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Practical Solutions to Increase Business' Resilience. Diagnostic Analysis of the Company's Financial Position and Performance

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Abstract

In the current context of economic and financial crisis created by COVID-19 pandemic period, internal as well as external/international businesses confront with many challenges. The diagnostic analysis is the starting point in finding solutions to the resilience of businesses.

Key terms: resilience, financial analysis, financial diagnostic, key performance indicators

JEL Classification: G17, G32, G14

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➲ Introduction

In the current economic and financial context affected by the COVID-19 health crisis, domestic and international business face a major challenge, namely to adapt and reinvent themselves at the same time, in other words, to gain resilience. The term *resilience* has been taken up by experts in the field of psychology to define a person's ability to adapt quickly, through learning, and with little stress, to a tragic event, problems or failures.

It is well known that, throughout history, humanity has also faced with health crises, but it seems that this one is more acutely publicized and experienced globally.

When we talk about all the decisions and activities that ensure the regulation of the financial flows of the business, we refer, in fact, to the financial management of the company that seeks to adapt, at all times, the resources and uses of funds. Therefore, we consider the relationship between financial analysis and financial management of the company to reach that balance between results and uses (resources).

➲ The concept of diagnostic analysis

Financial analysis uses specific tools and means for assessing (diagnosing) the financial situation of the company, in order to make coherent management decisions. The financial diagnosis of a company, made based on the results of the financial analysis, is an approach that follows the following directions (Petrescu, 2010, p. 15):

- Highlighting the unfavorable elements, the existing dysfunctions in the financial situation of the analyzed company;
- Identifying the causes of these dysfunctions;
- Fixing, proposing actions to improve or rectify the situation.

Diagnostic analysis is a comprehensive and complex research of the financial system, which helps to identify a possible "disease" as well as the application of a "treatment" starting from "symptoms" (Petrescu, 2004, p. 11).

In other words, diagnostic analysis helps to understand what was in the past, what exists today and, at the same time, offers the possibility to anticipate the economic phenomenon in the future.

In order to get to know the factual state of a company's financial position, using as analysis-diagnostic procedure, the financial analyst must synthesize this piece of information on the analyzed company, namely: data about the sector in which the company operates, the object of activity and the organizational structure of the company, the evolution of turnover in the last four-five years, profitability, indebtedness, and other indicators. In other words, they must choose the appropriate financial indicators for the analyzed business according to the objectives pursued by it.

The information necessary to analyze these indicators is extracted from the financial reports published on the website www.mfinante.gov.ro and www.anaf.ro. Results obtained from the analysis of these indicators are to be compared with the average of the market in which the business operates, or more eloquently would be their comparison with competitors over the same period of time. Then you can determine the strengths, weaknesses, opportunities and threats for the analyzed company.

➲ Key performance indicators

Business owners and managers constantly strive to make an adequate profit to stay in the market. The only way to truly increase profits is to evaluate the business and determine how the share of sales revenue that is held by the company increases.

The ways of evaluating the business are based on the key performance indicators (KPI). A **key performance indicator** is a value that indicates the level of achievement of a certain goal by an individual, a department or company (https://www.jurnaldedigitalmarketing.com/digital-marketing/ce-inseamna-kpi/). To accurately define these KPIs, financial analysts need to use SMART goals.

SMART goals, as a concept, have been around for decades, in one form or another under the English acronym: Specific, Measurable, Attainable, Relevant and Time-Bound). In defining these objectives, financial analysts and managers consider some recommendations related to (Marr, 2015):

- **Specific.** Managers need to clearly define the goals they pursue in their business.
- **Measurable.** It is necessary to use measurable values in order to be able to easily determine the performance of the activity carried out.
- **Attainable.** Managers need to make sure that the goals set are realistic. Specifically, it is useful to set goals that you can achieve.
- **Relevant.** The essential question is: Are the indicators relevant? If you have identified the expected objectives, this should help you determine whether the KPIs are relevant or not.
- **Time-bound**. Set a time frame. Choose the beginning and the ending date so that you can set the initial level and intermediate milestones. This set interval will also help you identify factors such as seasonality, migration, product launches, and more.

Goals are not limited to a certain number, nor are they standard. They vary from one type of business to another.

Example: The identification of KPIs for a business in the field of wholesale and retail trade, main NACE code 4618 "Intermediaries in trade specialized in the sale of specific products, n.c.a."

In order to see how to establish the key performance indicators in practice, we will detail on each objective of the company Example LLC (company operating in the field of trade, NACE code 4618 "Intermediaries in trade specialized in the sale of specific products, n.c.a." – business which is carried out only on the basis of online orders and payments) the analysis user, the analyzed indicator and the analysis executor (see Table 1).

Table 1. Goal setting for Example LLC

The objective	User	Analysis addresses	Contractor
Sales (turnover) growth	Management	Turnover	Financial analysts, financial and accounting department
Increase in remaining profit on product (profit margin)	Shareholders (business owners)	Profitability	Financial analysts, financial and accounting department
Achieving a financial balance	Management, shareholders	Debt	Financial analysts, financial and accounting department
Obtaining bank loans	The bank	Solvency and liquidity	Specialists of the creditor bank
Identifying weaknesses, vulnerabilities	Management, shareholders	Bankruptcy risk (insolvency)	Financial analysts, financial and accounting department

Sursa: Own projection.

Once the main objectives of the business are defined, it is necessary to establish a series of directions and the strategies for achieving them. For example, if one of the goals of the business is to increase revenue by increasing customer sales, key questions may include:

- How can we gain new customers?
- What would be the growth rate: twice as many customers as last year? Is it realistically possible?
- If possible, then what should we do to achieve this?
- Why is it important to double the customer's acquisition rate for our business?
- What would be the impact on sales and profitability?

To arrive at the correct answers to these questions we need an analysis of the selected indicators, an interpretation of the results gathered to obtain a diagnosis.

➲ Analysis of key performance indicators

The main indicators analyzed are turnover, operating costs, net profit margin, net margin, current liquidity, indebtedness, average collection time, average payment period.

In the following we will conduct a study on a business in the field of wholesale and retail trade, which operates on the main NACE code 4618, that takes place only on the basis of orders and online payments. For the analysis, we need data from the financial reports of the company taken as an example, but also of all the companies operating on the main NACE code 4618. All of the following tables and graphs are the author's contribution based on the information obtained from the sites www.anaf.ro and https://www.confidas.ro/.

1. Annual sales (percentage series) of the analyzed company vis-à-vis the media NACE code 4618

The turnover extracted from the financial reports of the company Example LLC are presented in Table 2.

Table 2. The turnover in absolute sizes in the period 2015-2020

Example LLC	December 2015	December 2016	December 2017	December 2018	December 2019	December 2020
Turnover (lei)	652,483	673,551	741,353	789,834	540,817	747,909

The evolution of the turnover in percentage series of the analyzed company vis-à-vis the main NACE average 4618 is calculated in Table 3.

Table 3. The turnover in percentage series in the period 2016-2020

Example LLC and market average	December 2016	December 2017	December 2018	December 2019	December 2020
Turnover of Example LLC (%)	3.13	10.07	7.20	-31.53	38.29
Market average of turnover (%)	18.00	8.00	30.00	15.00	30.00

For a better view we will present the results in the figure below:

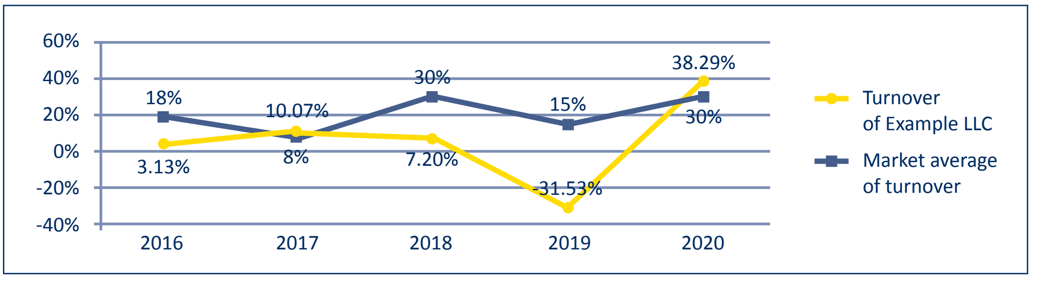

Figure 1. Parallel between the turnover of Example LLC and the market average in the period 2016-2020

It can be seen that the analyzed company has a good evolution compared to the average of the main NACE core activity code 4618, but for a more conclusive result, the direct competitors should be identified and compared on this financial indicator. If the analyzed company had a turnover below the level of the competing company, the sales and purchasing policy of new customers would have had to be revised.

2. Operating expenses and profit margin

Operating expenses can be found in the financial statements for each financial year ended. Profit margin is a financial indicator of profitability, which shows us in percentages how profitable the total activity of the company is (Dorneanu, 2008, p. 143).

For the company Example LLC, the analysis of the operating expenses and the net profit margin in the period 2015-2020 is presented in Table 4.

Table 4. The operating expenses and the net profit margin of Example LLC in the period 2015-2020

Example LLC	2015	2016	2017	2018	2019	2020
Operating expenses (lei)	641,048	667,299	718,865	762,818	483,105	688,224
Gross profit (lei)	14,435	16,766	25,248	34,120	39,805	33,330
Net profit (lei)	12,125	14,503	17,927	26,209	34,371	27,533
Turnover (lei)	652,483	673,551	741,353	789,834	540,817	747,909
Gross profit margin (*Gross profit/Turnover* x 100) (%)	2.21	2.49	3.41	4.32	7.36	4.46
Net profit margin (*Net profit/Turnover* x 100) (%)	1.86	2.15	2.42	3.32	6.36	3.68
Operating expenses/ Turnover (%)	98.25	99.07	96.97	96.58	89.33	92.02

For a better analysis we will continue the comparison of this index with the main NACE code 4618, on average. For this we will establish the market average for the five years in Table 5.

Table 5. The market average of operating expenses and net profit margin in the period 2015-2020

Market average	2015	2016	2017	2018	2019	2020
Operating expenses (%)	91	92	93	90	88	73
Net profit margin (%)	7	7	7	9	10	12

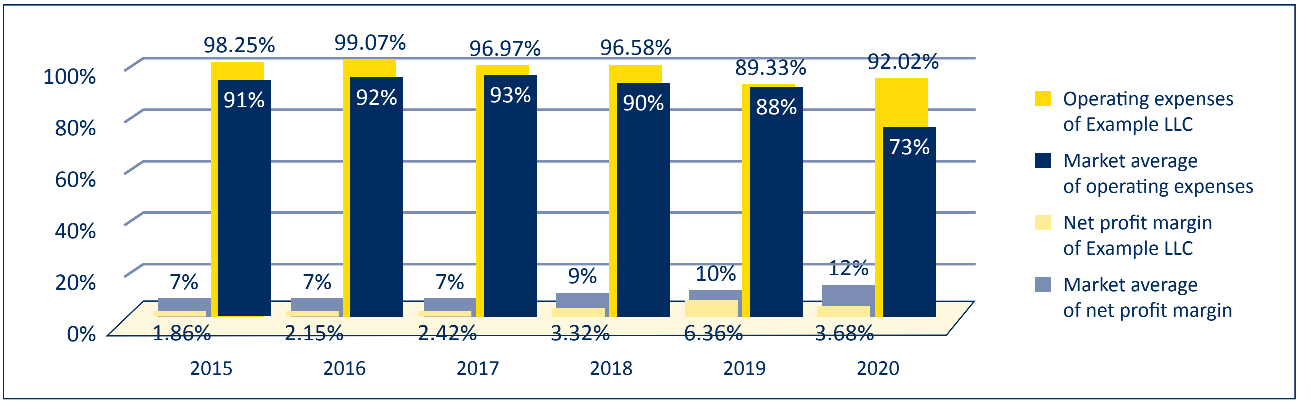

Figure 2. Parallel between the operating expenses and the net profit margin of Example LLC and the market average in the period 2015-2020

Following this analysis, several aspects of great importance for the analyzed company can be identified, namely:

✓ Operating expenses are above the market average, which means that they need to be reduced by tracking them at operational level.

✓ The net profit margin is lower than the market average, which means that the company's records a small profit due to operating expenses, large enough not to be covered by operating revenues.

3. EBITDA margin

The analysis continues with the EBITDA margin, which shows what remains of the profit before spending on bank interest, amortization and other taxes (Ciora, 2013, p. 147). The calculation formula for this indicator is:

EBITDA = Net profit + Interest expenditure + Depreciation expenditure + Taxes

The EBITDA margin is also calculated based on the information contained in the financial statements for the five years of analysis. The results are presented in Table 6.

Table 6. The EBITDA margin of Example LLC in the period 2015-2020

Example LLC	December 2015	December 2016	December 2017	December 2018	December 2019	December 2020
EBITDA (lei)	60,000	50,000	60,000	75,000	78,000	66,403
Turnover (lei)	652,483	673,551	741,353	789,834	540,817	747,909
EBITDA margin (%)	9.20	7.42	8.09	9.50	14.42	8.88

The level of this margin must be compared with the market average, presented in Table 7.

Table 7. The market average of EBITDA margin in the period 2015-2020

Market average	December 2015	December 2016	December 2017	December 2018	December 2019	December 2020
EBITDA margin (%)	11	10	10	12	16	8

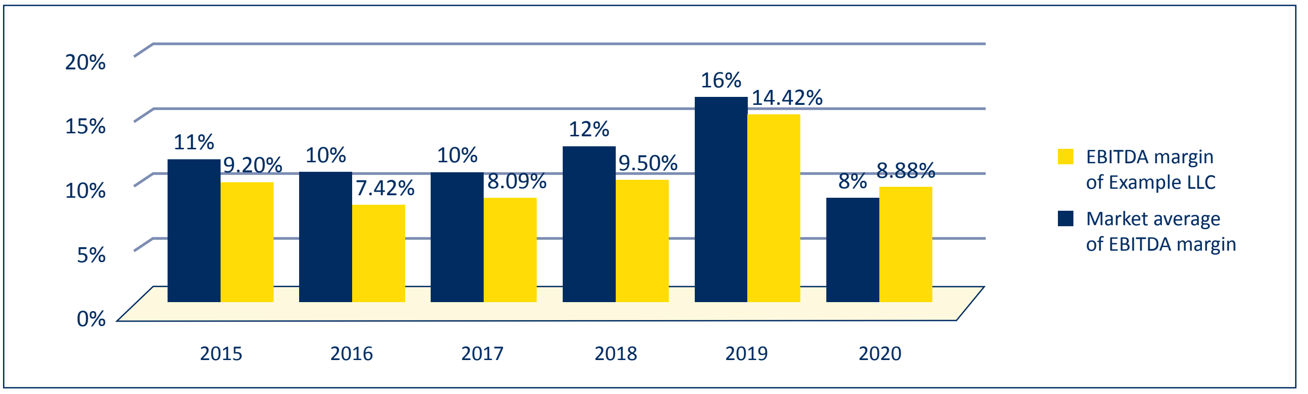

Figure 3. Parallel between the EBITDA margin of Example LLC and the market average in the period 2015-2020

It is observed that the EBITDA margin of the analyzed company is close to the average values on this market, which means that the company aims to keep the operating profit as high as possible because it is the healthiest resource for cash, development, investments or credit payments or dividends.

4. The evolution of the expenses structure

Expenses are above the market average, which require increased attention to track them in terms of purchases, productivity, employees, third parties, etc. Therefore, a follow-up of the evolution of the expenses in the structure is the solution to the identification of the neuralgic points where it is necessary to act.

5. Current liquidity

Current liquidity = Current assets/Current liabilities > 1 (Petrescu, 2010, p. 249)

The current liquidity indicator is calculated for the company analyzed in Table 8.

Table 8. The current liquidity of Example LLC in the period 2015-2020

Example LLC	December 2015	December 2016	December 2017	December 2018	December 2019	December 2020
Current liquidity rate	9.83	9.14	7.24	5.60	7.14	4.30

Current liquidity is the indicator that shows whether the company can honor short-term payments even if its evolution is declining, given the effects of the pandemic on the economy as a whole and the market average, presented in Table 9.

Table 9. The market average of current liquidity in the period 2015-2020

Market average	December 2015	December 2016	December 2017	December 2018	December 2019	December 2020
Current liquidity rate	2.14	2.12	2.26	2.34	3.08	2.24

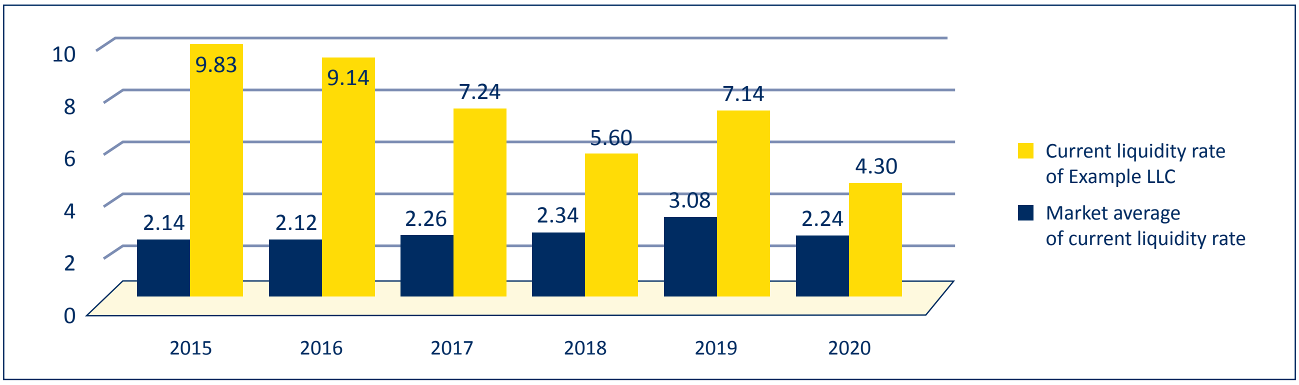

Figure 4. Parallel between the current liquidity of Example LLC and the market average in the period 2015-2020

It is recommended that this indicator be between 1.2 and 2.

6. Indebtedness

Indebtedness = Total debts/Total liabilities (Petrescu, 2010, p. 221)

The analysis of this indicator shows that the company taken as an example has a degree of indebtedness between 33% and 43% which means a high but still moderate level, when referring to the literature (above the maximum threshold of 70% the company may be in difficulty).

Table 10. The indebtedness of Example LLC in the period 2015-2020

Example LLC	December 2015	December 2016	December 2017	December 2018	December 2019	December 2020
Indebtedness (%)	37.78	40	43.66	37.59	33.21	35.70

If we compare with the market average, we notice that the analyzed company has a level below the average registered in this period 2015-2020.

Table 11. The market average of indebtedness in the period 2015-2020

Market average	December 2015	December 2016	December 2017	December 2018	December 2019	December 2020
Indebtedness (%)	68.20	73.07	69.43	69.99	57.91	58.06

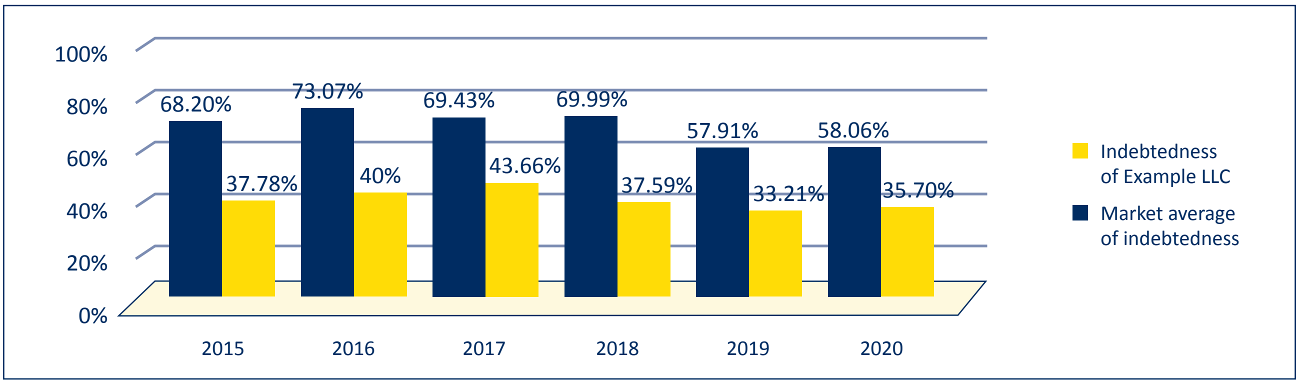

Figure 5. Parallel between the indebtedness of Example LLC and the market average in the period 2015-2020

It is observed that the market average is much higher, but the trend is decreasing.

7. Average collection time

The indicator average collection time (*Customers/Turnover* x 360 days), expressed in number of days, is presented in Table 12. It can be easily seen that the trend is upward which is not good, because collecting money is essential for the health of the business.

Table 12. The average collection time of Example LLC in the period 2015-2020

Example LLC	December 2015	December 2016	December 2017	December 2018	December 2019	December 2020
Average collection time (number of days)	17	2	27.58	22.17	43.68	74.93

If we compare with the market average, it is above the level of revenue recorded by the analyzed company.

Table 13. The market average of average collection time in the period 2015-2020

Market average	December 2015	December 2016	December 2017	December 2018	December 2019	December 2020
Average collection time (number of days)	76	7	76	78	93	94

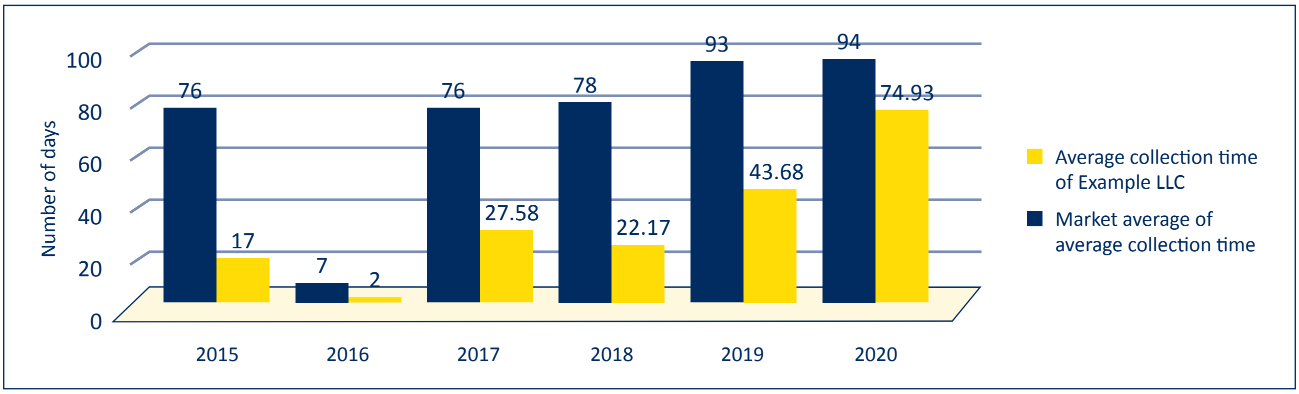

Figure 6. Parallel between the average collection time of Example LLC and the market average in the period 2015-2020

This shows that the analyzed company carefully monitors its average collection time. The lower the values, the better.

8. Average payment period

This indicates how credible the analyzed company is in the eyes of suppliers. It is good to have a longer agreed payment period (a supplier credit) but not a very long one, given that these terms are correlated with price discounts.

The indicator average payment period (*Suppliers/Turnover* x 360 days), expressed in number of days, is analyzed in Table 14, and the market average, in Table 15.

Table 14. The average payment period of Example LLC in the period 2015-2020

Example LLC	December 2015	December 2016	December 2017	December 2018	December 2019	December 2020
Average payment period (number of days)	19	31	1	17	36	37

Table 15. The market average of average payment period in the period 2015-2020

Market average	December 2015	December 2016	December 2017	December 2018	December 2019	December 2020
Average payment period (number of days)	82	98	27	93	146	140

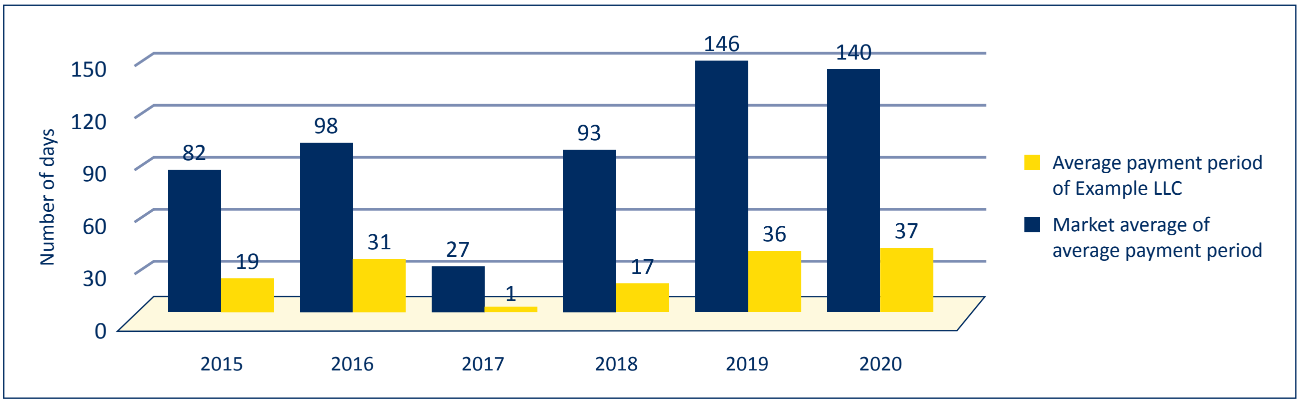

Figure 7. Parallel between the average payment period of Example LLC and the market average in the period 2015-2020

The company has an average payment period below the market average, which means that all measures have been taken to provide confidence to suppliers by honoring payment obligations on time.

Following the analysis of the presented indicators, a diagnosis of the company Example LLC can be established.

➲ SWOT analysis (Strengths, Weaknesses, Opportunities, Threats)

✓ **Strenghts.** The company's position in relation to the average of the market in which it operates is good for all the analyzed indicators: turnover, net profit margin, indebtedness, average collection period and average payment period. In other words, the pandemic did not significantly affect the liquidity, solvency or volume of the company's turnover taken as an example, given that it operated only online, and staff costs in particular were very low. In conclusion, companies that have been active or moved in the online environment have withstood the effects of the health crisis that began in March 2020.

✓ **Weaknesses.** The negative effects of the COVID-19 pandemic are felt throughout the economy only this year, effects that are seen in the decrease in purchasing power, inflation rate, budget deficit, etc. Lack of liquidity can increase the company's debt.

✓ **Opportunities.** Include measures to maintain liquidity (financial support measures stated by the means of the Government Emergency Ordinance No. 130/2020 or loans and credit lines for SMEs guaranteed up to 80% of the amount of financing granted). It should be noted that developing of online commerce by investing in specialized software such as SFA (Sales Force Automation) had an efficient sales process.

✓ **Threats.** The COVID-19 pandemic is not over yet and the domestic and international economy are struggling in their recovery efforts. The company already has a degree of indebtedness of 58%, but it must try not to exceed 70% because above this threshold the company will find it very difficult to face the pressure on cash, which will be very high.

➲ Solutions and recommendations

After diagnosing the observed company we can go in detail with the follow-up of the indicators regarding the ways to increase the profit. In economic theory, the increase of profit is achieved in two ways – the reduction of expenses (costs) and the increase of revenues (sales).

Profit growth strategies

✓ **Decreasing direct costs**

Direct costs are the known expenses, identified by each business owner each month and are of course necessary to carry out the activity. How can these direct costs be reduced?

The first way to reduce direct costs for goods sold is to negotiate with suppliers. You need to develop a mutually beneficial relationship with suppliers while they have evaluated your business and are willing to cut one or two per cent in price to help you achieve a higher profit margin.

The second way to reduce costs is by reducing the stock in the inventory, known as *stock control*. Constantly keep up with inventory and know why products should or cannot substantially improve margins. Some small business owners order inventory arbitrarily and do not use all the data when deciding on quantities. A robust POS system with high inventory management and advanced reporting capabilities helps determine what to cut or not.

The third way to reduce direct costs is to reduce operating expenses. Many business owners assume that they are mandatory and cannot be compromised. The reality is that there are almost always solutions to save costs (for example, small expenses such as paper, inventory items have an overall impact on the business and, therefore, solutions can be found to reduce them).

✓ **Decreasing indirect costs**

Indirect costs, as the name suggests, are difficult to recognize. They also reduce profits.

Two such examples of indirect costs that can substantially decrease profit growth are waste (if the company has to dispose of everything that is not sold and has left the warranty period, then it must carefully monitor the average values sold per day to determine how much to buy in stock and to reduce thus the amount discarded (waste)) and inventory variation (this is an important metric to follow, being the difference between the inventory reflected in the reports and the actual amount in the store (accounting for missing or stolen items)). The more these statistics are tracked, the easier it is to reduce the associated costs.

Another indirect cost for many small businesses comes in the form of online system errors (if payments are unsecured if orders are not honored on time, etc.). There are ways to reduce all of these events to help increase business profit.

✓ **Increase sales**

When business owners think of ways to increase the total amount of profit, they are automatically asked "How can I sell more?!". We will look at increasing sales in two ways: getting more sales with your employees and expanding distribution channels to drive sales.

A sure way to increase sales is to monitor employee performance and find new ways to get higher sales. Sales training, if possible, is a great way to do this. Stimulation is another way to motivate your employees, creating contests to motivate and reward.

Another way to increase sales is to look for new distribution and advertising channels (expanding the database and attracting new customers), intensifying marketing efforts in social media, online content and SEO, expanding the database and attracting new customers.

✓ **Increasing the average sales per product**

Practice shows that it is not necessary to increase sales to stimulate revenues and profit. Rather, it is good to focus on increasing the average value of each sale. This is an opportunity that the vast majority of small businesses overlook. There are several ways to increase the average sale, such as training staff for Upsell (educating employees to suggest and provide additional items to customers at the time of sale), offers to buy a package of products, etc.

Rising prices (in moderation): small price increases can sometimes stimulate average sales without losing the customer completely.

✓ **Analysis of profit margins on the product**

If there are products that have a high profit margin and tend to sell every day, then employees should focus on them. These items are both relatively high profit generators per unit and sell well.

If there are products that have a low profit margin but fly off the shelves, you can reduce costs – such as supplier costs, in-store shipping, and so on. You can also try a slight price increase if it is a known item that sells well.

If there are products that do not sell so well and have a high profit margin, it is worth considering their positioning in the store. If there are products that do not sell well and have a low profit margin, those should be avoided.

➲ Conclusions

In the current economic and financial context, characterized by the general concern to limit the negative economic effects of the COVID-19 crisis and to support the recovery, financial analysis through financial diagnosis can identify those losses and ways to recover. The analyzed financial indicators must be selected according to the objectives pursued by each company. They are useful for both large and small companies, because they facilitate the knowledge, organization and planning of their economic situation in order to achieve the desired objectives.

The practical solutions that emerged during the diagnostic analysis performed in this paper can be concentrated in identifying:

- Weaknesses and following them in detail until finding the elements that need to be limited or eliminated;
- Strengths and insisting on maintaining them;
- The business development opportunities and their immediate achievement, with the analysis of the cost of their fulfillment.

Therefore, we conclude that the basis of a successful solution of a business are the results of a diagnostic analysis of indicators concerning both the financial position and the profitability of the company. Managers together with financial analysts, the financial-accounting department, can develop unique performance indicators that best suit their business to achieve organizational performance and gain resilience.

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