

## MONITORING THE STATE OF PROFITABILITY AND ASSESSING THE RISKS OF FINANCIAL ACTIVITY OF THE ENTITY USING FINANCIAL DIAGNOSIS

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***ABSTRACT:** Being essential in the conditions of a dynamic economic environment, assailed by numerous changes, profitability is the expression of any entity earnings, and obtaining the profit as a measure of profitability (income increase in relation to the reduction of costs) represents the main objective of the activity of an economic entity. The purpose of this article is evaluation the state of profitability and assessing the risks using the financial diagnosis of profitability, as a measure of monitoring the financial health of the entity. Research shows that the financial diagnosis of profitability gives us a realistic view of the entity's financial health by identifying risks, strengths and weaknesses, vulnerabilities, of any threats that may arise in relation to business efficiency. The diagnosis of the state of profitability represents a measure of prevention of risks that threaten the development of the business entity, which allows the formulation of financial recovery paths of activity, to be used by stakeholders to justification of opinions.*

***Keywords:** profitability, diagnosis of profitability, risk, financial health status, business efficiency*

***Classification JEL:** L25, M40, M41*

### 1. INTRODUCTION

In a business environment in a constantly changing, any business is subject to a risk, on the grounds that in any activity unexpected events may occur which may have less pleasant track on the activity carried out by any entity in the economic part. Any entity must adapt to the conditions of a competitive environment increasingly more complex, difficult, and channeled on results without putting the value factors that lead to the achievement of strategic objectives. To deal with all challenges, and to be prosperous, attractive, efficient and promising development, an entity must obtain a profit. As a consequence of the risk assumed, the profit represents a reward for the sound management of resources. Being essential in the conditions of a dynamic economic environment, assailed by numerous changes, profitability is the expression of any entity earnings, and obtaining the profit as a measure of profitability (income increase in relation to the reduction of costs) represents the main objective of the activity of an economic entity. Profitability has been, is, and will be, a major point of interest for both the internal environment and the external environment of an economic entity.

The need for knowledge of financial performance brings with it the need to diagnose profitability as tool for monitoring the financial health of the entity. The purpose of this article is evaluation the state of profitability and assessing the risks using the financial diagnosis of profitability, as a measure of monitoring the financial health of the entity. As research objectives we aim to illustrate how the diagnosis of profitability represent the tool used for identify the strengths and weaknesses, opportunities, threats and causes they generate and/or generate them, to formulate recommendations for the abolition or reduction of the negative aspects and/or use of positive ones.

Research shows us that the diagnosis gives us a realistic view of the state of the entity's profitability by identifying strengths and weaknesses in relation to the financial health of the entity, representing such a measure for assessing the health status of the entity and identification of deficiencies, risks, anomalies, irregularities which threaten good of the economic activity of the entity. The diagnosis of the state of profitability represents a measure of prevention of risks that threaten the development of the business entity, which allows the formulation of financial recovery paths of activity, and it is an important activity which should be carried out at the level of each entity, throughout the economic activity leading to the smooth running of the activity.

## **2. PAPER BODY**

### **Methodology of research**

In this article, the literature review (document method) aims at presenting the current state of knowledge, through recourse to citations, highlighting current concepts regarding diagnosis profitability. At the same time, theoretical documentation of allowed presentation of concepts considered significant in relation to the topic studied as well as the importance of profitability in diagnosis prevention of risks affecting the financial health of entity. The case study used aimed at illustrating how the diagnosis of profitability represent the tool used for identify the strengths and weaknesses of the performance of the entity as a state of financial health. Also, diagnosis of the use of SWOT analysis, was chosen as a method of complex research to economical aspects, technical, sociological, legal and managerial activity that characterizes a company to identify strengths, weaknesses, opportunities, threats and causes they generate and/or generate them, to formulate recommendations for the abolition or reduction of the negative aspects and/or use of positive ones. Participatory observation was used for the analysis and interpretation of the results of the study case, and last but not least, grounding some opinions in the light of the results obtained and the achievement of the objectives proposed.

### **Literature review**

Literature brings us various attempts at definition, characterization, presenting the concept of diagnosis. Many of these refer to the establishment of the health status of an entity by means of diagnosis and financial accounting. Diagnosis known a number of definitions: System health monitoring, analysis of the potential of the company, the process of identification of deviations, until the substance/substrate of managerial decisions through recommendations. We can say that the diagnosis of financial accounting is aimed at identifying disturbances on all landings of the business entity. Diagnosis of financial accounting is intended both to overall profitability through the study of the performance of the operation of the account entered in the outcome, and the impact of funding on the profitability of capital in relation to the means employed, through financial performance (Holt G, 2009). We believe that such a presentation is partly incomplete, given the complexity of financial and accounting activity. Even if obtaining profit represents the main object of activity, in our opinion, in addition to profitability and performance, factors such as liquidity, solvency, risk, financial balance should be taken into calculation so when discussing about the financial accounting diagnosis.

Some authors (Achim M.V., 2015) consider financial diagnosis as a tool to support managers allow the formulation of value judgments regarding the qualitative and/or quantitative status, dynamics and prospects entities, suggesting the need for periodic consultation of the Organization to identify the health, vigor and ability to adapt to changes foreseeable environment. Diagnosis definition concerns financial accounting meet and to Gâdoiu M. (2007) showing financial diagnosis as a whole measures and checks made to determine or verify the technical and functional characteristics of a system, in order to maintain or improve, as well as identifying difficulties encountered. In this sense, the same source cited states that financial diagnosis becomes an indispensable tool able to find opportunities of development, various kinds of risks and strategic

choice of the most suitable. We presented opinion in part some authors (Șușu Ș. & Bîrsan M., 2009), which consider that the diagnosis represents a prognosis of progress of a company assuming appreciation of vulnerabilities, research and analysis of the facts and responsibilities, identify the specific causes of the disturbances, without proposing surely, applying a recovery program or treatment. In our opinion, it is not enough to identify risks and complications if not propose measures to halt, and even to prevent subsequent occurrence.

On the basis of a diagnosis, many items can be identified, that could cause an increase in the value of a company or otherwise decrease (Șușu Ș., Bîrsan M., 2009). The same bibliographic source recalls that based on the information provided, the diagnosis may bring some activities to deepen economic restructuring process times to bring managerial system, prerequisites the long-term consolidation of its position in the market. Pop I.L. (2017) underlines the idea that the diagnosis is a financial management tool that can be used successfully. Moreover, according to the source cited, benefits financial diagnosis depends largely on the extent to which an organization's leadership will take into account and implement the proposed solutions after diagnosis. In addition to the above mentioned opinion of the author, we can say that the recommendations must be completed in full by the management entity, since the existence of a measure which has not been put into practice can result in other financial problems, which require reassessment. Moreover, we believe a more complete approach offered by the authors (Șușu Ș. & Bîrsan M., 2009) according to them, a firm diagnosis, has as its objective the identification of weaknesses, in order to correct them and strengths, in order for them exploit in achieving better results, the latter must be capitalized, thus representing the future opportunities of the undertaking's activity.

Financial Diagnosis role of "System Center" for guiding management decisions, making the act of management should not be carried out on the principle of intuition (Baltes N, 2010). The diagnosis provides useful information on the chances of the company, as well as the direction and trend of business (Spătaru L, Stancovici A., 2014). Note to this bibliographic source the idea that diagnosis involves a difficult endeavor, sprinkled with various obstacles and traps, and his importance derives from the fact that a wrong diagnosis leads to further evaluation, what it means that the company had not known the true value. Support the idea presented by some authors (Suciu G., Bîrsan N., 2013), according to which, the diagnosis of possible situations detected financial imbalance. Diagnosis involves, in a speech, sightings of symptoms, disruption, establishing economic and financial status of the entity, prescribing "therapy" to redress a situation existing at a given time (Achim M.V., Borlea S. N, 2017).

Diagnosis offers the opportunity of adequate planning to mitigate risks (Andekina R.& Rakhmetova R., 2013). In a study published by Amarfii-Răilean N. (2015), mention is made of the fact that the diagnosis represents an efficient tool for ascertaining the State of "health" of enterprises at one point valuation and prospects of their development. All of these things don't do anything other than to bring out the major importance that financial accounting is a diagnosis in monitoring health status of economic entities. Financial diagnosis involves some judgments on the financial health of the company, the strengths and weaknesses of financial management, through which one can appreciate the risks of past, present and future of financial situation and solutions for reducing risks and improving results (Căruntu, Lăpăduși, 2010).

To ensure continuity, any economic activity must take place in conditions of profitability, (the income bigger them expenditure) and to obtain such a profit (Achim M.V., Borlea s., 2017). From the analysis of studies has shown that profitability is essential for entity in a dynamic economic environment conditions, and obtaining the profit as a measure of profitability (income increase in relation to the reduction of costs) represents the main objective of the activity of an economic entity. Literature brings to light various visions relating to the profitability of the entity, a component so important that it should be analyzed, interpreted, diagnosed, but mostly, harnessed. In a study published by some authors (Căruntu C, Lăpăduși M, 2012), it is stated that the profitability is one of the most synthetic forms of expressing the effectiveness of economic and financial activity representing the expression obtained earnings through an operation and condition

of the maintenance and development of the business. Profitability, is assigned once and for all with the draw of a firm's productivity, and, thus high productivity (low cost) firms will permanently enjoy higher mark-ups than their competitors and in an open economy they will also get a share of their profits from their revenues abroad (Grazzi M, 2011).

Profitability has been shown to be the best indicator of business performance, it is analyzed by studying the structure of profit and the return on capital and, referring to the structure of profit from the annual profit and loss statements, that gives an adjusted income statement based on expense categories: operating margin (EBITDA), operating profit (EBIT), net profit, total profit, and profit from the fiscal year (Penttinen, Rummukainen, Mikkola, 2011). The condition of profitability is the first level to ensure the performance of an economic activity; it can be placed in both absolute form (by calculation of the levels of profitability) and relative-by calculating ratios profitability (Achim M.V., Borlea s., 2017). The most important productivity and profitability analysis factors are measured by the balance sheet ratios based on account data which represent the economic and financial aspects of a company (Zeli A, Mariani P, 2009).

### Results and discussions - Case Study

To diagnose the state of profitability we make a case study at a metallurgical company in the field of using several indicators, such as: turnover (CAN), exercise productions (Qe), commercial margin (DBM), industrial margin (MI), value added (VA), gross profit from operations (RBEXP), the result from operations (REXP), cost of goods sold and services rendered (Ccan), gross profit on net turnover relating thereto (RBcan) gross profit (RBF) Financial result (RF) gross profit or loss of the accounting period (RBE) gross profit before deduction of interest and tax (EBIT) gross profit before taxes, interest, depreciation (EBITDA) the profit or loss of the accounting period (RNE) Capacity of self-financing (CAF) Self-financing (AF). First we determine the intermediate management balances, whose value will then be used to determine the condition of profitability indicators. Intermediate management balances is presented in table no. 1.

**Intermediate management balances of a metallurgical company**

**Table no.1**

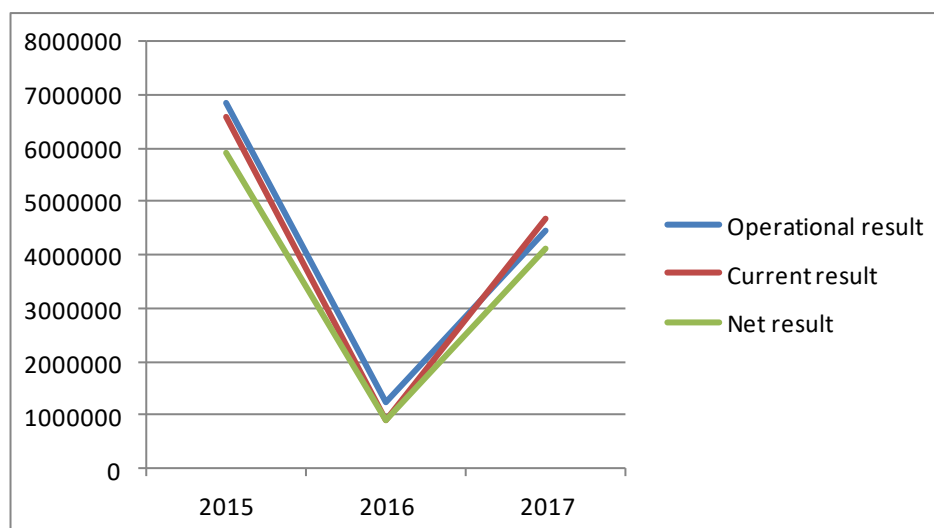
No	CALCULATION	2015	2016	2017	2016-2015	2017-2016
1	Sell goods income (707)	35937	15879	32930	-20058	17051
2	Goods expenses (ct 607)	38812	37107	55169	-1705	18062
3	Commercial Margin (1-2)	-2875	-21228	-22239	-18353	-1011
4	Sell Production (ct 701-706+708-709)	99000462	84923561	90924979	-14076901	6001418
5	Change in stocks (ct 711 +/-)	-1449303	-1762347	507909	-313044	2270256
6	Stock production income(ct 721+722)	653745	305225	0	-348520	-305225
7	Exercise productions (4+5+6)	98204904	83466439	91432888	-14738465	7966449
8	Third expenses (gr.60-607, gr.61, gr.62-621)	57545546	45942504	49012600	-11603042	3070096
9	Added value (3+7-8)	40656483	37502707	42398049	-3153776	4895342
10	Tax expenses (gr.63)	273301	231594	200011	-41707	-31583
11	Wage expenses(gr.64+621)	26495631	26752878	28687166	257247	1934288
12	Gross operational surplus (9-10-11)	13887551	10518235	13510872	-3369316	2992637
13	Other operational revenue	2812836	1744129	1263979	-1068707	-480150
14	Other operational expenses	7824092	8007475	7724795	183383	-282680
15	Depreciation Expenses	2032044	3026952	2601601	994908	-425351

16	Operational result (12+13-14-15)	6844251	1227937	4448455	-5616314	3220518
17	Financial revenue	1133848	996245	1007370	-137603	11125
18	Financial expenses	1379243	1320201	765004	-59042	-555197
19	Financial result (17-18)	-245395	-323956	242366	-78561	566322
20	Gross result (16+19)	6598856	903981	4690821	-5694875	3786840
21	Tax	692696		569101	-692696	569101
22	Net result (21-22)	5906160	903981	4121720	-5002179	3217739

*Source: Indicators were calculated using data from the financial statements of the company*

We observe in table no.1, that although the profit or the net result of the year fell drastically in the year 2016, in 2017 trend is in the growth sense. Commercial margin, exercise productions, value added and gross operating surplus from operations decreased in the year 2016 compared to 2015. Other indicators, such as financial result, the result from operations, the result of the current and last but not least, the net result recorded significant reductions. 2016 year is a year in which the company recorded profit accountant, but tax loss; given that it was not tax on profit. A year later, in 2017, the trend indicators are to return to the year 2015. However, the best performing year is considered the year of 2015. Record company in the business of marketing the goods costs far higher revenues, leading to a trade margin with negative values recorded in all three years taken into account. Changes in stocks in the year 2015 and 2016 have negative values, and in the year 2017, stock production income value is null. As regards production, this year has seen a decrease of 14738465 modifications approximately proportional of production sold. In addition to third expenses with 11603042 in the year 2016, and increasing them by 3070096 a year later, production for the year was unable to influence the positive contribution of the entity at the national wealth will, through the efficient use of resources through financing activity and implicitly through compensation of employees, shareholders and the rule through increasing value added with 4895342 in the year 2017 in relation to the previous year. Staff costs also recorded an uptrend, despite spending with taxes and fees, which have registered a declining trend but, on the whole, gross operating surplus registered a decline of 3369316 in the year 2016, and an increase of 2992637 in the year 2017.

This increase confirms the effectiveness of the entity's industrial and commercial, and generating the necessary resources to finance the repayment of loans, investments, capital and reserves remuneration, the maintenance of technical equipment and payment of corporation tax. The discrepancy with the income items, operating expenses and depreciation charges soared in the year 2016, compared to the year 2015, leading to a drop in the operating result of 5616314 in the year 2016. We appreciate the fact that, although the company recorded decreases and increases revenue, operating expenses in the year 2016, which lead to substantial lessening the company's results in the year 2017 society manages to record income increases required to achieve performance results and close the year 2015, but the overall trend being the write-down. This can be seen from the chart no. 1. About the evolution of the operating result, the current result, and the net result.



**Diagram no. 1.** The evolution of the operating result, the current result, and the net result  
Sours: own screening

In order to diagnose the condition of profitability have calculated a series of indicators, based on the data provided by the annual financial statements (in particular, the profit and loss account and explanatory notes). Research results are presented in table no. 2.

**The calculation of indicators on the profitability levels of activity**

**Table no.2**

INDICATORS	2015	2016	2017	2016-2015	2017-2016
<b>a) Operating level</b>					
1. Turnover (CAN)	99036399	84939440	90957909	-14096959	6018469
2. Exercise productions (Qe)	98204904	83466439	91432888	-14738465	7966449
3. Commercial margin (MC)	-2875	-21228	-22239	-18353	-1011
4. Industrial margin (MI)	40659358	37523935	42420288	-3135423	4896353
5. Added value (VA)	40656483	37502707	42398049	-3153776	4895342
6. Gross operating profit (RBEXP)	13887551	10518235	13510872	-3369316	2992637
7. The operating result (REXP)	6844251	1227937	4448455	-5616314	3220518
8. Costs of goods sold and services rendered (Ccan)	86373121	75478696	80123547	-10894425	4644851
9. Gross profit or net turnover relating (RBcan)	12663278	9460744	10834362	-3202534	1373618
<b>b) Financial level</b>					
10. Gross financial profit (RBF)	-245395	-323956	242366	-78561	566322
11. Financial result (RF)	-245395	-323956	242366	-78561	566322
<b>c) Global level</b>					
12. Gross profit or loss of the accounting period (RBE)	6598856	903981	4690821	-5694875	3786840
13. Total gross profit (RBT)	6598856	903981	4690821	-5694875	3786840
14. Gross profit before deduction of interest and tax (EBIT)	6711490	1028260	4867999	-5683230	3839739

15. Gross profit before taxes, interest, depreciation (EBITDA)	8743534	4055212	7469600	-4688322	3414388
16. Net profit or loss of the accounting period (RNE)	5906160	903981	4121720	-5002179	3217739
17. Capacity of self-financing (CAF)	7795654	3263495	6679568	-4532159	3416073
18. Self-financing (AF)	7795654	3263495	6679568	-4532159	3416073

Source: Indicators were calculated using data from the financial statements of the company

Analyzing the results it is observed that, although the company recorded a negative commercial margin for the entire period under review, the industrial margin equivalent to significant positive, which confirms the quality of the production company (production activity being priority marketing), and even if in the year 2016 dropped 3135423 in the year 2017 has recorded a significant increase of 2992637. As regards self-financing, it has the same value as the self-financing capacity because in the period under review the company decides not to pay dividends. Among all indicators, the production and turnover for the year grew at the highest values, although a fall had quite representative in 2015 year 2016, in both indicators have risen. Their evolution can be seen in Figure No. 2.

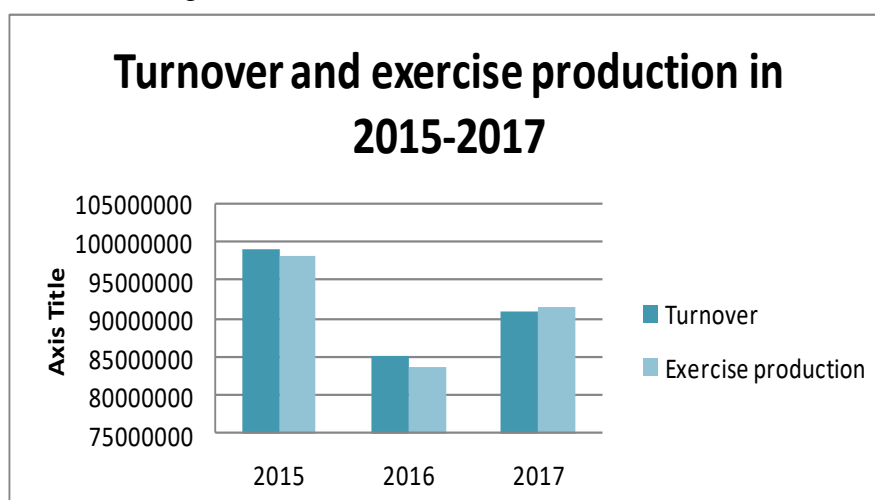


Diagram no. 2. Developments in net turnover and exercise production in 2015-2017

Source: own screening

On the basis of indicators calculated in table no. 2, we have achieved the synthesis diagnosis of the State of profitability, according to table nr. 3.

### Synthesis of profitability diagnosis

Table no.3

IND.	OBSERVATIONS	SWOT Diagnosis	Pct	Im p.	Agr eg.	Necessary measures
Exploitation level	The condition of profitability at the level of exploitation is situated at an average level, approaching the average of a satisfactory level	DOUBTFUL POINT	3,4 1	50 %	1,7	The increase in operating revenue, reducing expenses with raw materials
1. CAN	Values very good turnover of 90.95 mil and 99.03 mil, downward trend being slow	Forte status/Slow deterioration	3,5	14, 28 %	0,5	Increase the quantity sold, reducing commercial discounts
2. Qe	Values very consolidated, with values between 98.20 mil and 91.43 million downward trend being slow	Forte status/Slow deterioration	3,5	14, 28 %	0,5	The increase in production and production sold stored

3. MC	Commercial margin recorded a significant drop, and her negative value during the three reference years shows that it is not profitable of commercial activity.	Poor condition/sudden deterioration	1,5	14,28 %	0,21	The increase in revenues from the sale of goods, the goods costs reduction
4. MI	Values very consolidated, and the tendency is slow growing	Forte status/slow improvement	4	14,28 %	0,6	Maintain this level
5. VA	The company manages to create added value in amounts consistent with values between 40.65 million. and 42.39, while slow growth trend is	Forte status/slow improvement	4	14,28 %	0,6	Maintain this level
6. RBEXP	Values very consolidated, with amounts ranging from 13.88 million. and, while 13.51 downward tendency is slow	Forte status/Slow deterioration	3,5	14,28 %	0,5	The increase in operating revenue, reducing expenses with raw materials
7. REXP	Values very consolidated, and the tendency is slow growing	Forte status/Slow deterioration	3,5	14,28 %	0,5	The increase in operating revenue, decrease expenses provisions
<b>Financial level</b>	<b>The State of financial profitability lies at an average level.</b>	<b>DOUBTFUL POINT</b>	<b>3</b>	<b>20 %</b>	<b>0,6</b>	The increase in financial income and financial expenses decrease
8. RBF	Negative values recorded in the first two years, but the trend over the past year is the sudden improvement, being the year 2017 the company recorded financial profit	Critical condition/ The sudden improvement	3	50 %	1,5	The increase in financial income and financial expenses decrease
9. RF	Negative values recorded in the first two years, but the trend over the past year is the sudden improvement, being the year 2017 the company recorded financial profit	Critical condition/ The sudden improvement	3	50 %	1,5	The increase in financial income and financial expenses decrease
Global level	<b>The State of the global profitability lies to a satisfactory level</b>	<b>STRONG POINT</b>	<b>3,5</b>	<b>30 %</b>	<b>1,05</b>	Improvement of the financial result
10. RBE	Recorded significant fluctuations from year to year, a drastic decline in 2016 and a considerable increase in 2017, and the trend is decreasing	Forte status/Slow deterioration	3,5	14,28 %	0,5	Improvement of the financial result
11. RBT	Recorded significant fluctuations from year to year, a drastic decline in 2016 and a considerable increase in 2017, and the trend is decreasing	Forte status/Slow deterioration	3,5	14,28 %	0,5	Improvement of the financial result
12. EBIT	Recorded significant fluctuations from year to year, with values ranging between 6.7 and 4.8 mil, and the trend is decreasing	Forte status/Slow deterioration	3,5	14,28 %	0,5	Improvement of the financial result
13. EBITDA	Recorded significant fluctuations from year to year, with values ranging between 8,74 and 7,46 mil, and the trend is decreasing	Forte status/Slow deterioration	3,5	14,28 %	0,5	EBIT growth through an increase in the gross result of the year
14. RNE	Recorded significant fluctuations from year to year, with values ranging between 5,90 and 4.12 mil, and the trend is decreasing	Forte status/Slow deterioration	3,5	14,28 %	0,5	The result of the increase in gross domestic product of the year and lowering corporation tax
15. CAF	Recorded significant fluctuations from year to year, with values ranging between 7,79 and 6,67 mil, and the trend is decreasing	Forte status/Slow deterioration	3,5	14,28 %	0,5	Increase revenue, reduce expenses
16. AF	Recorded significant fluctuations from year to year, with values ranging between 7,79 and 6,67 mil, and the trend is decreasing	Forte status/Slow deterioration	3,5	14,28 %	0,5	Increase revenue, reduce expenses
<b>Profitability diagnosis</b>	<b>From the analysis of the profitability indicators noted that society presents a medium-level of acceptable profitability.</b>	<b>DOUBTFUL POINT</b>		<b>100 %</b>	<b>3,35</b>	<b>It is desirable to increase revenue, reduce expenses, improve the financial result</b>

Source: own screening



Following the analysis, we conclude that, although a company record profit, is performing, has significant values of indicators of profitability, it is necessary a more thorough analysis of the strengths, weaknesses, threats, risks, to see exactly what lies behind the profitability. Diagnostic activities, as we can see, a company can be classified into a particular category of risk, with the aim of prescribing a treatment necessary financial recovery.

### 3. CONCLUSIONS

Monitoring the health status of the entity is dependent on the need of the diagnosis. In this respect, it was granted an increased attention to the way in which financial accounting must be diagnosed and can be used as a method of laying out the journey of an entity, the entity's profitability, economic. We believe that emphasis should be laid on finality and the usefulness of diagnostic facilities. Aimed at the main demonstration of the importance of the diagnosis of the condition of profitability, as a tool for monitoring the financial health of the entity, research results show us that the diagnosis gives us a realistic view of the State of the entity's profitability by identifying strengths and weaknesses in relation to the financial health of the entity, thus representing a measure for assessing the health status of the entity and identification shortcomings, irregularities, anomalies, risks threatening the smooth running of the economic activity of the entity.

It can be said that the diagnosis of the condition of profitability is an important activity which should be carried out at the level of each entity, throughout the economic activity leading to the smooth running of the activity. Conclusion what can come off is that the diagnosis of the condition of profitability is an advanced tool for checking the function of the entity is used for determining, assessing the health status of the entity and identification shortcomings, irregularities, anomalies, risks threatening the smooth running of the economic activity of the entity.

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