

SUCCESSFUL COMPANIES AND INFLUENCING FACTORS

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Abstract

The success of companies is greatly ensured by achieving high economic performance. In turn, the economic performance is influenced by a complex of factors acting in the internal and external environment of the companies. The main objective of this study is to investigate the performance of companies and to identify the determinants of economic success. The research is conducted based on certain companies listed in the Top Companies of Romania, for the period 2005-2017. In the regression analysis carried out, the performance of companies is expressed by Return on Sales, and as explanatory variables we mainly used the financial ratios. The research results indicate that the performance of Romanian companies is significantly influenced by the way in which the financial capital is managed – its structure, its efficiency, the way of financing the company activity and the financial risk, as well as the extent of investment in fixed assets

Key words: successful companies, economic performance, return on sales, regression analysis

JEL Classification: D21, L25, M21

1. Introduction

The performance-based operation of a company is the way in which it implements its development strategy for increasing its own value for generating favourable economic, social and environmental effects.

The multidimensionality of the performance concept determines many possibilities of expressing it. The business performance of the companies is expressed in the literature by a multitude of different indicators [Combs, Crook, and Shook, 2005]. In the economic practice, a widespread way of assessing the performance of a company is to use profitability indicators [Richard et al, 2009]. For Romania, this option is expressed by the financial and accounting legislation that requires the companies to provide their stakeholders with performance information mainly using revenue, expense and outcome indicators [OMFP, 2014].

The objective of this research is to identify the success determinants in the entrepreneurial environment of Romania, with particular reference to the economic performance. It was considered that the business performance can be synthetically expressed through the Return on Sales (ROS) profitability indicator. The selection of this profit ratio is motivated by the fact that the validation of the economic and social utility of the output is given by the market *regression analysis*, the place where the consumer preferences are manifested. In this regard, the sales revenue is the premise of rewarding efforts, increasing profitability, and obtaining business success.

For the realistic substantiation of managerial decisions with impact on performance increase, it is necessary to know its attributes, i.e. to correctly identify the factors that have a favourable influence on the company profitability.

The analysis of the financial information found in the annual reports made by the companies provides a clear picture of their economic and financial situation, which grants them a certain position in the economic environment.

This paper proposes a multidimensional model of the performance of Romanian companies, identifying several determinants of the economic success.

2. Literature review

Increasing business performance is a major desideratum for all economic agents, ensuring the continuity of economic activity and increasing the value of the company, as well as increased possibilities to occupy a dominant position on the market.

The performance appraisal is a useful method for determining the current financial situation of a company, which enables making comparisons either with the competitors or with its own expectations [Tehrani et al, 2012]. In doing so, any approach for performance assessment and identification of the impact factors is targeting the managerial attention and efforts towards the key elements that must be carefully controlled in the future to minimise the related risks [Gallizo and Salvador, 2003].

In many specialised studies, the study of internal factors impact on performance was carried out using the financial ratio method, as it is believed that these factors have a strong prediction power over the success or bankruptcy of the companies [Beaver, 1966]. For a complex approach of the relationship between performance and its determinants, it is recommended to use a set of financial ratios that express the liquidity, solvency, profitability, and business activity of the companies [Altman, 1968].

The liquidity of a company's assets is an economic variable in a contradictory relationship with the performance phenomenon. Some studies have identified a negative impact of liquidity on the company's profitability [Oner, 2016], while other research highlights the existence of a direct influence of the working capital on the business performance [Appuhami, 2008]. Some authors suggest the need for a compromise between these two indicators [Tehrani et al. 2012; Deloof, 2003; Eljely, 2004]. An increased liquidity shows increased possibilities to continue the current activity and pay the creditors, but also shows an insufficient investment of the capital in fixed assets, with a direct negative impact on the future operational capacity and profitability. The decision-makers should consider ensuring an optimal level of the working capital to maximise the value and performance of the company [Enqvist et al., 2014].

The financial performance is often approached in close correlation with the capital structure, starting with Modigliani and Miller (1958). The recent studies consider that the capital structure is an important element of the company management, where the managerial decisions aim at judicious use of the owned funds and borrowed funds to maximise the value and performance of the company [Obim et al., 2014]. An analysis performed on the Romanian companies listed at Bucharest Stock Exchange shows that they support the asset financing primarily from their owned funds, then from commercial debt, and they lastly use loans [Dragotă and Semenescu, 2006]. They thus favour the financial independence and security, while preserving the flexibility towards leverage as a means of financing the future projects.

The relationship between leverage and performance has also different perceptions. Thus, the leverage ratio has been identified as having a negative influence on performance [Booth et al., 2001; Simerly and Li, 2000; Abeywardhana, 2015]. This is particularly the case for emerging economies where the leverage cost is high [Pathak, 2011]. The investigation of the link between performance and level of leverage is also found in other studies [Rayan, 2008; Myers, 2001; Eldomiaty, 2007]. Other authors identify a positive impact of the financial leverage on profitability [Champion, 1999; Gill et al., 2012]. However, the performance of the companies may be also influenced by other factors.

Considering the presented elements, this study contributes to the in-depth knowledge of the factors that improve the economic performance. The research provides a comprehensive perspective on the financial options that can boost the business success.

3. Research methodology

3.1. Data set and variables

In order to perform the research, we used data taken from the Romanian Companies Database [listafirme.ro]. The sample information refers to the period 2005-2017, for 50 companies that stood out during the analysed period and are listed in the Top Business Companies in Romania.

The chosen companies are active in different sectors of activity, but their inclusion in the most efficient segment of the national economy gives them a unitary character. The study of their characteristics raises interest in the various stakeholder categories.

The distribution of the 50 companies selected according to the NACE Code (classification of economic activities in the national economy) is presented in Diagram 1.

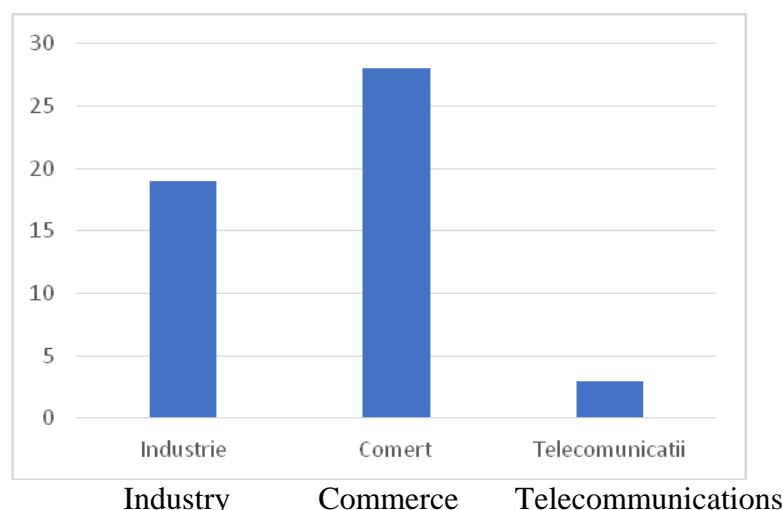


Diagram 1. **Distribution of companies in the Top Business Companies in Romania**

The distribution of successful companies in Romania in terms of business performance shows that the best represented is the services sector, in which wholesale and retail trade activities are carried out (56%). The companies engaged in industry account for 28% of the total of the analysed companies and they are active in the extractive industries, as well as in the manufacturing industry: Manufacture of coke and refined petroleum products, Manufacture of rubber and plastic products, Manufacture of basic metals, Manufacture of machinery and equipment n.e.c., Electricity production and supply. The telecommunication services have a share of 6% of the total performant companies.

For the selection of the variables required for this study, we took into account various categories of financial indicators that characterise important aspects of the micro-economic environment of the companies, such as: liquidity ratios, solvency ratios, efficiency indicators and profitability indicators. They express various aspects of the financial capital managed by the companies and are used in practice by the economic and financial bodies to monitor the financial situation, business performance and business risk [risco.ro].

The *Return on sales* (ROS) indicator was used as dependent variable for specifying the regression analysis model, and as explanatory variables we selected the following indicators: the Equity to Debt (EDR), the Debt to Assets (DAR) – also called *financial leverage ratio*, the Shareholder's Equity Working Capital (SEWC), the Ratio of Return on Invested Capital (ROIC), the Non-current Assets Ratio (NCAR), the company's size (SZ) expressed in number of employees (N), and the company's age (AG).

The Return on Sales (ROS) is used to assess how efficiently the business operations generate profit. In economic practice, it provides comparisons of businesses in different branches of

activity. This indicator also expresses the potential dividends, reinvestment potential and the company's ability to repay its debts. The calculation formula is [Farris et al, 2010]:

$$ROS = \text{Net Profit} / \text{Sales revenue} \quad (1)$$

A company that has a high profitability has the opportunity to better cover its expenses, being thus embarked on the road to a better financial performance.

The indicator *Equity to Debt ratio* (EDR) highlights the existence of funding sources and the type of financing used, showing the relative proportion of equity and borrowed capital used to finance the company's assets.

The good management of the main sources of funding can lead to an increase in the company's ability to take advantage of the market opportunities and to adopt appropriate investment behaviour.

$$EDR = \frac{\text{Equity}}{\text{Debt}} \quad (2)$$

In its reverse form, the Debt to Equity ratio expresses the degree of financial risk to which a company is subject. The business risk increases if the Debt to Equity is greater than one, which leads to lower financial security.

To assess the link between **assets solvency** and performance, we used the indicator *Debt to Assets Ratio* (DAR). It shows the company's indebtedness and is also known as *financial leverage ratio*.

$$DAR = \frac{\text{Debt}}{\text{Total Assets}} \quad (3)$$

The increase of indebtedness has a negative impact on the autonomy and financial security and increases the solvency risk. Also, this situation will lead to an increase in financial expenses, which leads to a decrease in profitability. If the company is efficient and obtains a high return on the assets it manages, it can increase its financial performance.

The **liquidity of assets** is another factor that can influence the company's financial performance. It is related to the ability to take advantage of the opportunities created by the adequate funding to increase the current workload. In this analysis, we used the *Working Capital* (WC) indicator to measure the assets' liquidity.

The Working Capital is related to various business activities, such as revenue collection, debt management, supplier payment, and inventory management. Its size shows how quickly a company can cover its current debts from its current assets.

In terms of ensuring the continuity of the company's activity, the working capital represents a permanent financing requirement that is covered from two sources: long-term debt and shareholder's equity. The Working Capital funded from equity, called *Shareholder's Equity Working Capital* (SEWC) is the stable component of the current business activity funding, and the size of this indicator reflects the real possibilities of the company to pay its immediate liabilities and, at the same time, to develop its business without increasing the financial risk [Vernimmen et al., 2009]. This indicator is used to assess the influence of the company's liquidity on performance. Its calculation formula is:

$$SEWC = \text{Shareholder's equity} - \text{Fixed assets} \quad (4)$$

A company with a higher working capital will have a lower vulnerability.

The *Return on Invested Capital* (ROIC) is a **profitability ratio** and shows the gain obtained from investing all sources of funding. A higher level of this indicator suggests that the companies are using efficiently their invested capital and have a better ability to financially reward the equity providers, shareholders and creditors.

$$ROIC = \frac{\text{Net Profit} - \text{Dividends}}{\text{Total Capital}} \quad (5)$$

The return on invested capital is an important indicator that assesses the value created by a company and, implicitly, an impact factor for financial performance. To the extent that the ratio exceeds the average cost of the capital, it is considered that the company creates value and is profitable.

The indicator *Non-current assets ratio* (NCAR) shows the **level of capital investment**, and is calculated as follows:

$$NCAR = \frac{\text{Non current assets}}{\text{Total assets}} \quad (6)$$

The companies that have a larger share of non-current assets in their total assets are often operating under risk, because they have a low flexibility and a lower response capacity to the changes in market demand. A high ratio favours the companies placed in a dominant market position, which operate in an almost unchanged economic environment [Schmidlin, 2014].

Another factor that can influence the financial performance is the **size of the company** (SZ), assessed by the number of employees. The personnel hired based on its own characteristics - volume, quality and productivity - can trigger a positive action on the economic processes.

The **age** of the company (AG) introduces in the model the companies' possibility to obtain favourable effects thanks to the reputation acquired over time [Ross, 2009] and represents the time period between the moment of observation and the date of company's establishment.

The data descriptive statistics, for the analysed companies in terms of dependent variables and explanatory variables, is presented in Table 1.

Table 1. **Descriptive statistics of variables**

| Variables | Mean | Maximum | Minimum | St. Dev. |
|---|--------|---------|---------|----------|
| Return on Sales (ROS) | 0.025 | 2.741 | -1.953 | 0.19 |
| Equity to Debt (EDR) | 1.516 | 39,8 | -5,489 | 3.44 |
| Debt to Assets (DAR) | 0.599 | 2.436 | 0.024 | 0.29 |
| Shareholder's equity Working Capital (SEWC), mil. RON | -3.95 | 4.09 | -1.04 | 1.5 |
| Return on Invested Capital (ROIC) | 0.06 | 2.403 | -1.007 | 0.178 |
| Non-current assets ratio (NCAR) | 0.44 | 0.983 | 0 | 0.276 |
| Number of employees (N) | 3499 | 48408 | 8 | 4969,135 |
| Firm age (AG), years | 13,575 | 28 | 0 | 5.903 |

Source: financial statements of the companies

During the period 2005-2017, the companies listed in the Top Companies of Romania had an average profitability ratio of 2.5%, one of the companies achieved a maximum of 274.1%, but there were also companies that suffered losses in some years. The analysed companies had a quite risky financing structure, preferring to finance the business from their own sources. Although there were many differences between companies as regards the combination of financial sources, it was found that, on average, the Equity to Debt ratio was greater than one, the companies using more

than 50% equity than borrowed capital. The average debt ratio was around 60%, suggesting that, in general, the performant companies used large amounts of loans to finance their own assets. However, they have evolved in a relatively safe financial environment within the analysed period, but quite close to the maximum permissible level (66%). However, the maximum indebtedness level of 243.6% and the minimum one of 2.4% show that there were also companies with a different financial behaviour, from excessively prudent to excessively risky. The average level of the own working capital was negative, which shows that, in general, the companies had insufficient own funds to cover the current production requirements. The share of non-current assets in total assets was 44%, with a maximum of 98.3%. Among the studied companies, there are also great differences in terms of labour force used. The average number of employees working in the studied companies is 3499, but there is a company with 48408 workers. The average age of the companies is 13 years, the maximum being 28 years.

3.2. Model specification

In this study, the research method used to establish the determinants of the company's performance versus the economic-financial variables specific to the internal environment is the regression analysis. The regression is performed for the data organised as a data set panel that contains time series for each cross-sectional member in the data set. This data organisation improves the empirical analysis [Gujarati, 2010].

The general form of the estimating equation for the panel regression model used in this study is:

$$Y_{it} = a + \sum_1^n b_i X_{it} + e \quad (7)$$

where Y_{it} is the company's performance, a is the intercept, b_i represents the regression coefficients, X_{it} are the independent variables with impact on performance, e is the error term, i and t are cross-section dimension and period of time.

The specific form showing the link between the performance expressed by the Return on Sales and a series of microeconomic variables is the following:

$$ROS_{it} = a + b_1 EDR_{it} + b_2 DAR_{it} + b_3 SEWC_{it} + b_4 ROIC_{it} + b_5 NCAR_{it} + b_7 SZ_{it} + b_8 AG_{it} + e_{it} \quad (8)$$

where: ROS represents the Return on Sales, EDR is the Equity to Debt ratio, SEWC is the Shareholder's equity Working Capital, ROIC is the Return on Invested Capital, NCAR is the Non-current Assets Ratio, SZ is the logarithm of number of employees, and AG is the company's age.

4. Estimation results and discussions

After performing the Hausman test, it became necessary to use the fixed effect model for data modelling, which enables the intercept model to vary from company to company, according to their own characteristics. The data were estimated using the White cross-section coefficient covariance method to obtain robust estimators to contemporaneous correlation and heteroskedasticity. The obtained estimates are shown in Table 2.

Table 2. Regression results

| Variables | Dependent variable: Return on Sales | | | |
|-----------|-------------------------------------|------------|-------------|---------|
| | Coefficients | Std. Error | t-Statistic | Prob. |
| EDR | 0.013029 | 0.0050 | 2.5720 | 0.0104* |
| DAR | 0.325236 | 0.1162 | 3.0323 | 0.0025* |
| SEWC | 2.14E-11 | 0.0000 | 2.0075 | 0.0452* |
| ROIC | 0.893570 | 0.2396 | 3.7281 | 0.0002* |
| NCAR | 0.310948 | 0.0928 | 3.3495 | 0.0009* |
| SZ | 0.052889 | 0.0352 | 1.4989 | 0.1345 |
| AG | 0.002304 | 0.0021 | 1.0928 | 0.2750 |
| Const | -0.797392 | 0.2205 | -3.6147 | 0.0003 |

R Square = 0.5787, Adj. R square = 0.5359, F value = 13.495, F significance = 0.000;
*p<0.05;

EDR is Equity to Debt Ratio, DAR is Debt to Assets Ratio, SEWC is Shareholder's Equity Working Capital, ROIC is Return on Invested Capital, NCAR is Non-current Assets Ratio, SZ is logarithm of number of employees, and AG is company's age

The analysis of regression results indicates that a valid model has been obtained, which has a high explanatory power. The value of the adjusted R-squared coefficient of determination indicates the fact that the performance variance of the studied companies is determined by the explanatory variables in a percentage of 53.6%. The model is relevant for studying the relationship between economic and financial factors in the domestic environment of companies and the manifestation of financial performance.

The results of regression show that, within the analysed group, the meaningful explanatory variables are specific to the various aspects related to the management of the financial capital. Thus, the Equity to Debt (EDR), Debt to Asset (DAR), Return on Investment Capital (ROIC), and Non-current assets ratio (NCAR) are significant variables, positively associated with the performance of the company.

Within the analysed group, the Equity to Debt Ratio (EDR) indicator exerted a positive influence on profitability, i.e. 1.3%. The relatively low level of impact suggests that the adoption by companies of a prudent financing strategy, preferring the funding from their own sources, although favourable, was not able to significantly stimulate the performance of the companies. This situation leads to the idea of using financial leverage as a source of development, by optimally combining the own sources with the borrowed ones. A necessary condition is, however, the efficient management of all the resources available to the company in order to obtain a high economic profitability.

The Debt to Asset Ratio (DAR) exerted an important positive influence on the company's performance, i.e. 32.5%, suggesting that some external sources of funding were needed to complement their own sources for ensuring their proper operation. For the analysed companies, an increase in the percentage of borrowed capital led to a significant increase in profitability. Other authors also considered that the increase of debt ratio is a source of company performance [Frank and Goyal, 2003], Champion [1999], etc.

The Shareholder's Equity Capital Working Capital (SEWC) variable had a very low influence on performance, which shows that, for the whole studied group, the way of financing the current activity was not a constraint for profitability. The companies were not affected by the liquidity risk.

The Profitability Ratio (ROIC) is the factor that produced the strongest effect on performance, i.e. 89.3%. The companies have used efficiently their own equity and the borrowed funds, generating gains.

The Capital Investment Ratio (NCAR) had also a favourable impact on the financial performance. On its account, the performance increased by 31.1%. This shows that the companies have invested capital by increasing their share of fixed assets in the total assets. The increase of operational capacity has led to increased profitability.

The company size (SZ) and age (AG) are factors that did not have significant impact on the financial performance of the studied group.

4. Conclusions

This study aimed at identifying the relationship between the economic and financial factors acting in the companies’ microenvironment and the performance expressed by the *Return on Sales* variable.

For the successful Romanian companies making up the performing sector of the economy, the regression analysis has highlighted the existence of a strong link between a set of internal factors associated with the management of the financial capital and profitability.

The obtained results show that, in the period 2005-2017, the determinants of the profitability of Romanian companies performing in the economy were: the efficiency of invested capital, the level of indebtedness, the way of investing the capital in assets in order to set up a productive structure adequate to the market requirements, as well as the companies’ option to choose the financial security. These results are in line with the results of other studies that also appreciate that the performance is directly influenced by the financial capital structure [Frank and Goyal, 2003], [Berger and Bonaccora di Patti, 2006].

Based on the obtained results, some suggestions on several action directions can be made in order to better manage the performance of the business, so that a larger number of companies to acquire the characteristics of the successful companies.

An element over which the decision-makers need to focus is how to use the financial capital. The increase of return on invested capital depends on the quality of financing decisions, allocation and efficient use of the productive resources, measures to reduce the costs and increase the sales, etc. At the same time, the adoption of certain measures for stimulating the investments will have as effect the increase of the technical-productive base of the companies, which means an increased production capacity and a higher earning potential.

Another route that needs to be the subject of a managerial decision is to establish an optimal funding structure, i.e. the use of a capital mix that fully covers either the long-term or the short-term financing needs, but which also corresponds to a minimum level of financing costs in order not to jeopardize the financial security.

Although this analysis revealed a positive but low effect of the liquidity on the companies’ profitability, it can be considered that the improvement of the working capital management ensures the continuity of the operational activity, being an important way to increase the performance, which is in agreement with the results of other studies carried out in this respect [Appuhami, 2008].

The quality of managerial decisions regarding the performance management depends on knowing the characteristics of the business environment in which the company operates. The central place is occupied by the variables related to the managed capital, elements that can be largely controlled.

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