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The information about the performances of an institution is needed in order to assess potential changes of the economic resources which the entity will be able to control in the future, to anticipate the ability to generate cash flows with the present resources, to formulate judgments about how efficiently it can engage and use new resources.

To assess the economic performance of an enterprise four indicators are commonly used: return on investment, residual income, economic value added and profitability of sales.

The performance analysis is a constituent of any managerial control system. Strategic planning and control decisions require information on how different subunits of the enterprise worked. To be efficient, performance indicators and remuneration have to motivate the managers and the employees from all enterprise levels and to make sustained efforts to implement strategies and to attain business objectives.

Taking into account the practices of companies one can observe that companies use varied financial indicators for performance evaluation.

1. The concept of performance

According to the Romanian Explanatory Dictionary, "performance" is "a very good result in sport, in a practical activity domain, etc, the best result of a machine, of a device, etc."

Although it is a frequently used term, the concept of performance is seldom defined clearly, its meaning being considered as implicitly known.

Another definition (Judy Pearsall, 1999), translated from English, explains the term "performance" as, among other things, "the proportion/extent to which an investment is profitable."

Extending this definition, one can consider that firm management is efficient if it is able to generate profits or it is advantageous, useful, noting that profit does not necessarily mean a financial plus, but meaning a gain, a benefit, or the converted form of capital gains, that is to say that it can be of various kinds: financial, social, human, environmental, etc. Therefore, performance can be interpreted as the gained profit, namely the result of the action and performance evaluation as the realized gain assessment.

The information about the performance of an institution is needed in order to assess potential changes of the economic resources which the entity will be able to control in the future, to anticipate the ability to generate cash flows with the present resources, to formulate judgments about how efficiently it can engage and use new resources.

In practice, financial performance information is provided primarily by "the profit and loss account", respectively by the budget execution account, but things are not as simple as to reduce them to the synthetic data in a particular periodic reporting form because it would be a pity to ignore the information in real time the account book provides. Performance is more important than money. Money reflects a possession, performance expresses the ability to capitalize the possession.

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2. Performance as a function of effectiveness and efficiency

Performance is often seen as a function of two components: effectiveness and efficiency.

Performance = f(effectiveness and efficiency)

Effectiveness is the extent to which an action, an operation carries out a definite purpose, understanding through purpose an anticipation toward which the actions are pointed, a proposed goal to be reached, a potential state toward which an agent inclines to.

Assessing effectiveness is closely related to defining the purpose, it as such should be a rational choice and potentially achievable.

Reflecting the "measure", even in the case of effectiveness one can identify several categories. If an agent fully achieves the purpose, we can say that it has maximum effectiveness, but if it does not at all, it is completely ineffective. Between these two extremes there are different intermediate states of effectiveness that can be grouped into states of partial effectiveness and partial ineffectiveness.

For an agent it is not important only the extent to which he accomplishes his purpose, but the effort to achieve that goal. Economic category that takes into account both aspects is that of efficiency, which is most often considered the relationship between all relevant effects (results) and total effort (costs).

Efficiency = Effect/Effort

The bigger the proportion is, the greater the efficiency is. As such, we could say that an agent increases his efficiency if:
- minimizes his efforts-costs;
- maximize his positive effects;
- optimizes his efforts and effect relationship through a higher rate of effects growth compared with the efforts growth rate;
- optimizes his effects and effort relationship through a lower rate of effects decrease compared with the efforts growth rate.

Given the relationship between efficiency and effectiveness, one can see that if in the first three cases the efficiency improvement is accompanied by the effectiveness growth, in the fourth situation the improvement of efficiency is accompanied by a decrease in effectiveness.

3. Performance measurement from financial perspective

Performance measurement is part of any managerial control system. Strategic planning and control decisions require information on how different subunits of the company worked. To be efficient, performance indicators and remunerations should motivate the managers and the employees at all business levels and make a sustained effort to implement the strategies and to achieve the business objectives.

A variety of performance indicators are based on internal financial information. Businesses supplement more and more the internal financial indicators with indicators based on:
- external financial information (eg. the stock);
- internal non-financial information (eg. Product fabrication time, the number of new patents, the rate of flaws);
- external non-financial information (market share, customer satisfaction).

These indicators are often compared to those registered in other subunits of the same companies or other businesses.

In some companies financial and non-financial performance indicators registered by their subunits are presented in a single report called balanced scorecard. In the balanced scorecard (C.T. Horngren et al., 2006) the enterprises record various elements, but most scorecards include:
- indicators of profitability;
- customer satisfaction indicators,
- internal indicators of efficiency, quality and time;
- innovative indicators.

Some performance indicators, such as the number of patents, have a long-term time horizon. Others, such as effi-
ciency deviations of direct raw material, have a reduced
time horizon. In this article we will refer to the most com-
monly used performance indicators, covering a medium to
long-term time horizon. They are internal financial indica-
tors based on accounting data of an enterprise.

In order to establish such performance indicators based
on accounting data, it is necessary to follow six steps:
1. Choosing the performance indicators which align to
the financial goals of the senior management.
2. Choosing time horizon for each performance indicator.
3. Choosing a definition for each performance indicator
components chosen in the first step.
4. Choosing an alternative indicator for each perfor-
mance indicator chosen in the first step.
5. Choosing a target level of performance.
6. Choosing the appropriate data for feedback presenta-
tion.

These six steps need not to be followed sequentially. The
issues studied in each step are interdependent and the
superior management will go over them several times be-
fore taking a decision on one or more performance
indicators based on accounting data.

The answers to the questions raised at each step depend
on the beliefs of superior management about the ability of
each alternative to meet the behaviour criteria for
matching goals, managerial effort, performance
evaluation and subunit autonomy.

To assess the economic performances of an enterprise
four indicators are commonly used.

Some companies record high levels of the profit made
from operating, but the question is whether they are the
most advanced.

The main weakness of making comparisons on the sole
basis of profits from operating is that this way one ignores
the differences between the volumes of investment in
each firm. Investments refer to resources or
assets deployed to achieve profits. There is no question of
how much is the profit made from operating, but how
much is the operating profit compared to investments
made to obtain it.

Three of approaches regarding performance measure-
ment include also an indicator of investment: return on in-
vestment, residual income and economic value added.

The fourth approach, the profitability of sales, does not in-
clude an investments measure indicator.

3.1. Return on investment

Return on investment (ROI) is a book value of profit
divided by a book value of investments:

\[
\text{Return on investment (ROI) = Profit/ Investments}
\]

Return on investment is one of the most common ways to
measure performance, and this for two reasons:
- combines all the elements of profitability - revenue, costs and investment - into a single indicator;
- can be compared with the rate of return opportunities from other parts.

ROI is also called accounting rate of return or cumulative
accounting rate of return. Managers usually use the term "ROI" when assessing the performance of a subunit and the term "cumulative accounting rate of return" when an
ROI indicator is used to evaluate a project.

Some companies prefer to use operating profit in the
denominator, others prefer to focus only on assets
financed by a long-term debt, using total assets minus
current liabilities.

Businesses may increase ROI through increasing revenue
or through lowering costs, through reducing investments. ROI can clearly define the performance issues when it is
determined by its components:

\[
\text{Profit/ investments = Profit/income} \times \text{Income/investments}
\]

or

\[
\text{ROI = Return on investment} \times \text{number of investment rotation}
\]

This approach is known as DuPont method of profitability
analysis. This method identifies the two basic ingredients
in making a profit: increasing the proportion of profit from
each lei income and mobilizing assets to generate higher
revenues. Improvements in a component without
changing the other component will generate an increase
in ROI.

ROI sets out clearly the benefits the managers can obtain
by reducing assets investment or fixed assets
investments. Some entrepreneurs are aware of the need
to increase revenue or reduce costs, but pay little
attention to reduce the investment base. Reduction of the
investment base means good credit management,
reducing the amount of idle cash, setting appropriate
levels for stocks and the mobilization with high attention
to the long-term assets.

3.2. Residual income

Residual profit (RP) is an accounting measure of profit
minus a value expressed in lei of the required return on
investment.
Residual profit (RP) = \text{Profit} - \left( \frac{\text{Required rate of investment} \times \text{Investment}}{} \right)

By multiplying the required rate of return on investment to investment value is obtained imputed cost of investment. The imputed costs are costs identified in certain situations which usually are not reflected in financial accounting systems.

Some companies prefer RP, because managers will focus on maximizing the absolute value, such as RP expressed in RON and not on a percentage, as the ROI. The objective of maximizing the RP means that, while a subunit records a return that exceeds the required rate of return on investment, that subunit activity should be extended.

The objective of maximizing the ROI might determine the very profitable subunit managers to reject the projects which, in company's view as a whole, should be accepted.

Matching goals (ensuring that division managers are working towards achieving company goals) is more easily achieved using PR and not ROI as an indicator of the division manager performance.

### 3.3. Economic value added

Attaining the major objective of the company, maximizing the overall value can not be achieved, but by creating value within firms. The overall performance is defined according to the company's ability to create value to its holders of interests, eg. shareholders, creditors, employees, suppliers, local community etc. Of course, company shareholders prevail, who are in fact the owners. Managers appointed by these must constantly seek to achieve this objective by permanently creating value.

The major indicators used by companies to assess the growth of value are: value added, economic value added and market value added.

#### 3.3.1. Value added

Value added is a synthetic indicator which expresses the new value created by businesses productive activity - in - a certain period of time.

Value added (VA) is the excess of income over consumption value from third parties, wealth created by exploiting the technical, human and financial resources of the firm.

Introducing the value added to the industrial production indicators system eliminates the possibility of increasing artificially the activity volume by repeated movement of a product between companies for processing. At the same time, the value added reflects better the direct effort of each industrial enterprises to create the gross internal product allows a more accurate assessment of economic efficiency, stimulates the reduction of material costs, efficient use of the means of production and employment.

Two methods can be used for determining the value added: indirect or synthetic method and direct or analytical method.

The synthetic method (indirect) is most widespread in the calculation of added value because it is more accurate and can be easily applied.

The setting of gross value added using the synthetic method is determined by subtracting the intermediate consumption from third parties from the year production:

\[
\text{VA} = Q_e - C_m
\]

Where:
- VA = value added
- \(Q_e\) = year production
- \(C_m\) = material costs (raw materials, fuel) from third parties.

If companies operating trading activity, the total added value includes trade margin (TM) determined as the difference between the value of goods sold (Vmv) and cost of goods sold (CMV):

\[
\text{VA} = \text{TM} + (Q_e - C_m)
\]

Where:
- TM = trade margin
- \(Q_e\) = year production
- \(C_m\) = material costs (raw materials, fuel) from third parties.

Analytical method (direct) or additive calculation of the value added allows its determination by adding its components:

- Expenditure on salaries (Es);
- Social security contribution (SSC);
- Contribution to Social Welfare (CSW);
- Financial expenses (FE);
- Amortization expense (A);
- Gross profit (GP);
- Other taxes (OT).

\[
\text{VA} = \text{Es} + \text{SSC} + \text{CSW} + \text{FE} + \text{A} + \text{GP} + \text{OT}
\]

In this case, value added includes wages by staff costs, capital or shareholders by dividends, interest on capital borrowed, technical capital through depreciation, the state through taxes and company by capital invested(used for self-financing).

Using this method, the net value added is obtained by adding elements of added value, less depreciation expense or by lowering depreciation expense from the total or gross value added.

In recent years, value added is split depending on the structure of production, in added value sold, corresponding to the output sold, and in added value
produced, associated with the stored and assets production.

Using these concepts requires the producing company to separate production costs in external costs (EC) and internal costs (IC) or added costs.

### 3.3.2. MVA - stock index

Indicators such as stock are the tip of the spear of the analysis on the way of creating value in an enterprise, but obviously specific to listed companies.

In response to VEA method critics, its creators (American company Stern Stewart) have developed more comprehensive measure that refers to the total value created in a firm – in a certain period of time. This measure is called Market Valuation. Published in short MVA (Market Value Added). MVA exists only if the market value of equity and debts of the company is higher than the total capital used during analysis. The production key MVA lies in creating VEA. A company capable of generating VEA will get to create MVA too.

Market value added (MVA) is the difference between the market value of an enterprise. (Sum of equity and debt) and its invested capital, according to the formula:

\[
MVA = \text{market value} - \text{Capital invested}
\]

Thus, the market value of the company includes the market value of all its capital, respectively the market value of equity and the market value of debts.. Capital invested is the capital providers of the company have invested. It is believed that the company creates value when the MVA indicator is positive, respectively when the capital market value, which depends on investor expectations of future cash flows, exceeds the capital invested in business. Conversely, a negative MVA value shows that capacity management forecast to use capital efficiently is bad, therefore the market value associated with the firm is below the invested capital.

Apparently, maximizing MVA is automatically followed by the increased business value. There are still cases when maximizing MVA leads to lower firm value because of inefficient investment projects with an internal rate of return below the cost of capital. Also, the sales rise by expanding the distribution networks, the adequate promotion of products, the product quality improvement or the expansion of market share are not always sure ways to increase firm value. So MVA rise only if the additional capital investment generates a higher return than the current cost of capital.

Another drawback of this indicator is that it ignores the dividend policy of firms both in terms of granting or not granting dividend and the amount of these. Undoubtedly, a company that distributes significant dividends to shareholders has a greater capacity to generate value than a similar one, in terms of MVA obtained, but which never gave dividends.

### 3.3.3. Economic value added

Performance indicator most commonly used for assessing the growth in value of the enterprise is the economic value added.

EVA is not a new discovery. An accounting performance measure called residual income is defined to operating profit subtracted with capital charge. EVA is thus one variation of residual income with adjustments to how one calculates income and capital. One of the earliest to mention the residual income concept was Alfred Marshall in 1890. Marshall defined economic profit as total net gains less the interest on invested capital at the current rate. The idea of residual income appeared first in accounting theory literature early in this century by e.g. Church in 1917 and by Scovell in 1924 and appeared in management accounting literature in the 1960s. Also financial press discussed the concept as early as in the 1970s. It was defined as a good way to complement ROI-control. In the 1970s or earlier residual income did not got wide publicity and it did not end up to be the prime performance measure in great deal of companies. However EVA, practically the same concept with a different name, has done it in the recent years. Furthermore the spreading of EVA and other residual income measures does not look to be on a weakening trend. On the contrary the number of companies adopting EVA is increasing rapidly. We can only guess why residual income did never gain a popularity of this scale. One of the possible reasons is that Economic value added (EVA) was marketed with a concept of Market value added (MVA) and it did offer a theoretically sound link to market valuations.

Normally, a company should not reinvest the net profit, but if its future investment projects are capable of generating a higher return rate than the rate of fructification of capital market for comparable risk projects.

Otherwise, the net profit should be distributed as dividends to shareholders or redemption of own shares. Investors will be able to capitalize the amounts received at the obtained market return from the financial assets of similar risk.

As the main problem of any performance indicator of a title based on the issuer profit, beyond a possible "creative" handling, is not taking into account the cost of capital used by the firm in the analyzed period, a more accurate measure could be considered to take account of this element, comparing it with the return obtained.

The concept in this way is called Value Based Management (VBM). Accepting the assumption that business value is directly dependent on the future
financial flows generated by the firm, conceptual VBM, becoming in time a real philosophy of doing business, acknowledges that a company generates value in excess in time only if its capital investments will have a higher return than the cost of capital.

VBM is used by many leaders of companies as a way of managing them and through which to generate an additional value for shareholders.

VBM appeared initially and experienced a tremendous development in the United States, giving rise to a managerial philosophy which enforces the managers to run the companies so that the shareholder wealth (whose first constituent is the amount of shares) to increase over time. So it is put emphasis on the interests of business owners unlike some earlier approaches, common in many European countries (e.g. Germany), according to which the interests of employees, customers, suppliers and the public ones were considered at least as important. The harsh reality of capital markets globalization, evidenced by international corporations access to formerly protected markets, the more increasing competition in high technology and resource control, the major acquisitions, takeovers and mergers between leaders of economic sectors have led to rapid spread of this philosophy in Europe too, it being understood, accepted and required in Western Europe economies. Based on this philosophy running a company it have been developed various concepts and methods to allow detection of capital gains made in past times and to provide valid criteria for selecting investment projects for horizontal or vertical development.

The best known alternative concept, based on the central idea that there is no real income if one does not exceed the cost of capital used, is that one launched by U.S. firm Stern Stewart: Economic Value Added, in short EVA.

“EVA” - Economic Value Added or economic value added is the most famous and one time, the most publicized performance indicator in the specialty press.

The economic value added has become in the decade 1990 - 2000 a quality standard of company's total, a performance indicator of the management team, a reference in foundation and assessing the efficiency of decisions.

The reasoning underlying this indicator is simple and logical: equity, like borrowed capital, has a specific cost. Unlike the cost of borrowed capital, which appears explicitly in the profit and loss account, the cost of capital, expressed by compensation set to investors, has a different accounting treatment.

To create value, the company must earn enough to cover both the cost of financial debt and the opportunity cost of capital. Also, bear in mind that pay equity must be at attractive rates, in any case higher than that the investor could obtain in case of a risk-free investment. Economic value created by an enterprise during a period should take into account not only the amount recorded in the accounts, but also the opportunity cost of capital.

Cost of capital is a concept useful for management company helping it in the selection of alternative investment projects and allowing the development of strategies to optimize the financial structure of the company, respectively the optimal proportion between the medium and long-term, the capital consisting of preference shares and ordinary share capital formed. Optimization goal is to minimize the cost of capital of the business used on the market and to perceive profitability of the capital providers and company specific risk and, ultimately, the firm's accessibility to different forms of financing. Minimizing the cost of capital used by the firm has a direct impact on maximizing business value through minimizing input regarding the financing operations carried out.

Economic value added is a specific model calculation of residual profits which lately gained considerable importance. Economic value added (EVA) is equal to operating profit after tax minus the weighted average cost(after tax) of capital multiplied by total assets minus current liabilities.

\[
\text{Economic value added} = \text{Operating Profit after tax} - \left( \text{weighted average cost of capital} \times \left( \frac{\text{Total Assets} - \text{Current Liabilities}}{\text{Total Assets}} \right) \right)
\]

Economic value added substitute the following figures in residual income calculations:
- profit is equal to operating profit after tax;
- required rate of return equals the weighted average cost of capital after tax;
- investment equals total assets minus current liabilities.

Total assets less current liabilities may also be calculated as:

\[
\text{Residual profit (RP)} = \frac{\text{Fixed assets}}{\text{Current assets}} + \frac{\text{Current assets}}{\text{Current liabilities}} = \frac{\text{Current assets}}{\text{Working capital}}
\]

Where:
- Working Capital = Current Assets - Current Liabilities

Economic value added, and residual profit, are costs associated with investments in long-term assets and working capital. The value is created only if the operating profit after tax exceeds the cost of capital investments. To improve the EVA, managers should:
- record operating profit after tax higher with the same capital;
• to raise less capital to achieve the same operating profit after tax;
• the capital to be invested in projects with high profitability.

Managers of firms use the estimated impact on EVA to take certain decisions. The division managers consider EVA useful because it allows them to use the cost of capital to take decisions at the division. The comparison between the actual and estimated EVA is useful for performance evaluation and for obtaining feedback on performance managers.

3.4. Return on sales

The relationship between profit and income (or sales), also called return on sales (RS) is a financial indicator of performance. RS is a component of the ROI in DuPont profitability analysis method.

Some companies record high levels of RS, but their performances are considered to be lower than other companies performances using indicators such as return on investment, residual income and economic added value.

4. Conclusions

The economic theory has identified profit maximisation as an objective of financial management. In the specialised literature, several approaches to the concept of profit have been crystallised.

In another approach, profit is „the generic name given to the positive difference between the revenue obtained from selling the goods produced by an economic agent and their cost, considered as an expression of economic efficiency“.

Prestigious economists consider profit to be residual revenue, namely „the final or residual element of the difference between the overall revenue and costs, namely what remains from this difference after various amounts are deducted“.

Even the statement according to which the company's objective is to maximise profit "is considered to be a nomological assertion referring to motivation", which could be deductible from other financial theory elements. Then it was estimated that the objective was rather to maximise the company value. In time, other financial theories and techniques were developed.

In the financial (and economic) theory, the major objective of financial management changed in time simultaneously with the modification in general conditions of the economic and social environment.

A first recommended objective is represented by profit maximisation, considering that the maximisation thereof includes both revenues maximisation, costs minimisation and at the same time an effective company management.

The actions taken to achieve the fundamental objective of maximising the company value also emphasise the major implications which define the role of financial management which is to ensure long-term performances quality and level, to maintain solvency and to control the risks that occur at company level.

The role of financial management consists in the task it has to use various instruments which ensure an adequate protection against risks (the economic, financial, bankruptcy risks, which depend on the external environment, which depend on the company specificity).

At the same time, financial management aims at maximising the company value, not only with reference to its own capitals, but also to the future investment and projects which the company’s equity will be engaged in.

The wealth accumulated by a company at a given moment is only one of the elements that allow for the appreciation of its value. Thus, we must also take into account the results expected in the future, as a result of using the accumulated equity.

Consequently, the company value is a value anticipated in that it takes into account the current value, which is correlated with the forecast future revenues obtained from the company’s activities. For this reason, the company value cannot be separated from the quality of the projects its equity is engaged in.

Mastering all the means and tools in achieving the major objective of financial management, namely to maximise the company value, based on its performance, emphasises the important role played by financial management at company level.

To assess the overall performance, return on investment indicators, residual income and economic value added are more suitable than the profitability of sales because these take into account both the profits made and the investments.

ROI identifies the investment with the highest profitability. The EVA and RP indicators help solve problems of matching the goals generated by the ROI. Some managers prefer EVA, because it takes into account tax issues, while RP before tax does not include these considerations.

Other managers prefer RP before tax, because it is easier to calculate and because, in most cases, leads to the same conclusions as EVA.

Taking into account the practices of companies, it is noted that companies use multiple financial indicators to evaluate performances.

Company value maximisation appears to depend on the quality and level of long-term performances, on maintaining solvency and on controlling risks which occur at company level.
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