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Research on the Role of the Company's Financial Statements in the Decision-Making Process

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Abstract

The research comprises the importance of the accounting information provided in the financial statements with the purpose of having an effective and efficient decision-making process. The accounting information has to be clear, accurate and precise in order to present an objective and real image of the company. At the same time, the financial statements have the role of illustrating the company's financial position, performance, as well as the flows occurring in the company's cash. The major strength in the decision-making process of an organization would be a well-projected management plan, and a well-defined strategy. The research aims to outline and present the role of the financial statement in the complex decision-making process inside a company. The analysis is focused on examining and interpreting how much is the predicted variable influence by the independent ones, as well as establishing the relationship between them.

Key terms: accounting regulations, business decisions, financial statements, International Financial Reporting Standards

JEL Classification: M10, M41, M49

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1. Introduction

Prior literature states that the financial statements are considered to be the main source of financial information, according to which the users are able to assess and interpret it. By analyzing the financial statements, one aspect which is revealed represents the management's performance regarding the profitability, efficiency, as well as the risk assessment. Consequently, a company's performance can be assessed by comparing its results with the previous ones, with the type of industry in which it operates, with its main competitors, and with the aggregate economy. Thus, the role of the financial statements is to understand and evaluate how well the organization performed its activity during a certain period, how the company's management performed in managing its cost by generating profit, and how much the firm used debt and equity to finance its assets. (Kumar, 2016)

According to Anđelić & Vesić (2017), financial reports represent the most important tool for making decisions within an organization. The most important and significant connection is reflected between the company's management and accounting because all the management decisions are shown in the assessment of the financial statements. Moreover, the financial analysis represents a vital process in understanding these financial statements because it implies not only observing, examining and assessing, but also formulating a diagnosis for the events

which took place inside the organization. For each user, there are different interests in analyzing the performance of the business. From the management point of view, their interests are in planning, organizing and controlling the costs, in order to generate sufficient net profit. From the shareholder's point of view, the interest is in the assets of the company, the amount of investment, as well as in the gains coming from their shares. From the creditor's perspective, there is a concern in the liquidity and solvency of the business in order to assess the company's ability to pay its debts. Therefore, financial analysis is considered fundamental for evaluating the company's management, as well as the business development. (Anđelić & Vesić, 2017)

In the same context, Zager & Zager (2006) states that accounting represents a service function for the business management. It means that the unprocessed data is gathered and studied, having the purpose of turning it into adequate information for the decision-making process. Therefore, the final outcomes coming from this financial information are the financial statements. From the authors' point of view, the financial statements must prove their relevance in providing information in terms of making future decisions and assessing the business performance and quality.

Similarly, Socea (2012) affirms that holding information is the most important tool in reducing uncertainty. Furthermore, in order to make the correct decisions, the managers must have sufficient knowledge and information about the financial situation of the business. Thus, financial information has a great importance for the managers because it helps them understand the past and current situation of the business; it supports them in predicting future inflows and outflows; it ensures not only a quantitative, but also a qualitative overview of the business; and it helps them in planning, organizing and controlling the cost from the production activity. (Socea, 2012)

On the other hand, there are studies which state the importance of the International Accounting Standards in reporting the financial statements, as well as the impact of the IASB on the decision-making process. According to the authors, the most powerful accounting rule that had a great influence on the companies operating in Europe was the adoption of IFRS. This change impacted not only the decision-making process, but also risk management assessment. The IASB considers that all the modifications in the market value have to be illustrated in the financial reports. Therefore, the adoption of IFRS had the purpose of improving the way in which information is communicated, by presenting it in a transparent, comparable and high-quality way. All these things led to a better understanding of the information, to a reduction in information asymmetry and to an increase in the market competition, efficiency and liquidity. (Drăgulescu (Ghiță) *et al.*, 2014)

2. The role of the financial statements in a company

Understanding the role of the financial statements in a company deals with the process of analyzing and interpreting the information provided by each of them. By analyzing the available data in the financial statements, a company's management efficiency and performance is revealed over a period of time. Therefore, understanding the meaning of the financial statements elements leads to knowing the strengths and weaknesses of that organization, and allows the users to evaluate the company's profitability and operational efficiency. Moreover, by interpreting the financial statements in a proper manner, the managers, potential investors and financial investors could estimate if the business has the capacity to cover its short- and long-term debts.

A company's financial statements are formal reports which show how well an organization performed its activities during a period of time. There are three main financial statements: the balance sheet, the income statement and the cash flow statement. The principal users of these financial statements are represented by the external users, composed of potential investors, creditors, auditors, market analysts, suppliers, customers, and by the internal users, such as company's managers, employees, financial department and shareholders. The information arising from the financial statements helps the users evaluate the company's financial health and its profitability. (Murphy, 2019)

Overall, one key role of using the data provided by the financial statements is that it helps not only the external users, but also the internal ones to understand and measure the efficiency and effectiveness of a company. Therefore, accounting performance measurements are essential in assessing this information. One of their major functions is that they serve as a financial management instrument for the company, allowing the company's management to properly use financial resources for improving the financial operations, and, finally, to accomplish the main goals of the organization. Moreover, measuring the financial performance of a business represents a tool for motivation and control, meaning that a good management of financial resources will lead to a better control of the business in terms of performance. (Neely, 2008)

Nowadays, every organization is facing a lot of challenges in order to survive on the market. One of these challenges is illustrated in the management process, where financial planning and controlling plays a fundamental role. Controlling is made through monitoring and taking proper actions when deviations are identified. In the case of financial planning, the company has to focus on three key aspects (Neely, 2008):

✓ Preparing and forecasting the cash flow. It is essential for the company to know the cash availability in order to assess if the company's debts are met. Usually, in Romania, the payment is made in 30 days, but there are also cases in which the company can pay its obligations in more than 30 days. Therefore, it is vital for the company to plan the cash flow.

✓ The profitability of the company. Firstly, it proves the management's efficiency and effectiveness in administrating and controlling the financial resources. Secondly, it attracts new investors and gives the possibility of a company to obtain a credit. These users will be interested in the profit history and will evaluate the performance of the business based on its profitability. Finally, profitability proves the company's capacity to stay on the market and not go bankrupt.

✓ The balance sheet. The assets held by a company are very important, because they show the ability of the organization to pay the debts in case of bankruptcy.

Taking into account all the information presented, it can be concluded that a company's efficiency and performance is described in all five financial statements. Each of these financial statements plays an important role in every organization. The balance sheet presents, chronologically, the assets of the company whose value must be equal to the sum of what the company owes, and the value of the investments made in that company. This financial statement gives insights to the internal users, as well as to the external users, regarding not only the ability and the speed of the company in covering its debts, but also in converting the current assets into cash. The income statement reveals one of the most important elements of a company, namely its profit, which is computed by subtracting the company's expenses from the sales revenues. Looking at this element, the company is able to decide future prospects of the company, as increasing the sales of a product/service, cutting off the costs, or reducing/increasing the prices. The cash flow statement explains where the money comes from and where this cash was spent. In this way, the company's management has the ability to decide if future investments will be needed, if there are enough beneficiaries of the actual operations activities in order to generate sales revenues and if the company will be able to pay its long-term debts. The statement of changes in equity points out the modifications made to the capital of the company during a period of time and illustrates if the net value of the assets has increased and decreased. The last statement, the explanatory notes, explains in a more detailed way the information coming from the financial statements, information that has to be important and relevant for the current and future readers.

3. Using accounting information to make business decisions

The key users of a company's financial statements comprise the following: actual and potential investors, customers/account receivables, suppliers/account payables, creditors, the government, financial analysis, auditors, the pubic, employees and managers (Popescu, 2009).

Each of these users are looking for different information in a company's financial statement, but all of them have one thing in common: evaluating the wealth and performance of the business. A relevant management tool which is used in strategic and operating management represents the ratios. Financial ratios can be used by a company's managers for assessing the profitability of the organization, the rapidity of a company in selling its stocks, the performance rate of the business in transforming sales into cash, and, finally, for assessing the company's ability in terms of liquidity. (Popescu, 2009)

The financial ratios are considered the best option and, at the same time, a good management toll in the decision-making process. Thus, there are six categories of financial ratios that the readers can use:

✓ Liquidity ratios – indicate the ability of the organization regarding the payment of its debts in the short-run.

✓ Profitability ratios – indicate the company's performance in making profit.

✓ Leverage ratios – illustrate how much debt and equity was used by the organization for financing the assets.

✓ Asset management ratios – show if the company's assets were efficient enough to generate money.

✓ Financial efficiency ratios – measure if the organization has performed well in terms of generating revenue, as well as in controlling its costs.

✓ Market value ratios – used in general by shareholders or investors for measuring the economic health of the business related to the current market. (Popescu, 2009)

4. Materials and methods

We analyzed an accounting organization which provides professional services in the fields of finance, accounting, taxation, human resources and consulting in the management of companies.

This analysis is a multiple regression model which represents a method used for predicting how much a dependent variable is influenced by two or more independent variables. Also, this model studies and establishes the relationship between the predicted variable and the predictors. This analysis is focused on examining and interpreting how much is the predicted variable influenced by the independent ones, as well as establishing the relationship between them in order to show how the financial ratios calculated on the basis of the financial statements influence the economic decisions.

In this study, the chosen variables are profit, assets, liabilities and revenues for a period of 20 years. The variable profit is the dependent or the predicted variable and the three independent variables or the predictors are represented by assets, liabilities and revenues. In order to conduct this analysis, the SPSS Statistical Software was used, providing the following information:

Table 1. Descriptive statistics

	Mean	Standard deviation	Coefficient of variation
Profit	74,396.1735	58,693.65045	0.78
Assets	348,164.3165	334,106.47574	0.95
Liabilities	95,240.1100	166,093.24247	1.74
Revenues	318,162.7645	176,617.20597	0.55

Each variable with its computed mean, standard deviation and coefficient of variation is presented in Table 1. Looking at the values calculated it can be concluded that all variables are presenting a large variation (dispersion) within the period of analysis (20 years), their mean not being representative.

Table 2. Correlations

		Profit/Loss	Assets	Liabilities	Revenues
Pearson correlation	Profit	1.000	0.802	0.633	0.739
	Assets	0.802	1.000	0.815	0.799
	Liabilities	0.633	0.815	1.000	0.367
	Revenues	0.739	0.799	0.367	1.000
Sig. (1-tailed)	Profit	.	0.000	0.001	0.000
	Assets	0.000	.	0.000	0.000
	Liabilities	0.001	0.000	.	0.056
	Revenues	0.000	0.000	0.056	.
N	Profit	20	20	20	20
	Assets	20	20	20	20
	Liabilities	20	20	20	20
	Revenues	20	20	20	20

In Table 2, it is illustrated how strong the variables are related to each other, meaning the relationship between the dependent variable (profit) with the other independent variables (assets, liabilities and revenues).

Firstly, we are defining two hypotheses, the null and the alternative one:

- ✓ *H_0: All three coefficients of correlation are zero ($r_{xy} = r_{ij} = 0$), meaning there is no correlation between the predictors and profit.*
- ✓ *H_1: At least one coefficient is significantly different from zero ($r_{ij} \neq 0$), meaning at least one predictor out of the three is correlated with the profit.*

The second step is to interpret the Pearson coefficient which always takes values from -1 to 1. The value of the Pearson correlation indicator between assets and profit is 0.802, which belongs to the class (0.75, 1.00), and at the same time it is positive and ≠ 0; thus, it means that there is a high intensity correlation between assets and profit. Also, the value of Pearson correlation indicator between liabilities and profit is 0.633 which ϵ (0.5, 0.75), and at the same time it is positive and ≠ 0, it means that it is a medium intensity correlation between liabilities and profit. Finally, the coefficient of correlation for revenues influencing profit is 0.739 which ϵ (0.5, 0.75), it is positive and ≠ 0 which means that it is, also, a medium intensity correlation between revenues and profit. Taking into account these results, the conclusion is that the highest influence over the profit is represented by the variable assets of the company.

The next step is making the observation that P-value (the calculated probability) for assets is 0 (< 0.05, α), P-value for liabilities is 0.001 which is also < 0.05 (α), and P-value for revenues is 0 which is < 0.05 (α), so it means that assets, liabilities, and revenues are statistically significant. In this case, we can reject H_0, the null hypothesis, in favor of H_1.

5. Results

In conclusion, this correlation is a valid one for the company, so all the three predictors, assets, liabilities and revenues, are having a valid influence over the profit.

Table 3. Variables entered/removed

Variables entered	Variables removed	Method
Assets	.	Stepwise (Criteria: Probability-of-F-to-enter ≤ 0.050, Probability-of-F-to-remove ≥ 0.100)

This table describes the technique used to illustrate the relationship between the variables. The method used is stepwise, meaning that the most powerful relation is focused, deciding which is the factor influencing profit the most.

Further, we analyze the coefficient of correlation, its significance and Durbin-Watson statistics used to test the residuals autocorrelation existence (see Table 4).

Table 4. Model summary. Statistical results

R	R-squared	Adjusted R-squared	Standard error of the estimate	Change statistics					Durbin-Watson
				R-squared change	F change	df1	df2	Sig. F change	
0.802	0.643	0.624	36,006.71070	0.643	32.486	1	18	0.000	1.996

The coefficient of determination R = r_{ij} = 0.802, so it results that it is a linear relationship between assets and profit. Because R-squared = 0.643 it means that 64.3% out of variation of profit is explained by the variation of assets, liabilities, and revenues when holding constant the other predictors. Taking into account also the other influences over profit besides the one from assets, the coefficient Adjusted R-squared = 0.624, which means that 62.4% out of the variation of profit is explained by the variation of assets, liabilities, and revenues when also other factors are influencing profit beside these ones.

The computed probability to commit the error of type 1 in wrongly rejecting H_0, P-value, is 0 which is < 0.05 (α), meaning the associated risk for type 1 error to occurring is almost zero. This is why, we can reject it safety, in favor of H_1.

Regarding the autocorrelation of errors, because the statistic DW = 1.99 → 2, it means that there is no autocorrelation in the sample, so the errors produced by the model are independent.

The aim of ANOVA method is to establish if there is a significant difference in between the theoretical profit generated by the model which appears in Table 5.

Table 5. ANOVA[a]

Model	Sum of squares	df	Mean squared	F	Sig.
Regression	42,117,249,589.750	1	42,117,249,589.750	32.486	0.000[b]
Residual	23,336,697,873.208	18	1,296,483,215.178		
Total	65,453,947,462.958	19			

a. Dependent variable: Profit/Loss

b. Predictors (Constant): Assets

For this we are defining the hypotheses:

- ✓ *H_0: Residuals are independent of each other (r_{ij} = 0).*
- ✓ *H_1: Residuals are correlated between them (r_{ij} ≠ 0).*

Because the P-value for Fisher Test is 0, it means that the null hypothesis (H_0) is not rejected. So, we reject H_1 in favor of H_0. So, the function that is identified is a valid model for our period of analysis (20 years). The regressors are not highly correlated in between them and the phenomenon of multi-collinearity is not present (there is no increasing profit variation due to the correlation between regressors, as shown in Table 6).

Table 6. Coefficients[a]

	Unstandardized coefficients		Standardized coefficients	t	Sig.	95% confidence interval for B		Correlations			Collinearity statistics	
	B	Standard error	Beta			Lower bound	Upper bound	Zero-order	Partial	Part	Tolerance	VIF
Constant	25,333.347	11,786.565		2.149	.045	570.693	50,096.000					
Assets	.141	.025	.802	5.700	.000	.089	.193	.802	.802	.802	1.000	1.000

a. Dependent variable: Profit/Loss

$\widehat{\beta_0}$ = 25,333.347

$\widehat{\beta_1}$ = 0.141

$\widehat{\text{Profit}}$ = 25,333.347 + 0.141 x Assets – 0.062 x Liabilities + 0.272 x Revenues

The value of profit independent of assets is 25,333.347 Lei, representing the average profit. Assets is increasing by 1 unit, which means that the profit will increase by 0.141 million Lei. Because P-value is 0 which is < 0.05 (α), so the inference is possible: the lower limit in case of assets is 0.089 and the upper limit is 0.193, which means that in the future, profit could increase by minimum 0.089 million Lei and by maximum 0.193 million Lei for an increase in assets by 1 Leu. Because the model is producing VIF = 1 which is < 5, it results that the independent factor, assets, is not correlated with the other variables.

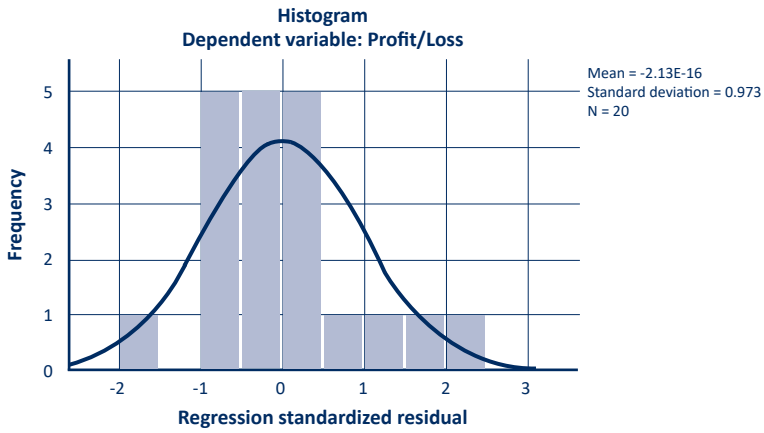
Table 7. Excluded variables

	Beta In	t	Sig.	Partial correlation	Collinearity statistics		
					Tolerance	VIF	Minimum tolerance
Liabilities	-0.062[b]	-0.248	0.807	-0.060	0.337	2.971	0.337
Revenues	0.272[b]	1.171	0.258	0.273	0.361	2.769	0.361

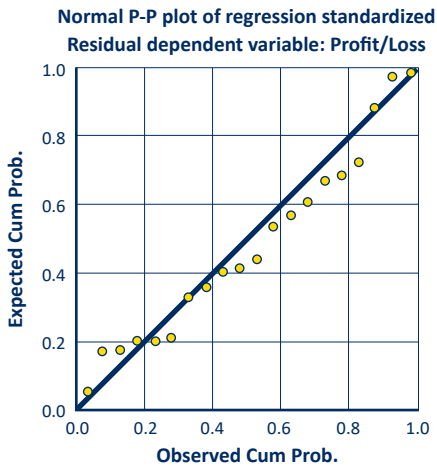
a. Dependent variable: Profit/Loss

b. Predictors in the model (Constant): Assets

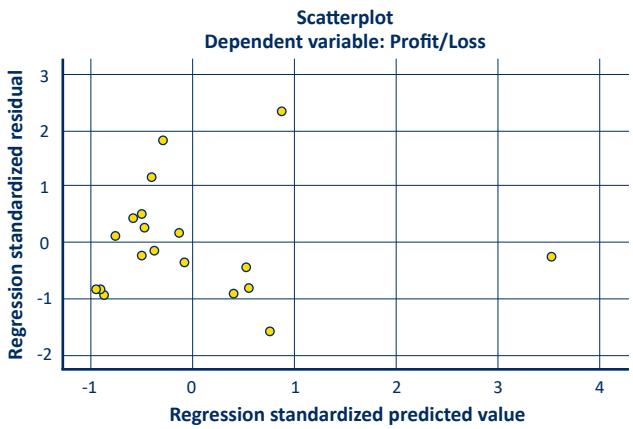
An alternative method to analyze the residuals is the graphical method for normality, homoscedasticity and autocorrelation of errors.



The assumption is that the residuals are distributed according to Gauss Bell (the normal function) and a slightly violation of the normality distribution assumption is observed.



The residual is slightly deviated to the right, showing a positive skewness induced by small residuals.



The model is heteroskedastic where liabilities increases and residual increases, too. The residual is not normally distributed.

6. Conclusion

After making the necessary research for gathering the relevant information for this research, it can be concluded that this paper presents in a chronological way each financial statement with its role, outlines what information has to be reported by them and illustrates the importance of this financial information in the decision-making process.

Each financial statement has its own role in this process and this is the main reason for which the end users have to analyze them in order to make the right decisions. As it was pointed out before, each user has its own interests in the information provided. From the internal stakeholder's point of view, their main concern will be not only on the company's profitability and cost efficiency, but also on the cash inflows and outflows, in order to make forecasts for improvement. From the external stakeholder's point of view, their main interest will be in the rapidity of the company in converting its current assets into cash in order to evaluate the company's ability in paying off its current debts, in the company's degree of leverage in order to assess the business capacity to pay its long-term obligations, in the earnings per share in case the company is listed on the stock exchange market, and in the company's ability of controlling the costs in order to generate sales revenues.

The accounting regulations represent an important and influencing factor when it comes to reporting the financial statements.

Also, accounting is considered to be the main function and service of the management process because the key decisions regarding the company's performance and efficiency are taken by the managers. This represents the main cause for which the company's managers should prepare a well-defined strategy in order to survive and perform in the current industry. Thus, business performance represents a key function of accounting and, at the same time, of management.

The decision-making process is a complex one, because the managers have to focus on planning, organizing and controlling all the things and issues the company is facing. Their decisions are implemented after making a detailed analysis on the financial statements, taking into account all the risks and deviations the company could meet. Therefore, it is vital to conduct a risk analysis, as well as to forecast future problems.

A key management tool in analyzing and making decisions is represented by the financial ratios. The financial ratios play a fundamental role in this process. The main reasons for using them are that any user can assess the business performance regarding profitability; the company's liquidity and solvency can be measured; the company's ability in paying its debts can be evaluated; the company's capacity of managing its assets can be assessed; and it can be seen if the business is able to increase the employee's wages. Thus, from the accounting point of view, this instrument is a useful one in making the correct decisions. Also, the financial ratios can help managers forecast cash inflows, as well as cash outflows and make predictions about the budget of the company. Overall, these ratios can be used by both internal and external stakeholders in order to assess a business efficiency and performance.

To sum up, the present research contains the most relevant information in order to prove the role of the financial statement in a company, as well as in the decision-making process.

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