

## **CONCEPTUAL APPROACHES AND ROLE OF DIAGNOSTIC ANALYSIS IN ENTITY'S VALUATION**

**MIRELA MONEA, CLAUDIA ISAC \***

**ABSTRACT:** *The purpose of the paper is to present the fundamental elements used in entity's valuation, starting with the most laborious step in practical activity of valuation which is the process of collecting and processing all the information necessary in that process and the analysis of that information in order to choose the adequate valuation method. Diagnostic analysis provides the main and essential information for decision making process making facile the process of establish the market value of an entity.*

**KEY WORDS:** *diagnosis, market value, usefulness, valuation.*

**JEL CLASSIFICATION:** *M21, M41.*

### **1. INTRODUCTION**

Economic literature assigns an appropriate space to the diagnostic analysis in accordance with its complexity and importance as a working method, as a subject of study and research, or as a process that is subject to continuous improvements. Diagnostic analysis has emerged as a new concept in contemporary world concerns, its implementation being the main advantage of modern organizations.

The systematic use of diagnostic analysis in contemporary leadership is one of the arguments and reasons that companies move towards performant management. The role of the financial and economic diagnosis is essential and should be used by managers, because the results from diagnosis leads to set qualitative and quantitative assessments about the status, trends, progress and perspective of an economic entity.

In practice occur many situations that require the need to establish the value of a business. In the estimation of a business value there are three general approaches in accordance with the National and International Valuation Standards: the income approach, the asset approach (asset-based approach) and the market approach, in all of

---

\* *Assoc. Prof., Ph.D., University of Petroșani, Romania, [moneamirela@gmail.com](mailto:moneamirela@gmail.com)  
Assoc. Prof., Ph.D., University of Petroșani, Romania, [isacclaudia@gmail.com](mailto:isacclaudia@gmail.com)*

these approaches the diagnostic analysis is very useful and could be considered essential.

## 2. APPROACHES ON ENTITY'S VALUATION

The concept of valuation refers to the process of estimate a particular type of value. Value is created and supported by the interaction of the following factors, associated to an product, service or goods (Popescu, 2009):

- utility – the capacity of goods to meet a particular needs;
- rarity – the current or forecasted supply for a particular good, as compared to the demand for that good;
- needs – the satisfaction produced by an economic good to the individual that needs it;
- purchasing power – the capacity of an individual or group of individuals to acquire the goods by using cash or cash equivalents.

To understand the entire valuation process, first we must understand some of the common valuation terminology.

In order to establish an entity value we have to consider that there are three general approaches:

- the asset approach (asset-based approach);
- the income approach;
- market approach (sales comparison approach).

The asset approach (or asset-based approach):it is determined a value for each balance sheet item and then added together (assets less liabilities).

In the asset based approach, diagnostic analysis, through financial diagnostic provides accounting data to the expert evaluator, in order to estimate value, are required corrections on the assets and liabilities.

Income approach: past or future income or cash flow streams are applied to a capitalization rate or discount rate. The income approach considers that value is created by the anticipated future benefits.

In the income approach diagnostic analysis is useful through conclusions provided in forecasted scenarios. This approach can be credible only if are used relevant information and if are available comparable information. If that information is not available the approach can be used only for a general analysis and not for a direct market comparison. In this scope financial diagnostic is also essential. Income approach can be applied in the estimation of market value or other types of values.

In the market approach the bases for a valuation is values or sales of comparable businesses, or interests in comparable businesses. When information are available, the market approach is most direct and systematic approach for estimating the market value; and when the information are not sufficient this approach can be limited or even rendered non-aplicable (Popescu, 2009).

Each of these approaches are based on the substitution principle, which is the most general valuation principle, applicable for all three approaches of valuation.

Valuation is not an exact process; it is only an estimation of a type of value, which takes into consideration all the relevant factors having an influence on that type

of value. Every valuation has its own particularities; therefore it cannot approach a valuation in an identical manner with another valuation.

All the approaches presented are independent from each other, even if there are based on the same economic principle, and the goal of all approaches is to estimate a value, but the final value depends on the taking into consideration of all information and processes used (Popescu, 2009).

The expert in their final report of valuation must be pointed out every approach and must to explain the reason for which chooses to apply one approach and why the others approaches have not been applied.

### **3. CONCEPT, ROLE AND TYPOLOGY OF DIAGNOSTIC ANALYSIS**

Etymologically, the word "diagnosis" seems to come from Greek language and it is translated as "able to discern" and the meaning conferred to the concept "diagnosis" in the context of its use in economic and financial analysis is very similar to that use in the medical field - which means assessing symptoms and determining external or internal causes of some difficulties involved - (Mereuță, 1994). It has become more widely used today and it is therefore assumed in the microeconomics.

Referring to the parallel between diagnosis in the medical field and diagnosis used in the microeconomic analysis, we found the same connotations: "symptomatology" - which means the identification of the main symptoms of the analyzed field; "etiology" - consisting in detection of causes that generates symptoms; "therapeutics" - assimilated to the recommendations for eliminating deficiencies; "prophylaxis" - associated with neutralization of the malfunctions and prevention of failures and disturbances of the activity.

At the microeconomic level, to carry out diagnostic analysis is required collaboration between specialists in order to discover the causes of malfunctions and disturbances of the activity. By using diagnostic analysis we establish company' health at one time, its evolution and causes which delay the achievement to get better results.

Diagnostic analysis carried out the performing activities describing the operations and trends in the evolution of the company's activity, taking into account the dynamic environment in which it operates; allows the assessment of existing resources, identifying opportunities for company activity and untapped wealth of an organization (Niculescu, 1997).

In specific economic literature we found a variety of approaches about the use of diagnosis: diagnostic analysis is often interpreted by some specialists as phases, processes, methods or results, while other authors do not make any references to such notions. The Professor O. Nicolescu manages to reconcile these positions, apparently convergent by showing that the major approach of diagnostic analysis is a method, the others approaches mentioned representing the simple embodiments of that method.

The diagnosis can be approached, on the one hand, that phase of managerial work (including control tasks and assessment) - in this situation it has an individual character, being operative and referring often to the elements of the operational activity. On the other hand the diagnosis can be used to examine a complex situation, as a singular method.

The sense almost unanimously accepted is that the diagnostic analysis ensures investigation of all structural and procedural components of the activity, with specific instruments in order to identify the main strengths and weaknesses, therefore, representing a first step in knowing the state of activity of a company and establish measures and recommendations to correct the deficiencies or improve enterprise performance.

M. Porter considered that diagnostic involves a detailed analysis of the entity or of the particular activity in order to: investigate the company or its components; of focusing on causal strengths and weaknesses, according to preset criteria; assess the potential of the company; formulating recommendations focused on the causes of the failures and positive aspects.

The need for a diagnostic analysis is required on two specific situations:

- when the entity is in difficulty (deficiencies in activity) – the aim of the diagnostic is to identify and remedy malfunctioning in activity and thereby to clarify the causes that led to this state;
- the company's situation is good, diagnosis purpose being to identify opportunities for performance improvement and to choosing the most appropriate development strategy for future activity.

Diagnostic analysis is to a real help in knowing the economic and financial situation, providing the necessary information on assessing past and present situation and also constitutes a basis for future forecasting, helping management in establishing the right actions and measures to be taken in future.

In financial diagnosis the performance of a company is associated to its profitability (Monea & Guță, 2011), and profitability indicators may be expressed through their absolute values under the form of results, or through their relative values under the form of a ratio.

Diagnostic analysis may have varying degrees of detail, may cover different periods, pursuing different purposes; a diagnostic type is recommended depending on the goals and objectives it pursues. Typically, diagnostic analysis is recommended for decisions in cases regarding:

- depth analysis of a specific area highlighting the weaknesses and threats, the competitive advantages of the company (strengths) and the opportunities;
- establishing and developing global or specific strategies;
- privatization of the entity, a critical diagnosis of economic and financial situation;
- restructuring process of the entity;
- renewal of the managerial agreements;
- drawing up a business plan;
- feasibility studies;
- business valuation, diagnostic analysis is needed as a basis for choosing and applying assessment methods

Due to increasing complexity of the decision making process information provided by the financial analysis is more and more considered an input of strategic diagnosis (Monea, 2013).

In the case of an entity confronted with financial difficulties and economic dysfunctions the diagnostic analysis must be able to establish the possible business potential and their opportunities, to be a fair, complete and relevant diagnostic and provide at least the following:

- to estimate all the risks and opportunities of the business;
- to analyse business competitive environment;
- to explain main causes of the deficiencies;
- to define an economic and financial strategy;
- to propose measures to improve economic health of the business in order to achieve the main objectives from the strategic plan.

#### **4. CONCLUSIONS**

Diagnostic analysis provides the main information for decision making process and is essential for the process to establish the market value of an entity. Essential in estimating entity value is financial analysis (financial statement analysis). The goal of the financial analysis is not only to provide information about financial health of an entity, but also interpreting financial ratios regarding the financial position, performances, cash flows being useful for different categories of users.

In entity activity occur situations that require establishing the value of the business. There are three general approaches in the estimation of a business value and in all of these approaches the diagnostic analysis is very useful and could be considered essential.

#### **REFERENCES:**

- [1]. **Anghel, I.; Oancea Negescu, O.; Popa, A.; Popescu, A.M.** (2010) *Evaluarea întreprinderii*, Editura Economică, București
- [2]. **Băileșteanu, Ghe.** (1998) *Diagnostic, risc și eficiență în afaceri*, Editura Mirton, Timișoara
- [3]. **Bărbulescu, C.** (2002) *Diagnosticarea întreprinderilor în dificultate economică – Strategii și politici de redresare și dinamizare a activității*, Editura Economică, București
- [4]. **Berheci, M.** (2010) *Valorificarea raportărilor financiare*, Editura CECCAR, București
- [5]. **Bușe, L.; Siminica, M.; Simion, D.** (2010) *Analiza economico-financiară*, Editura Sitech, Craiova
- [6]. **Colasse, B.** (2009) *Analiza financiară a întreprinderii* (traducere Neculai Tabără), Editura Tipo Moldova, Iași
- [7]. **Griffin, M.P.** (2009) *MBA Fundamentals. Accounting and Finance*, Kaplan Publishing, New York
- [8]. **Helfert, E.** (2001) *Financial Analysis Tools and Techniques. A guide for Managers*, The McGraw Hills Companies, ebook
- [9]. **Manățe, D.** (2002) *Diagnosticul și evaluarea întreprinderilor cotate și necotate*, Biblioteca ANEVAR
- [10]. **Mărgulescu, D.; Niculescu, M.; Robu, V.** (1994) *Diagnostic economico-financiar. Concepte, metode, tehnici*, Editura Romcart, București
- [11]. **Monea, M.; Guță, A.J.** (2011) *The Relevance of the Performance Indicators in Economical and Financial Diagnosis*, Annals of the University of Petroșani, Economics, vol.XI (4), pp.207-214

- [12]. **Monea, M.** (2013) *Information system of the financial Analysis*, Annals of the University of Petroșani, Economics, vol.13(2), 2013, ISSN 1582-5949, pp. 149-156
- [13]. **Needles, B.E.Jr.; Powers, M.; Crosson, S.V.** (2007) *Financial and Managerial Accounting*, Houghton Mifflin College, USA
- [14]. **Niculescu, M.** (1997) *Diagnostic global strategic*, Editura Economică, București
- [15]. **Niculescu, M.** (2003), *Diagnostic economic-vol 1*, Editura Economică, București
- [16]. **Niculescu, M.** (2003), *Diagnostic financiar-vol 2*, Editura Economică, București
- [17]. **Păvăloaia, W.; Păvăloaia, D.** (2006) *Diagnosticul și evaluarea întreprinderii*, Editura Tehnopress, Iași
- [18]. **Petrescu, S.** (2010) *Analiză și diagnostic financiar-contabil. Ghid teoretico-aplicativ*, Editura CECCAR, București
- [19]. **Popescu, D.D.** (2009) *Enterprise Analysis*, Editura ASE, București
- [20]. **Rusu, C.** (2006), *Diagnostic economico-financiar*, Editura Economică, București
- [21]. **Soffer, L.; Soffer, R.** (2003) *Financial Statement Analysis: a valuation approach*, Pearson Education
- [22]. **Stan, V.S.** (2006) *Evaluarea Întreprinderii*, Ediția a II-a revizută, IROVAL București
- [23]. **Verboncu, I.; Popa, I.** (2001) *Diagnosticarea firmei*, Editura Tehnică, București
- [24]. **White, G.; Sondhi, A.; Fried, H.** (2001) *The Anaysis and Use of Financial Statements*, Second Edition, Wiley & Son, USA