THE INCREASING ROLE OF RATING PROCESSES FOR INTERNAL MANAGEMENT AND INVESTOR RELATIONS OF ENTERPRISES

Volker Tolkmitt*

1. Executive summary

Competences of management are an essential part for the success of companies. They count, as so called, "Soft Facts" in processes of evaluation. Because of the fact that company crises usually start with strategic weaknesses obliged to management mistakes in market and competition analysis followed by wrong operational decisions of the management the importance of management competence is weighted very high by analysts. In fact the management competence is essentially influenced by their qualification and experiences. Both are indicators for the ability of managers to analyse current market situations and to forecast future economic development. These characteristics build the foundation basis for successful management.

2. Introduction

A company has a lot of stakeholders like managers, investors, lenders, customers, suppliers, and regulators with different views. They all use financial statements and business or rating reports to gather information about the company: E.g. managers to improve the performance, lenders to evaluate the likelihood of collecting on interests and principal and stockholders to forecast earnings, dividends, free cash flow and stock prices. All these information is usually collected, structured and analysed by the Controlling. In the literature for every stakeholder are recommendations for the right ratio mix. The problem investigating into this topic is that every author presents his own mix and ratios with little differences in the calculation. Helfert published a ratio matrix for the different analysis areas according to the viewpoint [1, p.98]. While external stakeholders try to evaluate the probability of stable relations, especially the complete and punctually payment, need internal stakeholders information of Controlling for ratios and key figures, forecasts, planning and budgeting, decision making and risk management.

Sound financial planning is essential to business success. It forces managers to be consistent in their goals for growth, investment and finance [2, p.837]. In the last decade the importance of reports to external stakeholders of an enterprise was steadily increasing [3, p.76]. Further more banks and other investors interpret a lack of information about a company as an additional risk [4, p.1]. Business partners and investors evaluate their partners by analyzing financial data as well as "Soft Facts" with ratios.

The complexity of the management decision making process and the raising number of operative decisions by more and more employees results in the necessity to build up strong internal systems for quick and successful management decisions. On the other hand efficient and successful management operations need defined objectives and parameters, which are regularly documented, forecasted and measured. For internal management processes analysis of information with well designed instruments is a value driver for the company.

3. Financial statements and rating reports

Accounting and analysis are crucial for two important matters of management. Firstly to analyze the past development managers need the financial analysis. Secondly to predict future development decision makers have to have financial planning instruments. Finally the existence of both methods

* Volker Tolkmitt; Prof.; Dr.; Faculty of Economics; University of Applied Sciences Mittweida (FH); Germany

and the use of these instruments for controlling reasons is an essential part of valuation in external and internal rating reports.

Financial analysis examines and judges the financial conditions of a company [5, p.561]. Financial ratio analysis let you calculate and compare relationships derived from information in the financial statements [6, p.65].

The main goals of financial analysis are:

1. Comparing the firm's performance with that of other firms in the same industry.
2. Evaluating trends in the firm's financial position over time.

Financial analysis can help the management to identify deficiencies in current and improve future performance. A short statement that expresses the importance of financial planning is articulated by Ross et al., who say that financial planners have six Ps: "Proper Prior Planning Prevents Poor Performance" [7, p.127].

Fabozzi and Peterson state that financial planning allocates the resources of a company to reach its investment objectives and point out some reasons why financial planning is crucial: it helps managers estimate the impact of a specific strategy on the financial position of the Company, its cash flows, its reported earnings, and its needs for external financing. By developing financial plans, managers can better react to changes in the market situation. Managers become more aware of the sensitivity of the cash flows and its financing needs to changes in sales or some other element. It helps managers comprehend the tradeoffs referring to its investment and financing plans [8, p.938].

Rating agencies like investors ask for information about financial statement analysis and financial planning. Additionally to that the absence of those information or the absence of instruments, which deliver the information is appreciated as a heave risk of such a company. In the next step it is useful to examine the areas of interest more in detail.

4. Key figures and their interpretation

Fabozzi and Peterson present some methods to forecast sales [8, p.941]. They point out that sales forecasts are uncertain because they are influenced by other factors, such economy, industry, and market conditions. However, it is possible to assign significant degrees of uncertainty in the forecast. They describe and analyze essential instruments for creating key figures and interpreting these instruments. They mention the importance for regression analysis as a statistica1 method to discover correlation effects or possible relationship between different parameters, for example sales and capital expenditure. Further more they focus on market surveys, pro forma statements and economic assumptions. Finally according to Fabozzi, Peterson the "Opinions of Management", the experiences with the firm's markets, customers, products and competitors should result in forecasts. Without data analysis this could lead into an over optimistic view of the management.

Ratios and Controlling instruments like the Balanced Score Card can help to avoid misinterpretation of experiences as well as a short term "Muddling-Through-Strategy". By using those instruments it is important to concentrate on a few but essential key figures in the core business areas of a company. Statistics, forecasts and deviation analysis of financial-, market-, personnel-, process- and technical ratios deliver fundamental information for management decisions.

Figure 1 shows the importance of ratio based management decisions. Becker ana1ysed with his study in 2008 the relevance of controlling and management behavior in Middle-Sized Companies in Germany [9, p.41]. Following this empirical study managers rely on ratios plus something. While no manager answered to act only ratio based, answered nearly 50% of the peer group that they base their decisions essentially on ratios and nearly all managers argued, that ratios should be taken into consideration. So, decisions usually base on key figures, but far not only.

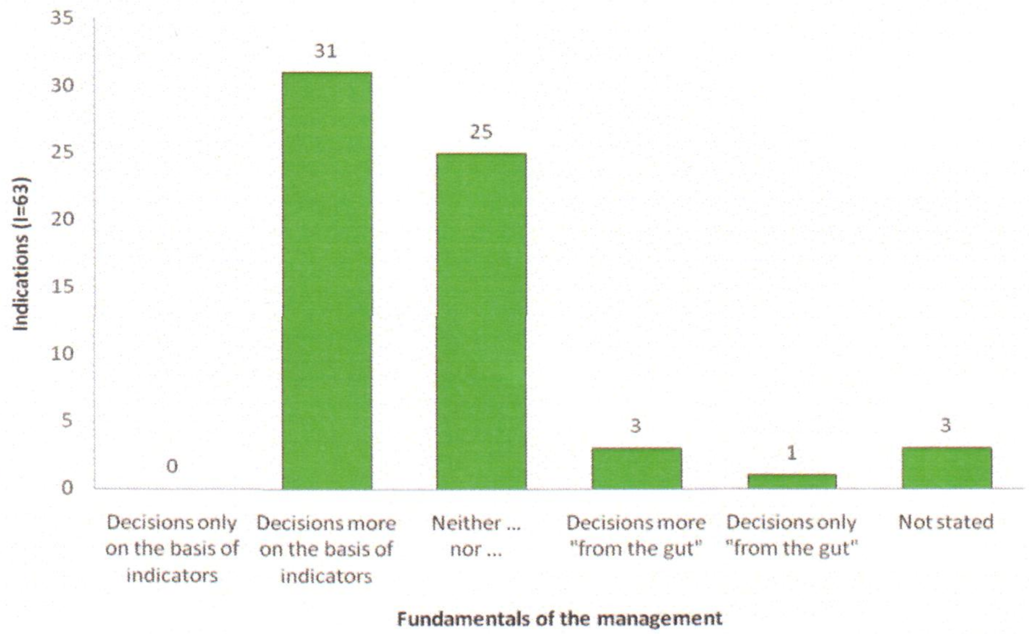

Fig. 1. Foundation of Management with Ratios and Controlling

Further more the study shows, that the most important reasons for quantitative analysis and interpretation of ratios are the information to owners, the foundation of management and Controlling. Managers mentioned as still important information to other stakeholders like creditors, investors on the capital market. In any case there is a lot of motivation for the management of companies to work with these controlling instruments. Transparency as we11 as strong and quick information to stakeholders wi11 be future parameters of success.

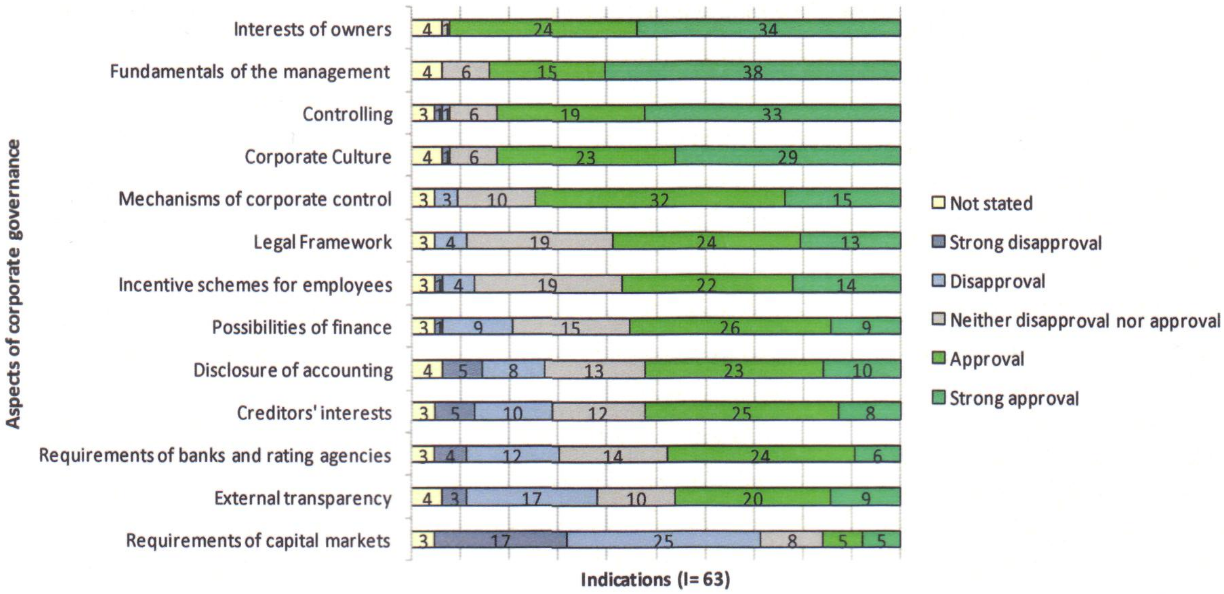

Fig. 2. Reasons for Ratio based reports and analysis

The main influencing factors are the Interests of owners, the Fundamentals of the management and the Controlling [9, p.38].

5. Importance of ratios for management decisions. Conclusion

The conclusion of a survey on managerial decisions was: managers make their decisions based on intuition. But they feel more at ease if the decision is prepared by a formal quantitative analysis [10, p.290]. From this perspective the financial statement analysis is a tool to get a look on companies in a standardized and simplified way. Depending on their legal form and their size firms are obliged by the commercial laws to publish their financial statements. This is a good source of information for the evaluation of a Company. Actua1ly the importance of a more complex quantitative analysis including “soft facts” is much higher in modem management analysis of all parts of the business.

In opposition to that the relevance of contro1ling and information systems as management instruments were raised in the last few years heavily. Management decisions are more and more ratio based. Analysis reports to stakeholders are more and more important. Becker confirmed with his empirical study the increasing role of analysis, ratios and contro1ling. Accounting and auditing are fundamental elements for analysis of enterprises.

References

1. Helfert E. Financial Ana1ysis: Tools and Techniques a Guide for Managers / E. Helfert. – New York: McGraw-Hill, 2001. – P.98.
2. Brealey P. A. Principles of Corporate Finance / P. A. Brealey, S. C. Myers. – New York: The McGraw-Hill Companies, 2007. – P. 837.
3. Prümer M. Rating-Leitfaden für die Praxis / Prümer Michael. – Gabler, Wiesbaden, 2003. – S. 76.
4. Köhler Peter Noten ffir das Management, Firmenratings, in: Handelsblatt vom 10.04.2006 / Peter Köhler. – Frankfurt, 2006. – S. 1–5.
5. Perridon L. Finanzwirtschaft der Unternehmung / L. Perridon, M. Steiner, A. Rathegber. – 15. Aufl age, München. 2009. – S. 561.
6. STANDARD & POOR'S: Standard & Poor's Corporate Govenance Scores and Evaluations: Criteria, Methodology And Definitions. – New York: The McGraw-Hill Companies, 2004. – P. 65.
7. Ross S. A. Essentia1s of Corporate Finance / S. A. Ross, R. W. Westerfield, B. D. Jordan. – New York: The McGraw-Hi11 Companies, 2010. – P. 127.
8. Fabozzi F. J. Financia1 Management and Analysis / F. J. Fabozzi, P. P. Peterson. – New Jersey: John Wiley & Sons, Inc., 2003. – P. 938–941.
9. Becker W. Untemehmensführung und Controlling im Mittelstand: Einflüsse von Uпtemehmensgröße und Leitungsstruktur, Bamberger Betriebswirtschaftliche Beiträge / Wolfgang Becker, Michaela Staffel, Patrick Ulrich. – 154, Bamberg. – 2008. – 154 s.
10. Breen B. What's Your Intuition / B. Breen. – Fast Company magazine. – 2005. – No. 38. – Gruner + Jahr USA Publishing, New York. – P. 290.

Summary

Finally to identify, to work with and to interpret key figures is very important for economic success. A lot of key figures is de1ivered by data from accounting. Other important data are delivered by ana1ists and research institutions. To interpret rating reports by banks, agencies or ana1ysts is decisive in modern decision making processes. Furthermore innovators and founders of companies go very often bankrupt because of 1ack in economic know1edge and management competence. That's why in a globa1 economic environment and comp1ex business structures the role of standardized business reports and ana1ysis tools is increasing.

Keywords: internal management; financial statements; ratios; controlling.

UD classification: 65.011