Determinants of Financial Performance in Albanian Economic Entities, Case of Construction Industry in Albania

ALBANA GJONI (KARAMETA)
Department of Finance and Accounting
Agricultural University of Tirana
Rr. Dritan Hoxha, Laprakë, Tiranë
ALBANIA

SHPRESA ÇELA
Department of Finance and Accounting
Agricultural University of Tirana
Rr. Elbasanit, Tiranë
ALBANIA

AHMAD MLOUK
Department of Finance and Accounting
Staffordshire University
Room LW123, Ashley 2 Building
UNITED KINGDOM

GRISELDA MARKU
Department of Finance and Accounting
Agricultural University of Tirana
Kodër Kamëz, Tiranë
ALBANIA

Abstract: - Financial performance mainly reflects the overall financial health of the business sector over a period of time. It shows how well an entity is using its resources to maximize shareholder's wealth. Although a thorough assessment of a firm's financial performance takes into account many other measures, the most common performance measurement used in the area of finance are financial ratios. This paper provides a comprehensive study of the financial performance measurement literature related to the construction sector in Albania. The literature covers studies from Albania, Iran, India and Pakistan, but some international evidence has also been presented. The construction sector is chosen because of its impact on economic growth in Albania, it represents the second main sector according to its share effect on Albanian GDP. The financial ratios used to measure the financial performance of the construction sector are the debt ratio, the liquidity ratio and the profitability ratio from the period 2018-2020 for 100 construction companies in Albania. Return on Assets (ROA) is taken as the predictor variable and three financial ratios are taken as the predictive variables. This research reveals that the financial ratios have positive correlation with the dependent variable whereas the leverage ratio has negative correlation. To overcome the limitations of the forthcoming studies, the considered number of years need to be increased and other models such as Market Value Added, Capital Asset Pricing Model and Economic Value Added can be used to be tested for research to analyze other factors that may affect financial performance.

Key-Words: - Financial Performance, Financial Ratio, Construction Company, Financial Statements, Profitability.

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1 Introduction

The financial performance of a business reflects the result of its core activities in relation to the market and competitors. Measuring and analyzing the financial performance of a business in the right way and with the right techniques always remains a challenge and a main objective for the economic entities. The financial performance of economic entities in the construction sector is very important for investors, shareholders, customers, suppliers, employees, government controlling agencies and other parties that judge and make decisions based on this performance. The construction sector represents the second largest sector in Albania based on the contribution on GDP, 13-15% of GDP according to INSTAT (2020). Therefore, it was considered very important to be analyzed through this study. Financial performance is measured through quantitative indicators such as financial ratios, but also through comparative horizontal and vertical analysis. However, recording and interpreting financial ratios in different reporting periods for different companies in the same sector of the economy is a good method of measuring and interpreting financial performance. This can be done periodically by entities using information derived from periodically reported financial statements. Measuring these ratios, interpreting them, and finding correlations and relationships between them is also a breakthrough in assessing the financial performance of a particular sector in a country.

2 Literature Review

The overall financial performance of the economic entities is used as a tool that measures the improvement of a modern-day business enterprise and its periodic success. Although there are many symptoms and techniques that show financial performance, the preference of up to date financial ratios relies on the quick method to compare and analyze figures of different economic entities in a short period of time. In many studies, return on Equity (ROE) and Return on Sales (ROS) are two of the most broadly used ratios to measure economic performance [45]. For example, some authors chose Return on Assets (ROA), ROE, and ROS as main ratios to measure corporation financial performance [44], while others selected ROE, ROS, and the percentage of increase in sales to learn about financial performance determinants [33]. Another author has measured economic performance based on ROA, ROE and ROS in order to find out about the relationship between corporate social responsibility and the economic entity's turnover. [24]. Other authors used ROE to evaluate the financial performance in different periods of time for the same economic entity or for a selected group of economic entities in a specific accounting period. [23] Many researchers agree using these financial ratios to generate very important records about the firm's financial performance and its financial health. While ROE demonstrates capital efficiency, ROS shows the profit margin achieved on sales. In other words, one report refers to the ability to use capital, the other refers to the capacity to change the level of operating sales. Therefore, the use of these two ratios will help the researcher to have concrete picture and complete conclusions regarding the economic performance of enterprises. According to some other authors, liquidity measurement reports are a technique to assist analysts decide over company's capability to meet short and long term obligations [42]. In a study in 2012 an author suggests that "liquidity" has an indispensable position in the success of a firm, because failure to meet its duty in a timely manner can lead to a low credit rating through creditors, a limit in the value of market growth and subsequently a limit in the capacity to raise more capital in the future [29]. Meanwhile, capital is the core of an exact economic performance. Therefore, the liquidity issue plays a vital role in working capital management [35], and its affect must be cautiously considered. Many studies such as [1], [11], [18], [47], observed the tremendous impact of liquidity on financial performance. There is a range of financial reviews to measure corporate liquidity and the preference of the suitable ratio depends on the characteristics of the subject studied. For corporations that have a large amount of short term debt such as meals processing firms, quick ratio (QR) is normally used. In their study [37] showed that if there is an increase in QR the liquidity performance is affected. According to other authors, Stephen et al. (2010), this statement helps managers understand how environmentally friendly they are at using corporate assets to generate sales. A very high level increase in sales might suggest an increase in company's market share, and finally, an improved economic performance. [37] assesses company overall performance by the efficient use of total assets, long-term asset turnover and short-term asset turnover. The authors point out that low turnover is a signal of inefficient use of actual resources and that the business enterprise has not efficiently utilized its potential or assets. Analysts conclude that the higher the efficiency of asset use, the higher the efficiency of the company. The leverage ratio

suggests the degree of debt and its effect on overall financial performance of the company. It is directly related to the efficiency of use of capital in a company, so it is a very important tool for decision-making for managers, shareholders, investors, and creditors. Therefore, research has been carried out to discover the effect of that variable on a company's overall financial performance, but there is no definitive conclusion about this relationship. Some researchers [4] found that leverage is negatively related to economic performance; the motive is that high debt requires extra resources to pay off debt. However, others like [7], [19] argue that additional debt can be applied to a good investment, which will amplify economic performance. Profitability has a tendency to concretely accomplish a strategic goal, which is claimed to determine the level of success of an economic entity. A profitability level might be set as a strategic goal for an economic entity. Managers think that earnings are dictated by efforts to coordinate income versus expenses associated with other operating enterprise objectives, which need to be achieved in order for it to cross into a generally dynamic market. Although profit is described as a measure of success, price range determination alludes to the relative extent of receiving this success. At the end of the day, economic performance is assessed by the ability of an economic entity to achieve its planned level of profit. Profitability is a measure to assess strategic objectives of an economic entity. It is an essential aspect of an economic entity's performance. Productivity is also an important ratio that measures the efficiency of a specific level of input on generating a desired level of outputs. Financial performance is affected by productivity and the methods of managing product export. Another author argues [46], that a very important method to improve financial performance is to improve productivity. One other very important component to improve financial performance is the level of income. By improving the level of income, improving the level of actual input to produce actual output, the economic entity can achieve higher financial performance goals. Achieving the desired level of productivity is one step forward to improving financial performance of economic entities. Through managing the levels of actual costs of capital and labor, on producing actual levels of output, economic entities can improve efficiency and achieve higher levels of productivity. Economic entities plan the level of cost for materials, labor, overheads, and at the end of the period they compare the actual level of costs with the planned level. The variances of cost are later on analyzed, interpreted and managers make decisions to improve productivity by managing better those cost levels. Managers make efforts to minimize the variable costs and if it is possible they eliminate fixed costs to achieve the desired levels of productivity and profitability, and through this way they affect financial performance of their economic entities. The ways managers use to examine performance by developing a relationship between the declared profitability and the reportd value of profit and loss are also known as methods of evaluating performance for economic entities [30]. [17] in 1973 also determines that a method to measure economic entity's performance is to develop a relationship between profitability and the financial position. Measuring financial performance can involve a process of identifying, developing relationships between elements of different financial statements, evaluating and interpreting the results, and finally generating reports. These reports can be an essential database for decision-making for managers, stock-holders, potential investors, creditors, contractors and all other third parties interested in the economic entity's performance. [31] The economic entity's financial performance is determined for decision-making by each potential investor and every financing institution that is contracted, and also each stock-holder evaluates his investment future through this information. All the interested parties evaluate financial performance to identify future problems of the economic entity, future potential cash inflows and potential negative effects. All these evaluation processes are made possible by interpreting figures taken from published reports. [16]. As a result of these interpretation and analyses of reports, manufacturers manage to reduce levels of cost [36]. Other researchers also used similar evaluation techniques to measure performance of the industry and also compare it with other industries in different countries of the world. In their studies they identified many different determinants such as productivity ratio, liquidity ratio, profitability ratio, working capital, asset turnover ratio, and other financial ratios calculated through published financial information, but still not all determinants of financial performance of economic entities have been distinguished. As [46] argues, [15], [39], [9], [6], [2] in their recent studies discussed the relationship between profitability and return on asset as key components to the evaluation of financial performance. [12] studied the importance of financial reporting in small medium enterprises in Albania by assessing the relations between qualitative reporting with specific qualitative characteristics of financial information. [26] also

studied possible methods to increase productivity in electricity industry in UK. [13] discussed relationship between indicators of financial performance in cement industry in India. This study was really important because of the large share of total turnover on their GDP. [14] also developed a relationship between productivity ratio and the profitability ratio in cement industry, and linked this relationship to the overall business performance. [5] also studied the relationship between managing input and output levels, and the profitability ratios [34], [28], [3], [43] selected profit margin ratio to determine the financial performance of economic entities listed in cement industry. This industry is largely selected for evaluation of performance because of importance to other important related industries all over the world. [22] developed a study with 5 selected ratios to determine economic entities' financial performance in textile industry, he also developed different relationships between selected ratios and identified them as significant or not. Later on [38] continued this study in the cement industry in India. [20] studied through more than a decade, from 1991-2004 the relationship between different financial ratios in terms of measuring financial performance. Through capital budgeting the economic entities can manage to improve their financial performance [25]. Liquidity ratio can be also crucial for determining an economic entity's financial performance [10], and this is related to the capacity of the economic entity to meet short-term obligations by using its short-term resources. [32] and [48] identified profitability and liquidity ratios as the most important components to determine the financial performance of economic entities in different industries of a country selected for research. Referring to [21], the nature of current assets also determines the capacity to settle short-term liabilities in a timely manner, determining the financial health of the economic entity. This relationship is directly linked to the working capital as a key determinant to the business performance improvement. The desired level of working capital vary in different industries and in different economic entities, depending also on its specific individual financial goals [8]. [27] studied the cash cycle and its main effects on financial performance of economic entities. Cash cycle management by economic entities can become a key to success in improving financial performance as well as providing the right energy to the company's business operations [41].

3 Methodology

We used secondary data available from financial statements officially published by the selected companies in the period selected for this study. Our research is underpinned by the above literature review. The data relates to the following indicators: Return on Asset, liquidity ratio, debt ratio, profitability indicator are as a result of the processing of data from the financial statements of 100 entities of the construction sector under consideration, officially taken from the National Centre of Registered Businesses in Albania. The data covers the period 2018-2020. We used the multifactorial econometric panel model using the Gretl econometric program to detect the existence of a relationship between the independent variables (liquidity, debt and profitability ratios) and the dependent variable ROA. The form of the function is of the type:

Formula 1. Multifactorial Panel Model
$ROA=\beta0+\beta1*debt\text{-}ratio+\beta2*liquidity\text{-}ratio+\beta3*profitability\ ratio+\varepsilon$

Main Hypothesis:
H0: There is no statistically significant economic factor that affects the financial performance of the construction industry in Albania.
H1: At least one of the economic factors taken into consideration is statistically significant and affects the financial performance of the construction industry in Albania.
Based on this main hypothesis we have raised three secondary hypotheses. The first hypothesis is about the relationship between ROA and the debt ratio, the second hypothesis is about the relationship between ROA and the liquidity ratio, the third is about the relationship between ROA and the profitability ratio.

The first hypothesis:
H0: The relationship between ROA and debt ratio is not significant.
H1: The relationship between ROA and debt ratio is significant.

The second hypothesis:
H0: The relationship between ROA and liquidity ratio is not significant.
H1: The relationship between ROA and liquidity ratio is significant.

The third hypothesis:
H0: The relationship between ROA and profitability indicator is not significant.
H1: The relationship between ROA and

profitability indicator is significant.

The null hypothesis is rejected if the correlation is of a significance above 95% and the econometric model turns out to be significant after the tests are performed and consequently the alternative hypothesis is accepted. Return on Assets (ROA) is an indicator that indicates how well a company is using its assets to generate desired profit. ROA gives to all stakeholders, such as managers, investors or analysts an idea of how efficient the management of a company is in using its assets to generate profits. Quick ratio here refers to the liquidity ratio, and it measures a company's ability to pay short-term liabilities or those payable within a year. Debt ratio measures the amount of leverage used by a company in terms of total debt to total assets. Debt ratio greater than 1.0 (100%) means that a company has more debt than assets. Profitability ratios are used to assess a business's ability to generate profits, relative to its revenue, operating costs, balance sheet assets or equity over time, using data from a specific period. In this study, profitability is expressed through margin such as gross profit margin and net profit margin in relation to overall sales.

4 Results

To measure the financial performance of the construction sector in Albania for the period 2018-2020, it is important at first to study the descriptive statistics of financial reports which are used as explanatory variables to measure the main impact on the ROA (predictor variable) obtained in the study.

Table 1. Descriptive Statistics 2020

VARIABLES	MEAN	STANDARD ERROR	MID-RANGE	STANDARD DEVIATION	MIN	MAX
RETURN ON ASSETS (ROA)	0,03	0,01	0,02	0,11	-0,73	0,55
DEBT RATIO	0,62	0,03	0,70	0,29	0,03	1,32
LIQUIDITY RATIO	4,92	0,87	1,63	8,73	0,11	48,25
PROFITABILITY RATIO	-0,20	0,15	0,04	1,54	-10,55	0,84

Table 2. Descriptive Statistics 2019

VARIABLES	MEAN	STANDARD ERROR	MID-RANG	STANDARD DEVIATI	MIN	MAX
RETURN ON ASSETS ((ROA)	0,07	0,01	0,03	0,11	-0,08	0,58
DEBT RATIO	0,62	0,03	0,67	0,28	0,00	1,01
LIQUIDITY RATIO	4,85	0,82	1,75	8,17	0,09	46,64
PROFITABILITY RATIO	0,08	0,02	0,07	0,16	-0,52	0,78

Table 3. Descriptive Statistics 2018

VARIABLES	MEAN	STANDARD ERROR	MID-RANGE	STANDARD DEVIATION	MIN	MAX
RETURN ON ASSETS ((ROA)	0,04	0,01	0,03	0,15	-0,58	0,70
DEBT RATIO borxhit	0,65	0,04	0,65	0,41	0,01	3,46
LIQUIDITY RATIO likuiditetit	26,12	18,99	2,18	189,92	0,28	1893,84
PROFITABILITY RATIO	-478,34	478,40	0,06	4784,03	-47840,21	0,78

Table 1 reveals the descriptive statistics of all study variables in 2020, the mean value of return on assets (ROA) is 3% with maximum value of 55%, and it concludes that performance of listed industrial companies' shows positive financial health during the study period. Besides, the debt ratio shows positive result to support it with mean value of 62%. The mean value of liquidity is 4.92. The mean value of profitability (PR) is -20% with 1.54 value of standard deviation.

Table 2 reveals the descriptive statistics of all study variables in 2019, the mean value of return on assets (ROA) is 7% with maximum value of 58%. The debt ratio has mean value of 62%. The mean value of liquidity is 4.85. The mean value of profitability (PR) is 8% with 1.54 value of standard deviation.

Table 3 reveals the descriptive statistics of all study variables in 2018, the mean value of return on assets (ROA) is 4% with maximum value of 70%.

The debt ratio has mean value of 65%. The mean value of liquidity is 26.12. The mean value of profitability (PR) is -478.34 but with a high value of standard error.
From this descriptive analysis of the data under consideration we can see that the ROA indicator marks the highest value in 2019, and decreases by 3% in 2020.

The coefficient 0.104 indicates that if all the independent variables remain constant, the ROA will increase by 0.104 times. The coefficient 0.091 indicates that if the debt ratio increases by 1 unit and the other variables remain constant, the ROA will decrease by 0.091 times. This is explained by the contribution of debt expense in reducing profits because of an increase in level of expenses. An increase in debt levels will reduce company's performance because of an increase in fixed costs.

ROA = 0.104-0.091*debt ratio+4.945*liquidity ratio+7.595*profitability ratio+ε

Table 4. The Weighted Mean

Res Sum of squares	285,3396		Reg. Std. Err.	0,995371
R-squared	0,992418		R-squared adjusted	0,992339
F(3, 288)	12565,73		P. critic value of F	6,6e-305
Log-p	−410,9613		Alcaic Criteria	829,9226
Schwarz Criteria	844,6296		Hannan-Quinn Criterion	835,8136

Table 5. Result based on weighted data

	Coef.	*Std. Dev.*	*t-Student*	*p. value*	
Const	0,104147	0,00558781	18,64	<0,0001	***
Debt Ratio	−0,0912428	0,00635828	−14,35	<0,0001	***
Liquidity Ratio	4,94463E-05	2,74672E-05	−1,800	0,0729	*
Profitability Ratio	7,59485E-06	3,51745E-07	21,59	<0,0001	***

Table 6. Result based on initial data:

Average variance.	0,049118			Dev. Std.Variance.	0,124104
Res Sum Square	3,858054			Reg. Std. Dev.	0,115741

After testing the model in the GRETL statistical program, we came to the conclusion that the independent variables taken into study are statistically significant, confirming their importance in analyzing the financial performance of the business in the construction industry in Albania. This is clearly seen from the model, where these variables are each presented in the significance star. As a result, the H0 hypothesis is rejected and the H1 hypothesis is confirmed: At least one of the economic factors taken into the study is statistically significant and affects the financial performance of the business. The result of this model proves the relationships between the independent variable and the dependent variables.

The coefficient 4.945 indicates that if the liquidity ratio increases by 1 unit and the other variables

remain constant, the ROA will increase by 4.945 times. The coefficient 7.595 indicates that if the profitability indicator increases by 1 unit and the other variables remain constant, the ROA will increase by 7.595 times.

The other indicators, such as correlation coefficient; R2 = 99.24%, 99.24% of ROA variability, is explained by the factors considered, respectively by the liquidity, debt and profitability indicators.
The debt indicator has the highest value in 2018, decreases by 3% in 2019 and in 2020 continues to maintain the same level, the value 62%.
The liquidity indicator from 2019 to 2020 has increased, thus showing an improvement in the liquidity indicator for construction companies. Econometric Model results: WLS (KVP), using 292 observations, Number of companies: 100. Dependent Variable: Return on Assets (ROA).

Specifically, negative relationship between the debt ratio and the ROA indicator and respectively positive effect between the liquidity ratio and profitability indicator with the ROA indicator have been proved through this study. Finally, a more advanced research study can be developed by using a larger amount of data, a bigger sample size and also data from other important industries.

5 Conclusion

Financial performance is a measure of the financial health of an economic entity over a specified period of time. Its main purpose is to provide useful information to the stakeholders to help with their decision making. Financial performance analysis can be used as a unique technique to evaluate similar economic entities from the same industry or to compare group industries, or to analyse a specific economic entity in a period of time by comparing financial information between different periods. The financial statements used in assessing overall financial performance include the financial position statement, performance statement and cash flow statement. Financial performance indicators, also known as key performance indicators are quantitative measurements used to determine, track and project the economic well-being of a business. The construction sector has returned sharply in the fourth quarter of 2021, compared to the same period a year ago, as a result of the reconstruction after the earthquake and new residential and hotel housing. In 2021, construction shrank by 11.6% year-on-year in the first quarter, most affected by the earthquake post situation in Albania. Subsequently, the sector recovered, expanding by 2.8% in the second quarter and almost 17% in the third, becoming a key factor in economic growth for this period. The Covid 19 pandemic period also had its effects on financial performance of construction companies in Albania. During the first 5 months of 2020, the construction industry suffered a total slowdown in their daily activities. They restarted only in the sixth month of 2020 and never stopped their activities again, this was reflected in better performance ratios in 2021. A positive effect from the reconstruction activities after the earthquake is going on and will continue until the end of 2022. Referring to the data taken from our study, determinability coefficient; R2 = 99.24%, 99.24% of ROA variability, is explained by the factors considered, respectively by the liquidity, debt and profitability ratios. From testing the model in the GRETL statistical program, we came to the conclusion that the independent variables taken into study are statistically significant, confirming their importance in analysing the financial performance of the economic entities in the selected industry. As a result, the H0 hypothesis is rejected and the H1 hypothesis is confirmed: At least one of the economic factors taken into consideration is statistically significant and affects the financial performance of the business. The selected indicators are important to analyze and interpret financial information and also to evaluate financial performance of the economic entities. The construction industry is very important for Albanian economy, and still needs a lot of analyze and interpretation of financial performance, in order to provide the right information for decision making for all stakeholders. We suggest other studies with larger amount of statistical data by increasing the number of companies taken in study and also by studying companies of other important industries in Albania.

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