and productivity are the most used performance criteria, but it should not be overlooked that the designation of objectives as a performance criterion must taken into account the interaction between the entity itself and its business environment.

4.1.2.2. Universality of criteria

It is assumed that successful economic entities all have the same criteria (flexibility, adaptability, conciliation, sense of identification) and the identification of a performance must be guided by a set of valid universal indicators. In practice, however, it follows that each economic entity has its own objectives and chooses individually a unique set of performance criteria.

4.1.2.3. Normative or descriptive criteria

There are three types of managers, in the sense that: a first category prefers to use suggested criteria, another category prefers to measure performance deductively, stating that the entity must admit and use effective standards, and a third category have an approach measuring purely descriptive performance, avoiding evaluation standards;

4.1.2.4. Dynamic or static criteria

The static or dynamic aspect of performance variables is another problem in measuring the performance of an economic entity. Therefore, the performance criteria may be different from their sources. Performance criteria are subject to conflict between several opinions as to who should determine the criteria and who should provide the data for their measurement.

4.2. Level of analysis

In determining the performance criteria, an important role is played by the external environment in which the entity carries out its activity. In evaluating the performance of an economic entity, financial rates play a major role in the analysis of profitability, liquidity assessment, estimation of future profit, competition analysis and bankruptcy prediction. With the use of financial rates, the question naturally arises. Which report is most relevant in the analysis of performance, from the number and type of reports that can be prepared based on available data? Thus, several variables must be correlated from which to result practically the factors that must be taken into account in the elaboration of the reports.

4.3. About performance indicators

At the level of each economic entity, the strategic and operational performance at the level of organizational team and individual, respectively, in the systemic approach of the management process, is the major objective, given that the entity must constantly relate to market demand and supply adequacy to identified needs. In order to be able to assess whether the strategies are

effective and the extent to which the objectives are achieved, an integrated system of performance indicators must be defined, through which the economic entity is able to constantly assess its resources and act towards their efficiency growth of their use. In this regard, any managerial decision must be based on a very good knowledge of the current state of the entity, which would not be possible in the absence of a system of performance indicators to inform management about the results obtained in all key activities and processes of the entity. To be effective, a performance indicator must be both the synthesis of several important data of the economic entity and meet the following S.M.A.R.T. criteria (smart indicator) shown in table 1:

Table no. 1. SMART criteria of performance indicators

SMART criteria	Explanation
-S for specific and simple:	it must be clear, specific, simple to understand by users;
-M for a measurable objective:	Allows the measurement of the achievement of an objective (efficiency) compared to a standard;
-A to be ambitious and achievable:	Must allow the challenge and its realization must be possible;
-R realistically:	Must consider available resources and means (efficiency);
-T for the defined period:	A good goal must be delimited in time (deadline).

Source: Authors' processing

In order to formulate the most appropriate performance indicators for an economic entity, several specific rules must be followed: (1) for a first orientation, the Internet allows access to a wide range of indicators; (2) formulating SMART indicators based on a set of questions such as: what? (discussing variables that can produce new ways to measure change in goals); how much? (to define the magnitude of the desired change); who? (to clarify who belongs to the target group); where? (specific information related to the area of applicability); When? (defining the time period).

It is preferable to create synthetic indicators that allow a comprehensive and rapid analysis. The indicator can be called an alert trigger. Only in case of slippage, the manager will ask for details to understand the cause of the discrepancy. The purpose of performance indicators is to improve the performance of the economic entity. In order to measure performance, there are three types of indicators: result indicators, process indicators and environmental indicators, and depending on the role played by the decision-maker, performance indicators can be classified into three categories as follows: (1) warning indicators, which inform of an abnormal state of the system that requires short-term intervention; (2) remedial action; in practice, the alert indicator may signal an increase in a certain cost or a decrease in quality for a particular product; (3) equilibrium indicators, to monitor the entity's progress towards the proposed goal. These indicators are able to measure the reliability of the deadlines and compare the results obtained with the previous ones and with the established objective. The question naturally arises: What performance indicators should be chosen? The performance indicators are numerous, but it is essential to identify the most significant of them, as well as those that correspond to the activity of the economic entity, in order to obtain reliability and efficiency. In order to have a global vision on the entity's performances, three main groups of indicators are distinguished (human resources, marketing, financial-accounting) presented in table no. 2.

Table no. 2. Main groups of performance indicators

Groups of indicators	Subgroups	Explanations
Human resources indicators - these indicators allow the evaluation of the costs, involvement and competence of the employees of the economic entity, in the light of the following:		
	Average recruitment cost (ARC):	The average total cost of recruitment over a reference period is measured; it is determined using the following calculation relationship: $ARC = \text{total cost of recruitment in period } x / \text{number of recruits in that period}$
	Employee turnover rate	It measures the variation between the number of those leaving and the number of new recruits. It is determined by the following calculation relation: $(\text{number of departures in year } N + \text{number of arrivals in year } N (2) / \text{number of departures on 1 January of year } N, \text{ the result obtained multiplied by } 100 \text{ to obtain a percentage.}$

	Absenteeism rate	It measures the cost of employee absenteeism from the economic entity. Determined by the calculation relation: (number of hours of absence from the period / number of theoretical hours of work per period) x 100
	Employee training rate	Measures the number of training hours per employee. It is determined as follows: the number of employees trained during the year / total workforce.
Profitability / efficiency indicators of economic entities		
	Increase sales	The change in the sales of a public enterprise from one reporting period to another. Formula: $([Current\ sales] - [Previous\ sales]) / (Previous\ sales) = (Increased\ sales)$
	ROI (return on investment)	It shows the efficiency of an investment. Formula: $([Return\ on\ Investment] - [Investment\ cost]) / (Investment\ cost) = (ROI)$
	ROE (return on equity)	The value of the net income that a public enterprise generates in relation to the value of its own capital. Formula: $(Net\ income) / (Equity) = (ROE)$
	ROA (return on assets)	Indicates how profitable a public enterprise is in relation to its total assets. Formula: $(Net\ income) / (Total\ assets) = (ROA)$
	Return on employed capital	It measures the profitability of a public enterprise and the efficiency with which its capital is invested.
	Operating profit margin	It measures revenue after variable production costs are taken into account. Formula: $(Operating\ income) / (Net\ sales) = (Operating\ profit\ margin)$
	Net profit margin	Percentage of revenue of a public enterprise that represents net profit. Formula: $(Net\ profit) / (Income) = (Net\ profit\ margin)$
	Net income	The amount of money that a public enterprise makes after deducting all expenses and other costs. Formula: $(Income) - (Expenses) = (Net\ profit)$
	Gross profit margin	Percentage of revenue that represents profit after taking into account production and sales costs. Formula: $(Gross\ profit) / (Income) = (Gross\ profit\ margin)$
	Gross profit	Profit of a public undertaking, after taking into account production costs and sales. Formula: $(Income) - (COGS) = (Gross\ profit)$.
	Economic added value (EVA)	An estimate of the additional economic profit of a public enterprise
	Average employed capital	Indicator showing profitability in relation to investments made in new capital
Key revenue performance indicators		
	Sales volume	The value of sales obtained in a reporting period and expressed in a number of units sold
	BT (Profit obtained before tax)	It shows the profit made by a public enterprise after taking into account the COGS (costs of goods sold), interest, administrative expenses (VAG), before deducting tax. Formula: $(Income) - (COGS) - (Interest) - (VAG) = (EBT)$
	BITDA (Gross operating income)	It measures profit after expenses and after interest, tax, depreciation and amortization. Formula: $(Income) - (Expenses\ excluding\ interest,\ tax,\ depreciation\ and\ amortization) = (EBITDA)$
	Profit before payment of interest and tax (EBIT)	An indicator of the company's profitability, which indicates the profit obtained before the payment of interest and tax Formula: $(Revenue) - (COGS) - (Operating\ expenses) \text{ or } Operating\ profit + Financial\ income = (EBIT)$

Non-financial indicators		
	innovation processes; production capacity; the number of new products or services; development time of new products, number of patents; operational: efficiency; number of defects; the time required to deliver the product to the customer; trial; real-time delivery percentage; the average time required to complete the production according to the orders; the time required for installation and adjustment; actual production time.	employee education and skill levels; figures indicating employee satisfaction; availability of information systems: processes with advanced controls; the percentage of suggestions of the implemented employees; the percentage of compensation based on individual and team incentives.

Source: Authors' processing

The performance analysis using financial and non-financial indicators can guide the economic entity's future decisions regarding investment policy, changes in strategy in relation to the market, employees, creditors and decisions to expand or restrict the activity. Achieving the objectives is always related to achieving some indicators. Indicators are those elements that can be quantified by achieving which we demonstrate the achievement of the proposed objectives. Strengthening the market position of an economic entity requires the possession of information on the level of past performance and solutions to increase performance and competitiveness adapted to the requirements of the present society. Financial indicators play an important role in assessing the performance of an economic entity. Over the years, empirical studies have repeatedly demonstrated the usefulness of these indicators, as they play an important role in profitability analysis, liquidity assessment, future profit estimation, competition analysis and business failure prediction.

5. Profitability rates - relative expression of profitability

Considering that the development of the lucrative activities of an economic entity presupposes the existence of a capital to finance the necessary resources for this activity, we can say that the profitability represents the level of return on capital, regardless of its origin. Regarding the absolute profitability of an economic entity, the profit analysis is the one that can provide the most detailed information. Knowing the capacity of the economic entity to produce absolute profit is not sufficiently representative, so it is necessary to measure the mass of profit with other quantities that express the effort to obtain the mass of profit, thus freeing up profitability rates. The expression of the relative return is achieved through an instalment system that expresses the capacity of the economic entity to ensure, with the help of its available resources, the remuneration of the invested capitals. That instalment system shall be determined as the ratio between the economic and financial effects of an entity and the efforts made to obtain them. Thus, in determining the profit, an instalment system is used that expresses the profitability, such as: the economic, financial profitability, resources consumed, commercial and expenses compared to income rates, aspect summarized in table no. 3.

Table no.3 Return rates

Name of return rate	Explanations - calculation relations
1. The return rate on expenditure to revenue	It is determined as the ratio between total expenditure and total revenue, as appropriate the following calculation relation: $Rt = Cht / Vt * 100$ or $Rt = Che + Chf + Chex / Ve + Vf + Vex * 100$ where: Cht = sum of total expenses; Vt = sum of total revenues, Che = sum of operating expenses; Chf = amount of financial expenses; Chex = amount of extraordinary expenses, Ve = amount of operating income; Vf = amount of financial income; Vex = sum of extraordinary income
2. Commercial profitability rate	With the help of this rate, the efficiency of the commercial policy (supply, storage, sale) and of the pricing policy is analysed. Regardless of the calculation method, the purpose of the analysis is to explain the evolution of this indicator, respectively to establish its trend. $Rc = Rexpl / CA * 100$ or $Rc = RBE / CA * 100$ or $Rc = Rnet / CA * 100$ or $Rc = (Re + Rf + Rex) - 1 / CA * 100$ Rc = commercial profitability rate; Rexpl = operating result; RBE = gross operating result; Rnet = net result of the exercise; CA = turnover; P = profit related to turnover

3. Return on used resources rate	It is determined by reporting an indicator of the results to the consumption of resources involved in obtaining it, thus expressing the efficiency of the effort materialized in costs. $Rrc = P / Ch * 100$, where: Rrc = rate of return on resources consumed; P = profit related to turnover; Ch = expenses related to turnover;
4. Economic profitability rate	It determines the efficiency of the invested capital, of all the material and financial resources involved in the activity of the economic entity. $Re = Rc / At * 100$ or $Re = RBE / At * 100$ or $Re = Rexpl / At * 100$ where: Re = rate of economic profitability; RBE = gross operating result Rexpl = operating result; At = total assets; Aexpl = operating assets; Rc = current result.
5. Financial return rate	It is a significant indicator in assessing the economic and financial performance of the economic entity, both in the internal diagnosis and in the analysis requested by external partners. $Rf = Rcurrent / Kpm * 100$ or $Rf = Rnet / Kpp * 100$ where: Rf = financial rate of return; Rcurrent = current result of the exercise Kpm = permanent capital; Rnet = net result of the exercise; Kpp = equity
6. Market capitalization coefficient (PER = price earning ratio)	This indicator determines the reaction of the financial market according to the financial profitability and measures how many times investors are willing to pay the return on a share: $PER = Cba / Pa$ where: PER = stock market capitalization coefficient; Cba = stock exchange rate of the action; Pa = profit per share
7. Interest rate	The interest rate is the main element on which the interest is calculated. $Rdob = Interest / Interest-bearing debts$, where: Rdob = interest rate.

Source: Authors' processing

The following lines present a summary of an empirical study on the example, producer and distributor of dairy products, which purchased the old dairy factory and developed it with the help of European money received on the Sapard program, in 2006. Thus the most significant rates were considered of the said economic entity and was performed on the basis of the balance sheet, calculation and interpretation of the net margin rate (Rpn), financial return (ROE), return on invested capital (ROIC), interest rate (Rdob) and analysis of the relationship between return on capital rates

Active	Balance at the end of the financial year		Capital and debt	Balance at the end of the financial year	
	Year 2018	Year 2019		Year 2018	Year 2019
I. Fixed assets	24.500.000	26.600.000	I. Equity	21.000.000	21.000.000
Intangible assets	700.000	700.000	II. Provisions	-	-
Tangible fixed assets	21.000.000	23.100.000	III. Debts	7.000.000	16.100.000
Financial assets	2.800.000	2.800.000	Long-term debts	14.000.000	10.500.000
II. Current assets	10.500.000	10.500.000	Short term debts	14.000.000	5.600.000
Inventories	3.500.000	4.200.000	Providers	4.200.000	3.500.000
Claims	5.600.000	4.900.000	Other operating debts	2.100.000	1.400.000
Register and bank accounts	1.400.000	1.400.000	Short-term bank debts	700.000	700.000
Prepayments	-	-	IV. Advance income	-	-
Active Total	35.000.000	37.100.000	Total capitals and debts	35.000.000	37.100.000

The simplified profit and loss account of the economic entity is:

- lei -

Element	Financial exercise 2019
Turnover (production sold)	42.000.000
Material expenses	28.000.000
Staff costs	5.600.000
Depreciation expenses	1.400.000
Interest expenses	700.000
Income tax expenses	840.000
Net income	5.460.000

1. Calculation of the return rates on capital:

1.a) Net margin rate (commercial profitability)

$$R_{pn} = PN / CA = 5,460,000 \text{ lei} / 42,000,000 \text{ lei} = 13\%$$

The net margin rate of 13% shows that for every 1,000 lei obtained from the sale of dairy products, 130 lei will be found in the net profit of the entity and will be available for the remuneration of entrepreneurs.

1.b) Financial profitability

$$ROE = PN1 / CPR0 = 5,460,000 \text{ lei} / 21,000,000 \text{ lei} = 26\%$$

Financial profitability is quite high, well above the inflation rate or the deposit interest rate, for a complete analysis it is good to analyse the risk assumed by the decision makers at the top of the economic entity's management.

1.c) Return on invested capital

$$ROIC = PN + \text{Interest} / AE = 5,460,000 \text{ lei} + 700,000 \text{ lei} / 21,000,000 \text{ lei} + 7,000,000 \text{ lei} = 22\%$$

The rate of invested capital is 22%, which means that, for every 1.00 lei invested in the business, investors obtained a gain of 220 lei.

1.d) Interest rate

$$R_{dob} = \text{interest} / \text{interest bearing debts} = 700,000 \text{ lei} / 7,000,000 \text{ lei} = 10\%$$

2. The connection between the return rates is made by the following calculation relation

$$ROE = ROIC + (ROIC - R_{dob}) * DTL / CPR;$$

$$ROE = ROIC + \text{Leverage}$$

$$\text{Leverage} = (ROIC - R_{dob}) * DTL / CPR = (22\% - 10\%) * 7,000,000 \text{ lei} / 21,000,000 \text{ lei} = 4\%$$

$$ROE = 22\% + 4\% = 26\%$$

The positive leverage effect shows that the indebtedness is in support of the shareholders, the general manager effectively allocating the resources attracted from various creditors and thus generating additional gains.

6. Results

From the point of view of statistical logistics, as well as from the methodological point of view, in order to compare the determined economic-financial performance indicators, it is recommended to use annual average determinations for all indicators extracted at a given moment from the balance sheet. The indicators being compared must have the same extension of time. In order to confirm a minimum of economic and financial performance, a benchmark of the general appreciation of the size of the financial rate of return is its comparison with the average level of interest rates granted by credit institutions for bank deposits, which must be slightly ahead of it. At the same time, the size of the economic rate of return is comparable to the rate of inflation and must be higher than this.

7. Conclusions

The analysis of the performance of economic entities has become more and more important, each economic entity emphasizing the fulfilment and support of this process, being important to know what is the viability and sustainability of the entity. There is currently a great diversity of opinions, both on the concept of performance and on related concepts, such as: profitability, productivity, effectiveness, efficiency and sustainability. Any economic entity must ensure the provision of quality products to customers. Therefore, performance indicates that it also depends on the prices at which the consumed resources are purchased and the prices at which they will be sold. The difference between them, practically, represents the profitability of the entity, the productivity putting / and more or less the imprint on the performance. The empirical study shows that high profitability due to high productivity is a solid basis for performance, but does not guarantee its maintenance in the future. In order to maintain good profitability, there must be quality and responsibility in the provision of services and good flexibility in adapting quickly to the demands of the ever-changing market. In conclusion, it can be stated that the rate of economic profitability is

a basic indicator used to measure the volume of the entity's activity and its performance, constituting one of the strategic indicators for measuring the economic performance of the entity. The size of the return rate, expressing on the one hand the degree of remuneration of the capital employed in the activity of the entity and on the other hand, the way of remunerating the risks assumed by entrepreneurs, plays a decisive role in determining the long-term and short-term financing of an economic entity.

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