

THE EFFECTS OF REEVALUATING THE BALANCE SHEET ON THE FINANCIAL STANDING OF THE COMPANY

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ABSTRACT: The annual financial statements of different companies must emphasize, for the internal and external users, the activity that was run and the standing at a specific moment of time. The assessment of a business doesn't affect the accounting registrations. However, "the accurate image" provided by the book-keeping is a significant landmark for the evaluator when applying the evaluation methods. In this paper, in order to emphasize the effects of reevaluating the balance sheet on pointing out the financial standing, we have presented the calculation and the significance of the analysis indicators on a case study, before and after the reassessment operations.

Keywords: Financial analysis, reevaluation, financial standing, balance sheet

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I. INTRODUCTION

According to IAS 1 „The Presentation of the Financial Statements” (1), the balance sheet is a structured financial representation of the financial standing of a company and of its transactions. The objective of the annual financial statements is to provide information about the financial standing, the performance and the cash flows of a company, which are useful for a large range of users when making economical decisions.

That's why, we appreciate that an accurate presentation of the accounting information is a fundamental principle of the International Financial Reporting Standards, which implies recognizing and evaluating the patrimonial elements of the annual financial statements according to *The General Frame for Preparing and Presenting the Financial Statements*.

When making the evaluation, some corrections of the patrimonial elements have to be done sometimes. These corrections must be carried out relying on the patrimonial value of each element at that time and on the potential capacity to generate profit.

After making the corrections of the information from the balance sheet, in order to point out the market value, the economical balance sheet emerges. The economical balance sheet is a theoretical, abstract balance sheet, elaborated by experts and comprises the patrimony of the company, expressed in economical values, and the profit the company is able to generate in the terms of the market it belongs to (2). This is the basis for determining *the corrected net assets* and for making the patrimonial evaluation of the company.

According to IAS no. 1, art. 5, “the financial statements are a structured financial representation of the financial standing of a company and of its transactions”. As a consequence, the changes of the value of the patrimonial elements lead to changes in the financial standing of the company.

The financial standing of a company is influenced by the economical resources it holds, by the financial structure, the liquidity and solvency and also by the capacity to adapt when the environment changes.

The information about the economical resources the company holds and its previous ability

to change these resources is useful to anticipate the potential of the firm to generate cash or cash equivalent in the future.

The information about the financial structure is useful to anticipate the future loan needs and the way the future profits and cash flows will be distributed to stakeholders; there are also useful to appreciate the financing potential.

The information about the liquidity and solvency is useful to anticipate the capacity of the company to pay its due debts. *The liquidity* regards the cash available in the near future after paying the financial debts. *The solvency* regards the cash available for a longer period when the due debts are to be paid.

The information about **the financial standing** is provided by **the balance sheet**. The appreciation of the financial standing of a company is the subject for every financial analysis, regardless the category of users it aims.

Thus, **the shareholders** consider that the company has a good financial standing if the yield of their investment compensates the risk they face. For them, the symptoms of the financial disequilibrium occur if they don't get the desired return on equity, by taking into account the economical, financial and bankruptcy risk. For **managers**, the appreciation of the financial standing is connected, as in the case of shareholders, with the objective of maximizing the company's value and also with the criteria of financial flexibility, economic growth and financial autonomy. For **creditors**, it is important to have the guarantee they will cash their claims, including their remuneration. For them, first of all, there are important the liquidity, the solvency and the payment capacity of the company.

II. CONCEPTS AND METHODOLOGY

The analysis of the financial standing aims at least two important issues:

- the analysis of the structure of the patrimony;
- the analysis of the financial equilibrium.

a) The effects of reevaluating the patrimony on the structure of the patrimony

The patrimony of a company is the main objective of the book-keeping and, together with the financial standing and the posted results, it has to be achieved so that to provide an accurate, clear and complete image of its components (assets and liabilities) with the help of the balance sheet.

At the end of the financial exercise, the patrimony a company holds is reflected by the balance sheet. In this document, the patrimony is presented as:

- **the asset elements**, presented in the increasing order of their liquidity;
- **the liability elements**, presented in the decreasing order of their terms.

Considering the modalities of presenting the patrimony of the company, its structure can be analyzed with the help of two types of groups of financial rates:

- the structure rates of the asset elements;
- the structure rates of the liability elements.

The reassessment of the patrimony leads to changes of its value and thus to changes of the level of the financial structure rates.

a.1. The Structure Rates of the Asset Elements

They are determined as a ratio between an asset element or a group of asset elements and the total assets or a group of elements. The most important rates are:

- *the rate of fixed assets* (R_{FA}) is calculated as a ratio between the fixed assets and the total assets;

- *the rate of current assets* (R_{CrA}) expresses the weight of current assets in the total assets;
- *the rate of inventories* (R_{Inv}) is calculated as a ratio between inventories (Inv) and current assets;
- *the rate of claims* (R_{Cl}) is calculated as a ratio between claims and current assets;
- *the rate of cash* (R_{Cash}) is calculated by dividing the cash to current assets or total assets.

a.2. The Structure Rates of the Liability Elements

They allow appreciating the financial policy of the company by pointing out some issues regarding the stability and the financial autonomy. The main rates are:

- *the financial stability rate* (R_{FS}) reflects the weight of the long term capital (C_{LT}) in the total capital of the company (C_T);
- *the global financial autonomy rate* (R_{GFA}) is determined as a ratio between the owner's equity (OE) and the total capital;
- *the long term financial autonomy rate* (R_{LTFA}) can be calculated in two ways:

$$R_{LTFA} = \frac{OE}{C_{LT}}, \text{ when it has to be higher than } 50\% \quad (1)$$

$$R_{LTFA} = \frac{OE}{D_{LT}}, \text{ when it has to be higher than } 100\% \quad (2)$$

D_{LT} – long term debts;

- *the total debts rate* (R_{DT}) measures the weight of debts in the total capitals. It is calculated as a ratio between total debts (D_T) and total capital;
- *the long term debts rate* (R_{LTD}) is calculated as a ratio between the medium and long term debts and the long term capital or owner's equity.

b) The Effects of Reevaluation on the Financial Equilibrium of the Company

In the specialized literature, the term of equilibrium has multiple meanings. As an outlook, the economical and financial equilibrium of a company is achieved when the utilized means are fully recovered, respectively when the incomes equal expenses (4). But such a conception is limited because it doesn't emphasize the connection between the whole equilibrium with its components that constantly evolve.

In order to appreciate the financial equilibrium, several types of "equalities" and "correlations" must be taken into consideration, meaning between the financial sources and the economical means which are necessary to run the operating activity on short and long term. The general equilibrium status means both equalities and inequalities, each with a specific economical significance.

When defining the financial equilibrium, specific indicators of appreciating the cash flows and the material flows must be taken into consideration. It arises from here that the economical and financial equilibrium of the company must be regard as an ensemble of *correlations that occur* while rotating the capital. Preserving the financial equilibrium is a constant objective of the financial policy that can be achieved when the financial exercise ends with a positive net cash flow.

As a result of reevaluation, changes occur in the value of patrimonial elements and these could affect the previously mentioned correlations and thus the financial equilibrium.

In order to analyze the financial equilibrium of a company and the effects of reevaluation, the following issues must be studied:

- o the analysis of the liquidity and solvency rates;

○ the analysis of the correlation between the working capital, the working capital need and the net cash flow.

b.1. The Liquidity and Solvency Rates

The patrimonial liquidity reflects the capacity of a company to pay, at the settling date, the short term due debts using the available cash. It arises by comparing the current assets (smaller than one year) with short term debts (smaller than one year). The patrimonial liquidity can be expressed by several rates:

- *the general liquidity rate (L_G)* - it is calculated as a ratio between the current assets and current debts;

- *the current liquidity rate (L_C)* - it is calculated as a ratio between the current assets diminished with the inventories and the current debts;

- *the quick test rate (L_{QT})* – reflects the capacity of the company for paying quickly its debts with the available cash. It is calculated as a ratio between cash and current debts.

The solvency points out the capacity of the company to pay the debts with owned resources. The following solvency rates can be calculated:

- *the general solvency rate (S_G)* – calculated as a ratio between the total assets and total debts;

- *the patrimonial solvency rate (S_P)*, also named the financial autonomy rate, calculated as a ratio between the owner's equity and total capital.

b.2. The Correlation between the Working Capital, the Working Capital Need and the Net Cash Flow

The working capital is an indicator frequently used in the financial analysis for appreciating the financial equilibrium/disequilibrium status of a company at a specific moment of time. It points out the excess of long term resources remained available after financing the fixed assets which is further used to finance the current assets. It is a premise of the company's solvency, respectively of the financial independence against the creditors.

The working capital is calculated with the relation:

$$WC = \text{Long Term Capital} - \text{Fixed Assets} = C_{LT} - FA.$$

By running the operational activity, the financing needs occur, and, for balancing, financial resources must be gathered. By comparing the financing needs of the operational cycle with the corresponding financing resources, **the working capital need (WCN)** emerges.

The working capital need can be defined as the capitals the company must hold so as to finance the inventories and the temporary gaps between the payment of suppliers and of other operating debts and cashing the claims from customers. Its level can be determined as follows:

$$\begin{aligned} WCN &= (\text{Inventories} + \text{Claims}) - \text{Operating Short Term Debts} \\ &= (\text{Inv} + \text{Cl}) - D_{OST}. \end{aligned}$$

The net cash flow is closely connected with the short term financial operations of the companies. It can be calculated this way:

$$NCF = \text{Cash} - \text{Financial Current Debts} = \text{Cash} - D_{FC}.$$

The financial analysis follows the correlation between the working capital, the working capital need and the net cash flow depending on the characteristics of the sector of activity. The

analysis can be done with **the rate method**.

The main rates used when analyzing the correlation between the working capital, the working capital need and the net cash flow are:

1) *The rate of financing the fixed assets (R_{FFA})*, calculated as a ratio between the long term capital and the fixed assets:

$$R_{FA} = \frac{C_{LT}}{FA} \quad (3)$$

2) *The rate of covering the invested capital (R_{IC})* – requires for the long term capitals to finance not the fixed assets only, but also the working capital need. It is calculated as follows:

$$R_{IC} = \frac{C_{LT}}{FA + WCN} \quad (4)$$

3) *The rate of financing the current assets (R_{CrA})*:

$$R_{CrA} = \frac{WC}{CrA} \times 100 \quad (5)$$

4) *The rate of financing the inventories (R_{Inv})*:

$$R_{Inv} = \frac{WC}{Inv} \times 100 \quad (6)$$

5) *The rate of financing the working capital need (R_{WCN})*:

$$R_{WCN} = \frac{WC}{WCN} \times 100 \quad (7)$$

6) *The rate of financing the turnover (R_T)* or the speed of rotation of the working capital – expresses the number of days the working capital is recovered through the turnover. It is determined with the relation:

$$R_T = \frac{WC}{T} \times 360 \quad (8)$$

7) *The rate of the working capital need*:

$$R_{WCN} = \frac{WCN}{T} \times 360 \quad (9)$$

8) *The rate of financing the working capital need through the net cash flow*:

$$R_{WCN/NCF} = \frac{NCF}{WCN} \times 100. \quad (10)$$

III. RESULTS

In order to emphasize the implications of reevaluation of the balance sheet on pointing out the financial standing, we are going to present, on a company study case, the calculation and the significance of the analysis indicators, before and after the reassessment operations.

Table no. 1

The balance sheet of APOLO

Assets	Initially	Reassessed
FIXED ASSETS	49,786,353	54,034,153
CURRENT ASSETS	27,636,488	27,066,488
Inventories	14,532,079	13,962,079
Accounts receivable	12,303,034	12,303,034
Cash and cash equivalents	801,375	801,375
TOTAL ASSETS	77,422,841	81,100,641

Liabilities	Initially	Reassessed
LONG TERM CAPITAL	58,171,283	61,849,083
Owners' capital	45,686,348	49,364,148
Medium and long term debts	12,484,935	12,484,935
SHORT TERM DEBTS	19,251,558	19,251,558
Short term operating debts	6,373,704	6,373,704
Current financial debts	12,877,854	12,877,854
TOTAL CAPITAL	77,422,841	81,100,641

Relying on this data, we have calculated the analysis indicators previously mentioned for the studied company.

The structure rates of the asset elements are presented in the following table:

Table no. 2

The structure rates of the asset elements

Indicators	Initially	Reassessed
1. The rate of fixed assets	64.30%	66.63%
2. The rate of current assets	35.70%	33.37%
2.1. The rate of inventories	52.58%	51.58%
2.2. The rate of claims	44.52%	45.45%
2.3. The rate of cash	*	*
- against the current assets	2.84%	2.90%
- against the total assets	1.01%	0.97%

Against the initial situation, one could notice that, by reevaluating the balance sheet, the weight of fixed assets has grown, from 64.30% to 66.63%, as the weight of current assets dropped from 35.70% to 33.37%. These changes were determined, on one hand, by the growth of the value of fixed assets, established as the result of their reassessing, and, on the other hand, by the reduction of the current assets, due to the recorded depreciations.

Although the differences of value aren't so big, they change the financial standing of the company and, thus, they change the politics regarding providing the necessary resources the company needs for its financing.

In the structure of current assets, it's observed a small decrease of the rate of inventories and

an increase of the rate of claims. The diminution of the rate of inventories was determined by the depreciations established after the reassessment operations were done.

The structure rates of the liability elements, for the analyzed company, before and after the reevaluation operations, are presented in the following table:

Table no. 3

The structure rates of the liability elements

Indicators	Initially	Reassessed
1. The financial stability rate (C_{LT}/C_T)	75.13%	76.26%
2. The global financial autonomy rate (OE/C_T)	59.01%	60.87%
3. The long term financial autonomy rate (OE/C_{LT})	78.54%	79.81%
4. The global debts rate (D_T/C_T)	40.99%	39.13%
5. The long term debts rate (D_{LT}/C_T)	21.46%	20.19%
6. The long term debts rate (D_{LT}/OE)	27.33%	25.29%

After the reevaluation of the patrimonial elements, the financial stability rate increased from 75.13% to 76.26%, while the global financial autonomy rate grew from 59.01% to 60.87%. This evolution has been determined by the growth of the level of own capital, as a consequence of the reevaluation reserves. Also, one could notice that the level of the financial stability rate is bigger than the fixed assets rate, which means the working capital is positive and this is a premise for the financial equilibrium.

The financial autonomy rate exceeds, in both cases, the minimum level of 30%-40%, a favorably appreciated situation.

As concerning the long term debts rate and the complementary rates, it's observed that, after the reassessment operations, they have become lower and don't imply major risks.

In order to emphasize the implications of reevaluating the patrimonial elements on **the liquidity and solvency rates**, we have calculated these two ratios for the analyzed company. The results are presented in the following table:

Table no. 4

The liquidity and solvency rates

Indicators	Initially	Reassessed
1. The general liquidity rate	143.55%	140.59%
2. The current liquidity rate	68.07%	68.07%
3. The quick test rate	4.16%	4.16%
4. The general solvency rate	243.96%	255.54%
5. The patrimonial solvency rate	59.01%	60.87%

The calculation of these rates, before and after the reassessment operations, allowed drawing the following conclusions:

- *The general liquidity rate* has values bigger than 100% in both cases, a favorably appreciated aspect. Still, after the reassessment operations were done, the level of this indicator has decreased with almost 3%, because of the depreciation of raw materials and merchandises stocks;
- *The current liquidity and quick test rates* are not affected by the reevaluations, because the level of claims and of cash is the same. The level of these rates is below the minimum recommended values, an unfavorably appreciated situation;
- *The general and patrimonial solvency rates* have increasing values as a result of the reevaluation of the assets and liabilities and that is appreciated as a favorable situation.

By comparing these rates, one could notice that the liquidity got worse after the reevaluation

of the assets and liabilities, as the solvency improved.

The level of the working capital, of the working capital need and of net cash flow, as well as the level of the analysis rates, before and after reevaluating the patrimony, are presented in the following table:

Table no. 5

The correlation between the working capital, the working capital need and the net cash flow

Indicators	Initially	Reassessed
1. The circulated found (CF)	8,384,930	7,814,930
2. The necessary of circulated found (NCF)	20,461,409	19,891,409
3. The net treasury (T)	-12,076,479	-12,076,479
4. Financing of immobilizations	116.84%	114.46%
5. Covering of invested capital	82.81%	83.66%
6. The financing of current assets ratio	30.34%	28.87%
7. The financing of stocks ratio	57.70%	55.97%
8. The covering of NCF ratio	40.98%	39.29%
9. The financing of turnover ratio	62.10%	57.88%
10. The financing of NCF from T	-59.02%	-60.71%

The level and evolution of the indicators from the previous table allow drawing the following conclusions:

- *The working capital* is positive both before and after the reevaluation operations. Still, its level dropped after reevaluating the patrimony, due to the owners' equity diminution, as a consequence of the depreciation of raw material and merchandise stocks;
- *The working capital need* is positive, which is normally for an industrial company. After the reassessment of assets and liabilities, its level dropped and thus generated a small change of the financial equilibrium of the company;
- *The net cash flow* is negative because the company uses bank loans in order to finance its activity. Its negative level is not appreciated as being unfavorable as long as the leverage is reasonable and the financial leverage effect is positive. After the reassessment of the patrimony, its level remains constant;
- *The rate of financing the fixed assets* is higher than 100%, which means that the long term resources were enough to finance the fixed assets. A level of this rate above one signifies a positive working capital, which is a must in order to have financial equilibrium. The diminution of its level, after the reassessment of the patrimony, affects the financial equilibrium of the analyzed company. As regarding the owners' equity, they finance about 91% of the fixed assets, a normal situation for an industrial company;
- *The rate of covering the invested capital* is below 100%, but, after the reassessment of the patrimony, it grew up. That means that the long term resources aren't sufficient to finance the fixed assets and the working capital need, resulting in a negative net cash flow;
- *The weight of the working capital in the long term capital* is decreasing with almost 2% after the reevaluation, which means the reduction of the security margin of the company;
- *The rates of financing the current assets, the inventories and the working capital need* have normal values, but in decreasing after the reassessment, which points out some risks undetected before the reassessment;
- *The financing of the working capital need* is mostly ensured through negative net cash flow, which increase the costs and the risks the company face.

In conclusion, as a result of the previously done analysis, we have observed that, as a consequence of the reassessment of the patrimony, the financial standing of the company changes, both due to the change of the financial structure and of its financial equilibrium.

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