THE ROLE OF FINANCIAL DIAGNOSIS IN SELECTING THE FINANCIAL DECISION

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Abstract
Financial decisions, regardless of their form, are made by the management of the entity on the basis of a prior financial diagnosis. When the purpose is to understand the implications and, at the same time, the compromises on which the financial decision related to operation, funding or investments is based, it is recommended to resort to different financial diagnosis methods and techniques. At the same time, an entity may also face financial problems that it can solve by using the correct financial diagnosis tools that generate the necessary answers.

Keywords: *financial diagnosis, financial decision, annual financial statements, financial ratios*

JEL CLASSIFICATION: *M10, M40*

1. Introduction and context of the study

It is well-known that the activity of an entity is based on a number of financial decisions made at different levels and in different fields of activity, with the purpose of achieving the proposed objectives and strategies. On a daily basis, a multitude of decisions are made in an entity in relation to various aspects, nevertheless, the decision-making task falls on managers. Therefore, financial decisions are fundamental acts of the management. They must meet a minimum of conditions, more specifically: to be scientifically substantiated; to be adopted at the appropriate hierarchical level; to be consistent with other decisions; to be adopted in due time; to be formulated precisely, clearly and concisely.

Depending on their nature, financial decisions are grouped into investment decisions, financing decisions, and dividend decisions. The investment decision is the decision to spend the capital that leads to the acquisition or construction of an asset in order to obtain future cash flows. In addition to the investment decision, the decision to disinvestment may also be adopted within the entity. This implies the decision to sell a part of the company assets, consisting of assets that are no longer in use in the company (especially the tangible ones). The same logic applied in the case of the investment decision is also applied in this case, namely to increase the value of the company or to increase the shareholders' wealth. Thus, the liquidities obtained following disinvestment decisions should be placed more cost-effectively either by reinvestment in the company (through the development of more efficient business), or by investing externally in order to financially participate in the formation and control of the capital of other companies, or by reimbursing them to their capital contributors.

The financing decision concerns the way of financing the company's asset, or the sources of obtaining the necessary capital, respectively. In fact, the financing decision envisages, on the one hand, the choice of the financial structure, more specifically, the division of the financial resources of the entity between equity and debt, but also the choice between internal (self-financing) and external financing (from equity capital or financial creditors).

The dividend is made in relation to the management's option in respect of the partial or total reinvestment of the net profit or its partial or total distribution in the form of dividends.

2. Characteristics of financial diagnosis

Financial decisions, regardless of their form, are made only by the management of the entity, based on a prior financial diagnosis. The primary purpose of the financial diagnosis is to help the management of the entity to make optimal decisions in the financial context in which the entity operates.

Before initiating the financial diagnosis, it is necessary to know the answer to the following questions:

1. How has the business of the entity evolved during the period subjected to the financial diagnosis and what are results from comparing its growth rate with that of the sector of activity?
2. Are the results proportional to the resources consumed?
3. What is the financial structure of the entity? Is it balanced?
4. Does the entity have vulnerabilities? Is there a high risk of bankruptcy or not?

After careful consideration of these questions, answers can be found to help managers make well-informed decisions. In other words, the answers to the above questions allow for knowing the information related to the economic growth, financial performance, financial balance and risks of the entity under analysis. All these are the objectives of the financial diagnosis designed to highlight the strengths and weaknesses that are likely to be signalled at financial level. From this perspective, the strengths are related to a balanced financial structure, sufficient financial resources to finance the business, good return on the assets held, sufficient funds for self-financing. On the opposite side, weaknesses highlight the fragility of financial balance, low asset liquidity, low profitability, or insufficient funding for self-financing.

The diagnosis is an important tool available to managers that allows for value judgments about the situation, dynamics and prospects of a company, highlighting the strengths and weaknesses of its business, and the ability to grow profitably in a competitive environment.

As a general management method, the diagnosis can also be used by managers and when either a thorough analysis of the led field is desired and, on this basis, to highlight the main dysfunctions and advantages, whether it is necessary to substantiate and elaborate the global strategy or the partial strategies related to the development of the company, either the financial year is completed and the administrator's management report is drawn up, or when business plans or feasibility studies are being prepared to obtain funding, the diagnosis being an important component of these plans.

The conclusions of the financial diagnosis are beneficial not only for the managers. Shareholders, business partners of the enterprise, financing lending cam also be interested when they analyse a loan application, as well as the central and local government bodies. Depending on the subject that makes or requests the financial diagnosis, it may be an **internal diagnosis** and users in this case are managers, shareholders or employees. The objective pursued by them is to detect possible financial imbalances and to adopt new business management decisions. These decisions are based on identifying the origin and causes of imbalances on the one hand, and on the other hand on establishing measures to correct imbalances.

From the aspects highlighted herein above, the main features of the financial diagnosis of an entity can be presented:

An **external diagnosis** can also be carried out, its users being financial analysts, potential shareholders, banking and financial bodies.

Figure no. 1 **Characteristics of financial diagnosis**

Characteristics of financial diagnosis	**Description of the characteristic**
▪ post-operative nature	the diagnosis focuses on the analysis of a completed period in the life of an entity (usually the past 2-3 years)
▪ provisional nature	based on the diagnosis, the strategy of the entity is designed
▪ multidisciplinarity	the diagnosis involves knowledge from various fields (economic, legal, technical)
▪ special complexity	involves not only different types of analysis, but also the synthesis of positive and negative aspects and the provision of recommendations
▪ causal approach of strengths and weaknesses	the diagnosis requires not only the enumeration of strengths and weaknesses, but also the discovery of the causes that have generated them

Source: own creation

Carrying out an effective diagnosis involves going through the following stages:
- stage 1: preparing the diagnosis that involves establishing the necessary documents for a significant period, as well as a series certain specific questionnaires that allow both the preparation of the discussions and the active participation of the staff in the collection of data. Also at this stage sectoral, zonal or general information are collected that has an influence on, or is related to the entity.
- **stage 2: the analysis of documents and information** is the most important part of the diagnosis that enables the analyst to know as precisely as possible the detailed operation of the entity. In this respect, deficiencies and their causes (weaknesses) will be identified, and their negative influence will be assessed. It will also highlight the competitive advantages of the company (strengths) as well as the possibilities to use them in the exploitation of the opportunities offered by the entity environment.
-stage 3: establishing the necessary measures follows the actual diagnosis stage and involves the identification of the measures to be taken in order to eliminate or alleviate the influence of the unfavourable factors, or respectively to strengthen the action of the favourable factors.
The completion of the diagnosis involves:
- -identifying and highlighting the dysfunctions or the unfavourable elements of the activity performed;
-determining the effects and causes of difficulties;
- presenting the evolution prospects and proposing measures to be taken to redress the situation

3. Methods of carrying out the financial diagnosis

The methods by which the financial diagnosis can be carried out can be grouped into two categories: classical (traditional) methods, and modern methods. Within these methods, the most used are: the method of carrying out the financial diagnosis in absolute sizes on the basis of the annual financial statements and the method of carrying out the financial diagnosis in relative sizes on the basis of the financial ratios determined on the basis of the balance sheet.

Performing the financial diagnosis based on the annual financial statements will be based on the analysis of the components of the financial-accounting function, namely the assessment of the reliability of the data included in the financial statements. The working procedures are limited to validity tests, and do not include compliance tests, the expert analysing only the financial statements for the past 2-3 years.

The assessment of the reliability of the data included in the financial statements is based on two key elements:

-the sufficient knowledge of the entity and the conclusions of other diagnoses (administrative, legal, commercial, technical, etc.);

- knowing the accounting principles and methods of the sector of activity.

After substantiating these key elements, it will be necessary to check whether the annual financial statements:

-are coherent, more specifically, whether the data recorded in them are correlated;

-are presented in compliance with the accounting principles and regulations in force;

- take into account the elements subsequent to the closure of the financial year;

- present a true image of the financial position.

I will present herein below an example of carrying out a financial diagnosis based on financial statements (balance sheet) for the company BETA S.A. in the 2016 – 2018 period. More specifically, I will present a practical model for the calculation of the working capital for the company BETA S.A.

Table no. 1 **Indicators needed to calculate the working capital of the company BETA S.A. in the 2016 – 2018 period**

It. no.	Indicators	2016	2017	2018
1	Equity	148,374,390	146,332,490	192,533,414
2	Provisions	861,440	296,453	2,184,078
3	Long-term debt	4,538,179	6,958,754	6,498,284
4	Subv. for investments	-	-	682,876
5	**Permanent capital**	**153,774,009**	**153,587,697**	**201,898,652**
6	**Fixed assets**	**153,128,404**	**156,302,972**	**203,805,513**
7	**Working capital** (Permanent capital – Fixed assets)	**645,605**	**-2,715,275**	**-1,906,861**

Source: Balance sheets for 2016-2018 of BETA S.A. Own calculations. The amounts are in RON.

In the analysed period, the working capital was negative, with the exception of the year 2016 when it was positive. This means that Beta led an unbalanced financing policy, its assets unable to be funded from own resources or long-term attracted resources. The company is forced to resort to short-term debts to finance its fixed assets. The company liquidity suffers because the current operational flow is unable to sustain the business. The working capital followed a downward trend, falling from 0.65 million RON in 2016 to -2.72 million RON in 2017. This situation is due to the fact that in 2017 the permanent capital decreased (from 153.77 million RON in 2016 to 153.59 million RON in 2017), while the fixed assets increased (from 153.13 million RON in 2016 to 156.30 million RON in 2017). Both situations, more specifically, the decrease of the permanent capital and the increase of the fixed assets, had negative effects on the working capital. In 2018 the company increased its production capacities (the fixed assets increased from 156.30 million RON in 2017 to 203.81 *million RON in 2018), but without an increase in the amount of permanent financing resources constantly rising from 153.59 million RON in 2017 to 201.9 million RON in 2018). The entity failed to achieve the financial balance, the growth rate of equity being outweighed by the growth rate of fixed assets.*

The annual financial statements, also called summary accounting reports, represent the official management document of the economic entities, ensuring the formation of a true, clear and complete image concerning the assets, the financial situation and the results obtained. At the same time, due to their informational content and the functions they fulfil, the annual financial statements constitute an extremely important tool in the process of substantiating the decisions aimed at directing the current and especially the prospective business.

Performing the financial diagnosis using the ratio method is particularly important, due to the fact that it synthetically expresses statuses of the economic and financial activity that allow for the assessment of the current performance and the projection of the future ones. The ratio-based analysis is generally a widely used method in financial diagnosis and is one of the key financial tools available to the analyst.

I will present herein below an example of carrying out a financial diagnosis using the ratio method (the asset structure ratios) for the company GAMA S.A. in the 2017 - 2018 period More specifically, I will present a practical model for the calculation of the financial stability ratio for the company GAMA S.A.

Table no. 2 **Indicators necessary for the calculation of the financial stability ratio of the company GAMA S.A. in the 2017 – 2018 period**

It. no.	Indicators	2017	2018
1	Equity	939,529	1,773,538
2	Provisions	51,125	0
3	**Permanent capital**	**990,654**	**1,773,538**
4	Short-term debts	6,019,809	14,308,242
5	Long-term debts	0	0
6	**Total debts**	**6,019,809**	**14,308,242**
7	Deferred income	0	0
8	**TOTAL LIABILITIES**	**13,030,272**	**30,390,022**
9	**Financial stability ratio** **(**Permanent capital/Total liabilities*100)	7.60%	5.84%

Source: Balance sheets for 2017-2018 of BETA S.A. Own calculations. The amounts are in RON..

The financial stability ratio decreases in the period under analysis, indicating a decrease in the share of the permanent capital in total funding sources, thus illustrating a decrease in relative magnitudes of stable sources in relation to cyclical or temporary sources. This involution is caused by the development of the permanent capital at a rate below the increase in total liabilities,

A low level of this ratio jeopardizes the financial stability of the economic entity, due to the fact that it does not have a good safety margin, namely permanent resources that it can use to finance the operating cycle.

Financial ratios are very important in conveying the necessary information for decision-making by different categories of users. Thus, if the user of the financial information is a banker, he must decide whether it is appropriate to grant or not the credit requested by the entity. Bankers primarily analyse the liquidity of the entity, using the financial ratios that measure this feature. Long-term creditors are particularly concerned about the gaining power and operational efficiency of the manager. They know that unprofitable operations lead to a decrease in the value of assets and that the strong position of the entity is not at present a guarantee that it will have long-term financial resources to pay off the debts. Thus, long-term creditors are concerned about the company's solvency, using the financial ratios that measure this feature. Investors in the share capital are interested in long-term efficiency and profitability. They are concerned with the profitability of the entity, using the financial ratios that measure this feature. Finally, the manager is interested in all aspects presented, namely the entity he manages must be able both to pay his short and long term payment obligations and to make profit for the shareholders.

4. Conclusions

The financial decision is essentially the act of leading and can be regarded as a management's way of communicating with the other parties involved in the financial activity of an entity by using accounting information normally taken from the annual financial statements.

Any financial decision is based on the financial diagnosis made by the financial analyst, an employee of the entity or external contributor, using the accounting information gathered from the annual financial statements or by resorting to specific tools and methods such as the ratio method.

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