

# THE DIAGNOSIS OF FINANCIAL STATEMENTS IMPORTANCE IN ESTIMATING THE VALUE OF THE COMPANY

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## **Abstract:**

*The financial analysis made upon the accounting statements helps improve the quality of the economic view, the possibility to make connections between the economic facts, financial statements and the market value of the companies. The financial diagnosis gives informations needed to risk evaluation, an important component of the discount rate, with direct influences upon the value of the company.*

**Key words:** *discount rate, diagnosis, risk, market value*

**JEL classification:** *M40*

## **1.1 The usefulness of financial accounting diagnosis**

The role of financial analysis in evaluating companies is specified in the International Valuation Standards, as well as in the International Accounting Standards.

According to the International financial reporting Standards (IFRSs), 2007, "Financial statements are a structured representation of an entity's financial position and financial performance. The objective of general financial statements is to provide information regarding the financial position, financial performance and cash flows of an entity that are useful for a wide range of users in making economic decisions."

According to the International Valuation Standards, 8th Edition, 2007, on the financial statements, there are three purposes and corrections of financial analysis:

- Understanding the relationships between elements in the income statement and balance sheet, including trends that occurred over time in assessing the inherent risks in the enterprise's activity, as well as the future perspectives for financial performance;
- Comparison with similar enterprises to determine the risk and value parameters;
- Correcting the historical financial statements to estimate the economic skills, as well as the enterprise's perspectives.

There are three approaches in accordance with the National and International Valuation Standards in the estimation of business value: asset based approach or patrimonial approach, approach based on incomes or financial approach and the approach based on market comparisons.

The usefulness of financial accounting diagnosis (FAD) is multiple for each of the three approaches. Any approach would use an assessor, this diagnosis analysis is essential.

But, the methods based on income valuation are very important for business evaluation, methods that use all elements of the diagnosis analysis.

We will briefly introduce the main utility for each of the three approaches.

The approach based on market comparisons requires comparability between the financial data of comparable companies in terms of stock assessment methods and depreciation allowance policy, accounting treatment of assets unincorporated, etc., and FAD provides just those corrections and adjustments necessary to ensure the comparability criterion.

In the asset based approach, FAD provides accounting data to the evaluator and he will make the necessary corrections on the assets and liabilities components required in estimating value.

For approaches based on income, FAD quantifies the diagnostic analysis' conclusions in forecasted scenarios (important step in the valuation process), leads to estimating the size of the average annual growth rate of income flows used in estimating the value of the company, serves to identify non-operating assets, respectively the identification of incomes and their expenses and the elimination of incomes and their extraordinary expenses. Of particular importance is its utility over the estimation of the discount rate. In the following we will focus on this element, developing the implications.

### 1.2 Impact on the capitalization rate

We recognize that the actual value of a company, calculated on a simplified approach based on income, applying the technique of capitalization is:

$I_{cap} = \frac{F}{c}$ , where "F" is the future annual flow considered and "c" is the capitalization rate.

The future annual flow considered and the capitalization rates are strongly influenced by the financial accounting diagnosis.

The capitalization rate, "c" is a transformation rate in present value, at the valuation date, of a single future income flow, presumably to be obtained in perpetuity, for an investment that generates economic incomes.

Discount/capitalization rate actually expresses the cost of the invested capital in an enterprise. If we pursue to estimate the entire enterprise's value, the discount rate will reflect the weighted average cost of the invested capital. The weighted average cost of the capital is given by the cost of each category of capital.

The weighted average cost of capital can be calculated with the relationship:

$$c_{WAC} = c_{CE} \frac{C_{CE}}{IC} + c \frac{C_{PS}}{IC} + c_{FD} \frac{FL}{IC} (1-T), \text{ where:}$$

IC is invested capital (permanent capital),  $C_{CE}$  - capital for common equity,  $C_{PS}$  - capital of preferred shares and FL - financial liabilities (borrowed capital for medium and long term),  $c_{CE}$  is the cost of common equity,  $c_{FD}$  is the average cost of capital and long-term loan through a bank loan or bond, T is the income tax rate.

If the cost of capital for preferred shares can be easily calculated as the ratio of dividend preferred shares and the price of preferred shares and the cost of borrowed capital is given by the cost of bank loans or debenture loans contracted on long-term, estimating cost of capital for common equity up sensitive issues.

According to the stepwise building model, the most appropriate for the capital market in Romania, a market insufficiently liquid, with short and irrelevant history and low efficiency:

$c_{CE} = \text{Base risk-Free rate} + \text{Rate that quantifies the additional risks}$
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The base risk-free rate is taken at a deflated rate of securities and bonds issued by the State (in practice, for the Romanian capital market you should consult [www.bvb.ro](http://www.bvb.ro)).

The rate that quantifies the additional risks can be estimated as follows:

- Sector risk
- Specific risk, of business

Sector risk is estimated in the analysis of the external environment. The usefulness of financial accounting diagnosis stands out in the estimate of specific risk, of business.

One way of composing a specific risk of business may be the next one, appreciated by the authors as one of the most complex and more suitable for the Romanian companies:

- Business risk (economic or operational) that considers the elements:
  - Forecasting risk (given by the historical and forecasted volatility of sales and purchase prices with the expected effects in the profitability volatility);
  - Operational leverage and breakeven sales;
  - Liquidity risk of the enterprise's securities;
  - Risk related to business size;
  - Risk related to management, staff, collaborators quality;
  - Risk given by the quality of assets;
  - Other relevant types of business risk in the examined case.
- Financial risk:
  - Financial leverage effect;
  - Risk of bankruptcy analysis: through general leverage calculation or through scores method.

### **1.3. Key elements of the diagnostic analysis with impact on the enterprise's value**

Financial accounting diagnosis determines the extent and efficiency with which financial resources are provided and used, assess the quality of the organization's financial accounting, financial management, investigates the past results and perspective of financial results in the explicit period selected by the evaluator. Investigating these issues has as a result the development of scenarios predicted by the impact of all mentioned items.

The analysis of *financial statements* allows the understanding of relations between elements of the balance sheet, income statement and statement of cash flows and their trends with influences on forecasted scenarios. Also, based on financial reports the necessary adjustments are made in the income approach, adjustments related to extraordinary income and expenses and events and elements from outside exploitation. The balance sheet expressed in fair values provides relevant information regarding the assessed company's financial position, Profit and Loss Account shows the company's performance during the analyzed period and cash flow analysis allows the assessment of changes in the financial position, all of these with direct influence in creating the forecast scenarios.

The analysis of *financial and economic indicators* primarily aims at quantifying the unsystematic specific business risk. Because the simple calculation of indicators represents only a relative value, they must be analyzed in comparison with indicators of other companies, with values of the same indicators calculated in other periods, with other correspondent indicators of the enterprise. These comparisons have as a final

utility the development of the forecasted situations and the basis evaluation by comparing the market.

*Among the classic indicators of profitability, with significant impact on company value* we mention the net profit margin rate, asset turnover and financial leverage (degree of indebtedness) resulting from the decomposition of the indicator of financial profitability (return non-equity ROE in Anglo-Saxon literature) on the three key directions: profitability, asset management and leverage. The financial profitability decomposition aims to compare indicators resulting from decomposition with those from the sector of the sector and respectively of competitors.

Also in FAD, regarding business risk (economic or operational) we estimate, the threshold of profitability of sales (the breakeven point) and operating leverage effect (operational).

In the *financial risk*, which occurs only in heavily indebted companies that have contracted financial liabilities, a more complex analysis is done by studying the effect of financial leverage, also called financial elasticity coefficient.

*Also in the financial risk* an important element would be capital structure and its analysis which is discussed in detail at the study of financial management through the direction of funding decision. In the case of a mixed structure consisting of equity capital and borrowed capital it is calculated as a weighted average cost of capital (as in the formula presented in the previous section). The structure of capital influences the size of the flow of income by the cost of borrowed capital, through the timing and proportions of repayments, rescheduling and damage in the amount of dividends or stock buybacks.

In assessing the risk of bankruptcy, the Ion Anghel model by his score function "A", according to the authors it is considered most appropriate for predicting the risk categories of Romanian companies. It is worth mentioning that this model is supported by the Academy of Economic Studies, with a prediction success rate of 97%.

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