EVALUATION OF MANAGEMENT PERFORMANCE BY MEANS OF INCOME STATEMENTS AND CASH FLOW

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Abstract: The evaluation of the economic and financial performance of a company actually illustrates the management's capacity of achieving the established goals. The evaluation of management performance requires a complex comparative and evolutional analysis of a company's financial development. The study aims at outlining the importance of the analysis of income statements and cash flows in the evaluation of management performance.

JEL classification: G17, G32

Key words: performance, cash flow, management, goals

1. Introduction

For any economic entity, it is important to know, at any time, its capacity to reach the proposed goals. The main competence of the management consists in maintaining a company at the desired performance level. For this reason, it is essential that the management should be permanently evaluated in terms of the recorded performances.

2.Concepts and Methodology:

A company has performance if it is profitable, competitive and provides customers with quality products[1]. This approach of professor Iulia Jianu incorporates the newest approaches of economic and financial performance and defines the most important goals of a company's management.

A company's performance depends both on the operational management and on financial management[2]. The financial management requires a more detailed approach, because its actions influence both the company's current financial situation and the future evolution thereof. The financial management is that component of the general management which controls the achievement of the established financial goals, manages the company's assets, in order to prevent its bankruptcy risk, draws up annual financial statements and accomplishes financial predictions for the following period. The fulfilment of all these attributions is essential for the company to reach the target performance and maintain it for a longer time.

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[1] Jianu,I., Evaluarea, prezentarea si analiza performantelor intreprinderii, Ed. CECCAR, Bucharest, 2007, p. 484

[2] Batrancea, I., Batrancea,L.M., Borlea,S.M., Analiza financiara a entitatii economice, Ed. Risoprint, Cluj-Napoca,2007, p. 35

Performance is a major concept in theoretical approaches and, at the same time, a permanent concern in practice[3]. For these reasons, performance must be assessed not only in theoretical terms, but also in practical terms, by means of the company's annual financial statements.

The evaluation of performances on basis of financial statements is oriented towards past, which is why extrapolations are extremely difficult. However, any decision is the result of such an analysis of performances, which can only affect the future[4].

A dimension of financial performances is outlined by means of the income statement. This statement provides information used both for the evaluation of a company's previous performance and for estimating its future financial results[5].

The income statement is a synthetic accounting document, which classifies the operating, financial and extraordinary flows of a company[6].

The structure of the income statement in Romania complies with the Order of the Minister of Public Finance no. 1752/2005 (for the financial statements elaborated from 2005 to 2009) and contains the detailed presentation of the achieved result, by outlining the incomes and expenses, according to their nature, as well as the result of the exercise, by categories of activities and globally[7]. Thus, the achieved gross result represents the accumulation of the operating result, the financial result and the extraordinary result. The net result is obtained by subtracting the income tax from the gross result. Within the accomplished study, only the specific results for each type of activity will be used, not the related incomes and expenses as well.

The income statement provides an incomplete image of performances, if not used in combination with the balance sheet and the statement on changes in the financial position[8]. Changes in a company's financial position is presented by means of the cash flow statement.

The balance sheet presents the balance of liquidities and liquidity equivalents at the end of the period. However, the balance sheet does not indicate why liquidities and liquidity equivalents increased or decreased. The income statement presents the information of the type of incomes, expenses and results released by the various activities, which represent key information on sources and uses of liquidities and liquidity equivalents, but this statement does not explain why such elements increased or decreased[9].

Thus, in order to assess management performances, besides the analysis of the information on sources and uses of liquidities, the analysis of the cash flow statement must be performed, in order to obtain information on the variation of liquidities. The

[3] Niculescu, M., Diagnostic global-strategic (Diagnostic financiar) vol 2, Ed. Economica, Bucharest, 2003, p. 42

[4] Helfert, E., Tehnici de analiza financiara. Ghid pentru crearea valorii, BMT Publishing, Bucharest, 2006, p. 111

[5] Batrancea, I., Batrancea, L.M., Borlea, S.M., Analiza financiara a entitatii economice, Ed. Risoprint, Cluj-Napoca,2007, p. 237

[6] Idem, p. 237

[7] Siminica, M., Diagnosticul financiar al firmei, Ed. Universitaria, Craiova,2008, p. 21

[8] Brezeanu, P., Finante corporative, vol I, Ed. CH Beck, Bucharest, 2008, p. 34

[9] Batrancea, I., Batrancea, L.M., Borlea, S.M., previously cited work, p. 271.

cash flow statement may also be used for evaluating any economic decision and reveals the company's economic performance[10].

Within any economic entity, in accordance with the structure of cash flows, three main financial cycles may be identified: the operating cycle, the investment cycle and the financing cycle[11]. The cash flow statement presents the surplus, respectively the deficit in each of the three cycles and the methods through which each of these has attained a certain result. The total amount of these flows is represented by the net cash flow obtained during the analysed financial exercise.

Because the financial evaluation of the managers' performances depends both on the human factor and on the company's policies[12], the results expressed by the income statement (expressing the consequences of the use of liquidity sources) and the cash flow (showing the statement of liquidities and the causes leading to this situation) must be analysed.

3.The Analysis of Management Performances by Means of the Income Statement and the Cash Flow in Pfizer Inc and Abbott Laboratories:

In order to outline the importance of an assessment of management performances by means of the income statement and the cash flow, a comparative study was made in Pfizer Inc and Abbott Laboratories, for the period 2005-2009. Both companies belong to the group of the biggest medicine manufacturers at a world level.

The study includes the analysis of the income statement and the cash flow statement for each company and the comparison of the obtained results, in order to reach the study conclusions.

The income statement and cash flow statement for Pfizer Inc are presented in table

Interpretation:

Analysis of the income statement: In order to outline the importance of the analysis of management performances by means of the income statement, an annual analysis of the evolution of synthetic indicators must be made:

During the period 2005-2009, except for the year 2006, the operating result is positive and the financial result is negative, which means that revenues exceeded expenses in the operating activity and the other way around, in the case of the financial activity, which diminished the total result. Analysing the total result, the management achieved its profitability objective, but with higher financial expenses than the revenues obtained from this activity. In the entire analysed period, the extraordinary activity did not influence the total result.

In the year 2006, the total result had the highest value, due to the positive financial result.

Cash flow analysis: In order to outline the importance of the analysis of management performances by means of the cash flow, an annual analysis of the evolution of its components must be made:

In 2005, the operating cash flow is positive, whereas the investment and the funding cash flows are negative. Such a situation is specific to mature companies,

[10] Idem, pag. 266

[11] Batrancea, I., Analiza trezoreriei entitatii economice, Ed. Risoprint, Cluj-Napoca, 2008, p. 72

[12] Jianu,I., Evaluarea, prezentarea si analiza performantelor intreprinderii, Ed. CECCAR,Bucharest, 2007, p. 501

undergoing a moderate growth, whose operating activity generates the funds required for the current activity, partially investment funds whose value has not been fully covered by selling decommissioned assets, but also but also the funds required for paying the debt or reducing the registered capital. The net cash flow is positive and the operating activity manages to generate additional cash.

Table no. 1 The income statement and cash flow statement of Pfizer Inc[13].

The analysed indicator	2005	2006	2007	2008	2009
	Income statement				
The operating result (Re)	14,925	14,282	10,336	15,034	15,456
The financial result (Rf)	-3,416	7,047	-1,169	-5,285	-4,624
The exceptional result (Rex)	0	0	0	0	0
The total result (Rt)	11,509	21,329	9,167	9,749	10,832
The income tax (Ip)	3,424	1,992	1,023	1,645	2,197
The net result (Rn)	8,085	19,337	8,144	8,104	8,635
	Cash Flow				
Operating cash flow	14,733	17,594	13,335	18,238	16,587
Investment cash flow	-5,072	5,101	795	-12,835	-31,272
Funding cash flow	-9,222	-23,100	-12,610	-6,560	14,481
Currency exchange differences	0	-15	41	-127	60
Net cash flow	439	-420	1,561	-1,284	-144

In 2006, the operating cash flow is positive, the investment cash flow is positive and the funding cash flow is negative. The surplus from the operating activity is increasing in comparison to the previous year, but also the deficit in the funding activity increases during this year in comparison to the previous year. The investment activity generates a surplus during this year, as the company collects money from the sale of decommissioned assets, more than the payments incurred for the purchase of new assets, and the resulting surplus is used together with the one resulting from the operating activity, either for repaying loans or for reducing the registered capital (capital repayment to shareholders), according to the increase in the funding deficit. The net cash flow is negative, which means that the company's activity throughout this year resulted in a temporary deficit of liquidities.

In 2007, the operating cash flow is positive, the investment cash flow is positive and the funding cash flow is negative. The operating surplus is lower than in the previous year, and the funding deficit is also lower than in the previous year. The surplus from the investment activity is lower than in the previous year which means that, together with the surplus resulting from the operating activity, it is used for

[13] www.smartmoney.com

repaying loans or reducing registered capital, but to a lower proportion than in the previous year, which is supported through the increase in the deficit from the funding activity. The net cash flow is positive, as the company manages to generate additional liquidities in this year.

In 2008, the operating cash flow is positive, the investment cash flow is negative and the funding cash flow is positive. The surplus in the operating activity is higher than in the previous year, the funding activity generates a significant surplus throughout this year, and the investment activity has a significant deficit in comparison to the previous year. The evolution of cash flow components is explained through the fact that investments increased significantly throughout this year and they are partially covered through the sale of decommissioned fixed assets, partially from the operating activity and partially from external funding sources. The net cash flow is negative, as the company has a cash deficit this year, mostly generated by the achieved investments, but the recorded deficit is lower than in the previous year.

Identifying correlations between the income statement and the cash flow analysis.

Reuniting the results of the previous analyses, the following information may be obtained (for allowing comparisons, the analysis was made starting with the year 2006):

In 2006, the total result had the highest value in the analysed period, given a positive result in the funding activity, and the net cash flow had a deficit of liquidities, given the achieved investments. The two results of the analysis support the idea of contracting a significant loan, for partially covering investments.

In 2007, the total result was diminished, given a negative result from funding activity, and the net cash flow has a surplus of liquidities, given the decrease in the value of the investments made this year.

In 2008, the total result is diminished as well, given the deficit from the company's funding activity, and the net cash flow presents a temporary deficit of liquidities, given the investments which are partially funded from the surplus generated by the operating activity.

In 2009, the total result is close to the total result of 2008, but the net cash flow still presents a deficit of liquidities, lower than in the previous year, which means that the management is more involved in decreasing the deficit of liquidities.

In the period 2006-2009, the variations in the income statement results are supported by cash flow, which provides information on the evolution of the financial result. Moreover, the cash flow analysis allows for an evaluation of financial management decisions.

The study also includes the analysis of the income statement and cash flow for Abbott Laboratories.

Table 2 includes the income statement and cash flow for Abbott Laboratories.

Interpretation:

Analysis of the income statement: In order to outline the importance of the analysis of management performances by means of the income statement, an annual analysis of the evolution of synthetic indicators must be made:

In 2005, 2008 and 2009, the total result was positively influenced both by the operating result and the financial result.

In 2006 and 2007, the total result was negatively influenced by the financial result, with a more significant impact in 2006 than 2007.

Table no 2: The income statement and cash flow statement of Abbott Laboratories.

The analysed indicator	2005	2006	2007	2008	2009
	Income statement				
The operating result (Re)	4,379	4,056	4,578	5,791	6,405
The financial result (Rf)	241	-1,781	-109	211	787
The exceptional result (Rex)	0	0	0	0	0
The total result (Rt)	4,620	2,275	4,469	6,002	7,192
The income tax (Ip)	1,248	559	863	1,122	1,447
The net result (Rn)	3,372	1,716	3,606	4,880	5,745
	Cash Flow				
Operating cash flow	5,174	5,329	5,184	7,344	7,275
Investment cash flow	-720	-11,398	-1,136	-2,087	-3,699
Funding cash flow	-2,592	3,622	-2,313	-3,486	1,002
Currency exchange differences	-194	74	200	-115	119
Net cash flow	1,668	-2,373	1,935	1,656	4,697

Cash flow analysis: In order to outline the importance of the analysis of management performances by means of the cash flow, an annual analysis of the evolution of its components must be made:

In 2005, the operating cash flow is positive, with the investment cash flow and funding cash flow having negative values. As in the case of Pfizer, the cash flow is specific to mature company, which undergo a moderate growth, whose operating activity generates the funds required for current activity, partially the funds for investments, but also the funds required for repaying loans or reducing the registered capital. The net cash flow is positive, with the operating activity managing to generate additional cash as well.

In 2006, the operating cash flow is positive, the investment cash flow is negative and the funding cash flow is positive. The surplus in the operating activity is higher than in the previous year, with the funding activity generating a significant surplus this year. The investment activity presents a significant increase of the deficit, in comparison to the previous year. The evolution of cash flow components is explained by the fact that investments have increased significantly throughout this year and they are partially covered through the sale of decommissioned fixed assets, partially from the operating activity and partially from external funding sources. The net cash flow is negative, with the company having a deficit of cash throughout this year, mostly generated by investments.

In 2007, the operating cash flow is positive and the investment and funding cash flows are negative. The surplus from the operating activity is lower than in the previous year, and the funding activity has a deficit. The deficit from the investment activity is lower than in the previous year, which means that investments have diminished throughout this year and the funding activity is focused on repaying loans. The net cash flow is positive, as the company manages to generate additional liquidities this year.

In 2007, the operating cash flow is positive and the investment and funding cash flows are negative. The surplus from the operating activity is higher than in the previous year, and the deficit from the funding activity is higher than in the previous year. The investment activity has a higher deficit than in the previous year, due to the increase in investments, which were partially funded from the valuable use of fixed assets and partially from the surplus generated by the operating activity. The net cash flow is positive, but slightly lower than in the previous year, due to the increase in the funding and investment deficits.

In 2009, the operating cash flow is positive, the investment cash flow is negative and the funding cash flow is positive. The surplus from the operating activity is lower than in the previous year, and the funding activity has additional financial resources. The investment activity has a growing deficit in comparison to the previous year. The evolution of cash flow components is explained by the fact that investments increased significantly this year and are partially covered from the sale of decommissioned fixed assets, partially from the operating activity and partially from external funding sources. The net cash flow is positive, as operating and funding activities have a surplus which is higher than the investment deficit.

Identifying correlations between the income statement and the cash flow analysis.

Reuniting the results of the previous analyses, the following information may be obtained (for allowing comparisons, the analysis was made starting with the year 2006):

In 2006, the total result decreases, given a negative result from the funding activity, and the net cash flow presents a deficit of liquidities, due to the achieved investments.

In 2007, the total result is still diminished by the financial result, but to a lower extent, and the net cash flow presents a cash surplus, given the decrease in the value of investments. The financial result is still negative, because the company prefers to repay financial loans this year. Hence, financial expenses are higher than financial revenues.

In 2008, the total result increases, with a positive value of the financial result, and the net cash flow also presents a surplus of liquidities. However, the value is slightly lower than in the previous year, given increases in investments.

In 2009, the total result increases as well, with positive values of the financial result and the net cash flow presents a surplus of liquidities, higher than in the previous year, although investments have gone up. However, the latter have been partially funded from external funding sources.

In the period 2006-2009, the variations of the results in the income statement are supported by cash flow, which provides information on the evolution of the financial result. Moreover, the cash flow analysis allows for the evaluation of financial management decisions.

4. Conclusions

The evaluation of management performance may be made both by means of the income statement and cash flow. Although the income statement represents a synthetic financial statement mostly used in evaluating performance, it cannot provide enough information for evaluating management performance, which is why cash flow must be analysed, in order to perform a full assessment of management performance.

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