

Investigate the Effect of the Financial Position Diagnosis, Performances Diagnosis and Cash Flow Diagnosis on the Firm Value in listed companies of Stock Exchange

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Abstract:

Financial diagnosis is a set of methods and tools that can help to assess the financial position and performance of company. In fact, it helps to understand the past, present and the future planning of the company. This study aims to evaluate the effects of three components of financial diagnosis on the firm value, using Structural Equation Modeling SMART-PLS as the tool of analysis. The research sample consisted of all listed manufacturing companies in Stock Exchange during the years 2009-2013. In this study dependent variable is the value of the company and indicators of financial position diagnosis, performance diagnosis, cash flow diagnosis are considered as independent variables. Results of this study showed that the variables cash flow diagnosis and performance diagnosis have a significant and positive effect on firm value. But financial position diagnosis has significant and weak effect on the firm value. In the modified model by removing the indicators related to negative factor loadings the significant effect between financial position diagnosis and firm value will be positive and strong.

Keywords: Financial Diagnosis, Financial Position Diagnosis, Performances Diagnosis, Cash Flow Diagnosis, Firm Value

1. Introduction

The term “diagnosis” comes from the Greek word “Diagnostikos” which means “able to know”. This term is borrowed from medicine, meaning an activity envisaging the recognition of certain diseases, based on their symptoms, in order to discover the causes and apply therapy necessary for the healing process. Similar to the activity of the company as a social organism, the diagnosis involves the identification of the company’s disfunctionalities, the research and analysis of facts and responsibilities, the identification of the causes of the disfunctionalities, as well as the elaboration of a forecast and the recommendation of a certain therapy (Cristiana, 2013). Financial diagnosis is result firm analysis and has different aims for the managers, shareholders or employees (for example: return of assets, return of investment, return of equity, risk of bankruptcy ...) and financial analysts, potential shareholders or banking (for example: risk of liquidity, risk of solvency, risk of bankruptcy, equilibrium of source ...). Financial diagnosis is a partial and specialized look at the financial position and performance of the company for the company’s capacity to ensure short-term and long-term solvency, avoiding the risk of bankruptcy, forecasting financial health of firm, recognition weaknesses and strengths of financial management from past, present and future risks from financial situation of firm, following the reduction of risk and improvement of results (Susu and Birsan, 2009). Starting from the content of the data base used in financial diagnosis, which is largely represented by financial statements, financial diagnosis is seen as a system that may be structured according to the following composing elements:

1. Financial position diagnosis based on the Accounting Balance Sheet;
2. Performances diagnosis based on The Profit and Loss Account;
3. Cash Flows diagnosis;
4. Risks diagnosis;
5. Provisional diagnosis represents the future prediction of the financial standing that would result from the set rights procedure (Achim and Borlea, 2009).

In this study, we consider three components of financial diagnosis including financial position diagnosis, performances diagnosis and cash flows diagnosis and evaluate the effects of each on the firm value.

2. Theoretical and Literature Review

Firm value is used for measuring the success of a financial manager in managing the company's finance. The purpose of the company is to increase firm value by increasing the value of the company's stock price. Investor perception of the value of the company is on firm performance and is often associated with a stock price that is indicated by the Price to Book Value (Sekar, 2013).

Firm value is an important factor for investment. All of the shareholders, managers, investors and different institutes look at the firm value as base factor for company analysis in total. Thus, financial diagnosis is a perfect and regular organization for inside the company and is to give financial information to those inside and outside it, with certain interests in the company (Gheorge and Nicolae, 2013).

In other words, three objectives of any company actually are to maximize profit, prosperity of owners or shareholders and firm value. Thus, the business world will always require management to be creative in an effort to improve their performance; they should have the ability to take advantage of any opportunities to improve company performance. It is important to improve the company performance to create strategies, techniques and business tools that are appropriate and suitable for the company (a part of financial diagnosis where in performances diagnosis by profitability diagnosis). In fact, the firm performance is a canonical for investors to invest their funds (Sudiyatno et.al, 2012).

According to studies done so far, the cash flow is one of the factors influencing on firm value. The data from the statement of cash flows can be applicable in assessing the company's ability in generating positive cash flow in the future and profit distribution methods (another part of financial diagnosis). It is necessary for the success of the company's financial policies (Banikhaled, 2012).

According to above, we study the effect of financial diagnosis criteria on firm value.

In a study of financial diagnosis, Hada (2009) studied the aspects of determining the financial diagnosis of trading companies by proposed method. The proposed method includes ROE, ROA, Invested capital productivity, Net debt evolution, Work factor remuneration, Financial autonomy rate, Patrimonial liquidity, Reduced liquidity, Solvency, Immediate liquidity indicators. He showed it is useful for the enterprise evaluation in the process of sustainable development of activity areas. He showed when the country's financial crisis is getting worse; companies must take targets to overcome the financial crisis. In this way, the financial diagnosis can be useful as the most important part of a general diagnosis, by showing the performance of companies in a given time through a system of indicators.

In a similar study, Gheorge and Nicolae (2013) studied the financial diagnosis of a certain company's activities. They analyzed a company's financial performance by inspecting the data in the balance sheet and comparing the company's values with those of the sector in which it operates. They also, considered six components for financial diagnosis, including: Diagnosis of financial position; Profitability analysis; Analysis of intermediary management balance and of self-financing capacity; Analysis of cash flow indicators; Risk and bankruptcy indicators; Conclusions regarding the company's general diagnosis. They concluded that positive aspects of financial diagnosis are as follows: decrease of stocks and receivables, increase of liquid assets; the negative aspects are the low efficiency of the employed capital, and a rentable surplus of tangible assets to third parties.

Arelvea et.al (2012) examined the financial diagnosis for a case study of lanka aluminum industries plc in SRILANKA. In their study, they used Liquidity ratios, Asset Management ratios, Debt Management ratios and Profitability ratios as proxies of financial diagnosis. They found that the industry performance is inefficient.

Bani Khalid (2012) examined the financial crisis, cash flows, and market value per share in the Jordanian Commercial Banks for the Period 2000-2009. this study evaluated the effect cash flows from operating, investment, financing activities on the market value per share before, during and after the financial crisis. The results of this study indicated that the statement of cash flows has a significant impact on the interpretation of the market value per share and affected the cash flows in general, which reflected negatively on the value of share in those banks.

Sekar (2013) examined the effect of Leverage ratio and profitability ratio on firm value. The results showed that Leverage ratio and profitability ratio simultaneously have significant and positive impact on firm value in the cigarette industry sector companies listed in Indonesia Stock Exchange. She suggested that investors can rely on leverage ratios and profitability in determining the value of the company.

Ahmadi and Aqalatifi (2008) examined the effect of operating cash flow and net profit on dividend in the listed automotive companies of stock exchange for period 2003-2008. The results showed only net profit variable has significant impact on dividend.

Pirashanthini and Nimalathan (2013) studied the capital structure and firm value in the listed manufacturing firms in Sri Lanka. They consider three factors for firm value. These factors include: Earning per share (EPS), Price earnings ratio (P/E) and Market value per share (MPS). They found there is a minor relation between P/E ratio with debt equity and debt to total funds. Also, the debt ratio will have a strong impact on MPS.

3. Variables of research

Independent variables include financial position, Performance diagnosis and cash flow diagnosis.

The company's financial position (FP) will be analyzed by using multiple indicators that we will use these indicators: working capital, need working capital, net treasury, current ratio, quick ratio, total assets turnover.

The financial diagnosis means that the financial equilibrium is analyzed on 2 levels:

- The upper part of a financial balance sheet between permanent resources and permanent needs;
- The lower part of a balance sheet between the temporary resources and temporary needs.

Table 1. The financial balance sheet (Berceanu et.al, 2010)

	Uses (way to use)	Resources (establishing way)	
Permanent needs	Net fixed assets (less than one year)	Corrected equity Medium and long-term debts	Permanent resources
Temporary needs	Circulating assets (less than one year)	Short term debts	Temporary resources

The working capital (WC) shows the long-term financial equilibrium and it is calculated as the difference between permanent capitals and net fixed assets. A positive working capital shows the existence of permanent capitals through which short term financing needs can be covered (those related to the operating cycle). A negative operating cycle shows a financing disequilibrium, because part of the fixed assets is covered by short term purchased resources (Gheorghe, 2013).

$$WC = \text{Ownership equity} + \text{Long-term debts} - \text{Net fixed assets}$$

Or

$$WC = \text{Current assets} - \text{Short-term debts}$$

The need for working capital (NWC) shows short term equilibrium and it is calculated as the difference between the sum of stocks and receivables on one hand, and operating debts on the other, represented by the debts towards the suppliers, employees, state and shareholders. A positive working capital shows that temporary resources cannot cover by themselves the temporary financing needs, thus new sources are necessary, either from the working capital (if it is positive) or from new loans. A negative working capital shows that temporary resources cover the temporary financing needs, thus showing a state of balance (Gheorghe, 2013).

$$NWC = \text{Stocks} + \text{Receivables} - \text{Operating debts}$$

Or

$$NWC = (\text{Current assets} - \text{Liquid assets}) - (\text{Short-term debts} - \text{Current bank loans})$$

The net treasury shows the company's general equilibrium and it is calculated as the difference between WC and NWC. A positive net treasury indicates a state of balance, while a negative one indicates that the company needs other new financing sources (Gheorghe, 2013).

$$NT = \text{Liquid assets} + \text{Short term financial investments} - \text{Current bank loans}$$

Or

$$NT = \text{Treasury assets} - \text{Treasury passives}$$

The current ratio is a popular financial ratio used to test a company's liquidity by deriving the proportion of current assets available to cover current liabilities. The concept behind this ratio is to ascertain whether a company's current assets (cash, cash equivalent, marketable securities, receivable, inventory etc.) are readily available to pay off its current liabilities (notes payable, current portion of term debt, payables, accrued

expenses, taxes etc.). It is computed by dividing current assets by current liabilities. Generally 2:1 is considered as the standard norm for current ratio. If the ratio is too low, the company may face difficulty in meeting the short term debt. If the ratio is too high, the company may have an excessive investment in current assets (Jahankhany and Parsaiyan, 2012).

The quick ratio is a liquidity indicator that further refines the current ratio by measuring the amount of the most liquid current assets available to cover current liabilities. It is more conservative than the current ratio because it excludes inventory and other current assets which are more difficult to turn into cash. Acid-Test or quick ratio measures the company's immediate short-term liquidity. It is computed by dividing the sum of cash, short-term investments and net receivables by current liabilities. In this ratio, 1:1 is considered as the standard norm (Jahankhany and Parsaiyan, 2012).

$$CR = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$QR = \frac{\text{Current assets} - \text{Inventory}}{\text{Current Liabilities}}$$

Total assets turnover shows the relationship between the value of the assets and operations of a company at one year. It is a component from active ratios. It calculates the volume of sales. So that a warning for companies would be to decrease in total asset turnover (Jahankhany and Parsaiyan, 2012).

$$TAT = \frac{\text{net sales}}{\text{total assets}}$$

Financial performances diagnosis (PD) is measured by comparing the means used and the obtained results. Multiple indicators will be analyzed in a profitability diagnosis that we use ROA, ROE, and NPM indicators. Profitability ratios show results of liquidity effects, asset management and the use of loans in operations.

$$ROA = \frac{\text{net profit after tax}}{\text{total assets}}$$

$$ROE = \frac{\text{net profit after tax}}{\text{stockholder's equity}}$$

$$NPM = \frac{\text{net profit after tax}}{\text{net sales}}$$

Cash flows diagnosis (CFD) should present the strong points and the weak points in the administration of the resources controlled by the cash flow generating company, classified on operating activities (CFOD), investments (CFID) and financing (CFFD), net return on investment, income tax indicators.

Firm value is a dependent variable in the study. In similar studies used the different variables for firm value. In the reason, we consider the most duplicate indicators in the studies conducted for firm value. These factors include: EPS, Q Tobin, P/E, Market value per share (P).

$$EPS = \frac{\text{Net Income}}{\text{Number of Equity shares}}$$

$$P/E = \frac{\text{Market value share}}{\text{EPS}}$$

$$Q\text{ Tobin} = \frac{\text{total debet} + \text{market value of equity}}{\text{total assets}}$$

Firm size is a control variable in the study. It indicates the value of assets that the company has. The indicator of firm size is log natural of Total Asset.

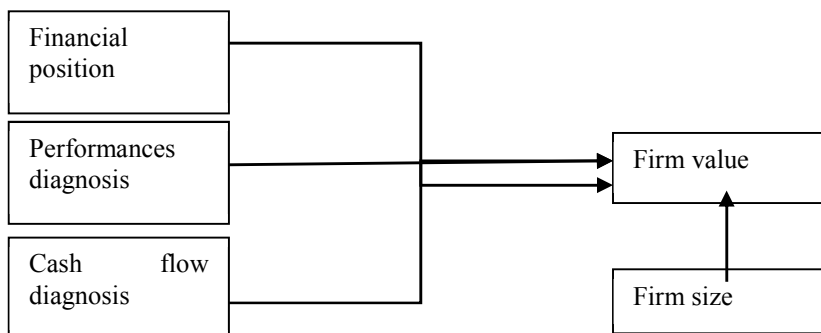
4. Research Objective:

- To determine the effect of financial position indicators on firm value indicators.
- To determine the effect of performances diagnosis indicators on firm value indicators.
- To determine the effect cash flow diagnosis indicators on firm value indicators.

5. Research Hypothesis:

- Financial position has a significant impact on firm value.
- Performances diagnosis has a significant impact on firm value.
- Cash flow diagnosis has a significant impact on firm value.

Figure 1 Empirical model of this study are:



6. Methodology of Research

6.1 Sample

The selected samples in this study are manufacturing companies that have been listed on the Iranian Stock Exchange. Purposive sampling is used as the sampling method, considering certain criteria set previously. Based on the criteria, from 345 companies, which meet the criteria as research samples are 105 companies. The data used are secondary data in the form of financial statement of listed companies during period of 2008 - 2012 is obtained from the Tehran Stock Exchange (TSE) 2013 and Rahavard software.

6.2 Data Analysis Method

A structural equation modeling approach is for test hypotheses of relationship between observed and latent variables. We can use PLS when the study model indicates more than one dependent variable, data are not multivariate normal, small samples or a limited number of cases are available. In PLS models, two models are tested. The external model is equal to the measurement model and the internal model is similar to the structural model in the structural equations models. In this study, this approach was used to estimate the factor loadings and path coefficients. The indexes or observed variables can be studied on one hand and the causal relationship between the latent variables and the explained value of variance can be assessed on the other hand. Structural equation model encompasses two models: measurement model and the structural model; and the variables of the model are divided into two groups: latent variables and observed variables (Kline, et al, 2010). In this study, financial position, cash flow diagnosis, performances diagnosis, firm size and firm value are five main latent variables, and the dimensions of each, are observed variables (Mohsenin and esfandiyani, 2013).

6.3 Conversion Chart Path to Systems of Equations

Outer model describes the relationship between the latent variable and its indicators. They are illustrated in figure 4 and 6 before and after modifying model.

Financial diagnosis (1)

$$X1 = \lambda_{x11} \xi_1 + \delta_1$$

$$X2 = \lambda_{x21} \xi_1 + \delta_2$$

$$X3 = \lambda_{x31} \xi_1 + \delta_3$$

Cash flow diagnosis (2)

$$X4 = \lambda_{x42} \xi_2 + \delta_4$$

$$X5 = \lambda_{x52} \xi_2 + \delta_5$$

$$X6 = \lambda_{x62} \xi_2 + \delta_6$$

$$X7 = \lambda_{x72} \xi_2 + \delta_7$$

Performances diagnosis (3)

$$X8 = \lambda_{x83} \xi_3 + \delta_8$$

$$X9 = \lambda_{x93} \xi_3 + \delta_9$$

$$X10 = \lambda_{x103} \xi_3 + \delta_{10}$$

$$X11 = \lambda_{x113} \xi_3 + \delta_{11}$$

Firm size (4)

$$X_{12} = \lambda_{x12} \xi_2 + \delta_{12}$$

Firm value (5)

$$Y_1 = \lambda_{y11} \eta_2 + \varepsilon_1$$

$$Y_2 = \lambda_{y21} \eta_2 + \varepsilon_2$$

$$Y_3 = \lambda_{y31} \eta_2 + \varepsilon_3$$

$$Y_4 = \lambda_{y41} \eta_2 + \varepsilon_4$$

6.4 Inner model describes the relationship between latent variables based on theory. It is shown in figure 5 and 7 before and after modifying model.

- Financial position, Cash flow diagnosis, Performances diagnosis, Firm size – Firm value
 $\eta_1 = \gamma_{1.1} \xi_1 + \gamma_{1.2} \xi_2 + \gamma_{1.3} \xi_3 + \gamma_{1.4} \xi_4 + \zeta_1$

6.5 Hypothesis Testing (Bootstrapping)

Exerting Bootstrapping method, hypothesis test is performed. Implementation of this method does not require the assumption of normal distribution, and does not require a large sample. The test can be done by t-test statistics. It means significant when t-value above $\pm t$ table (± 2.560 in 1% level of error or ± 1.980 in 5% level of error or ± 1.658 in 10% level of error). If the test results in a significant inner model, it means that there is an interaction between the latent variables (Mohsenin and esfandiyani, 2013).

At Latent Variable Correlations matrix must AVE root must be replaced with the original diameter. Acceptable value has to be more than the correlation between latent variable with other latent variables. In table 1 and 2 in pre-corrective and corrective model it is observed that there were acceptable conditions.

Table 2. Latent Variable Correlations (pre-corrective model)

	CFD	FV	FP	PD	FS
CFD	0.926976				
FV	0.411627	0.71568			
FP	0.452838	0.685044	0.60881		
PD	-0.107441	0.714228	0.602313	0.69421	
FS	-0.778033	-0.068411	-0.368066	0.232116	1.000

The structural model results are shown in figure 3 in Research Pre-Corrective model. Examining the path coefficients (Latent Variable Coefficient LVC); the numbers on the screen enables us to determine, that CFD and PD have strong effect on firm value (.742, .637). But FP has a weak effect on firm value (.114). Moreover, the model constructs explain that 81.4 percent of the variance of the endogenous latent construct firm value ($R^2 = 0.814$).

Table 3. The standard Estimate in Pre- Corrective model

Table 3-1. R Square

	R Square
CFD	
FV	0.813892
FP	
PD	
FS	

Table 3-2. Path Coefficients

	CPF	FV	FP	PD	FS
CPF		0.742118			
FV					
FP		0.113627			
PD		0.636993			
FS		0.402947			

Table 3-3. Outer Models (Weights or Loadings)

	CFD	FV	FP	PD	FS
TAT			-0.490884		
CR			0.378874		
EPS		0.968719			
ITAX	0.943390				
NFFC	-0.894225				
NIFC	0.927814				
NOFC	-0.953944				
NPM				0.881803	
NROI	0.914306				
NT			0.870326		
NWC			-0.536794		
P/E		-0.478175			
ROA				0.501355	
ROE				0.645640	
WC			0.808702		
Log assets					1.000
P		0.916488			
Q Tobin		0.204386			
QR			0.259450		

From the Path Coefficient Figure in Research Pre-Corrective model (figure 4) showed that FP has positive significant influence but weak on FV with t-value 1.703 (10% level of error). The influence of PD on FV showed significantly positive and strong with t-value 6.659 (1% level of error). Positive and strong significant influence also appeared between CFD on FV with t-value 4.844 (1% level of error).

Table 4. The standard Estimate in Pre-Corrective model

Table 4-1. Path Coefficients (T- Values)

	T Statistics (O/STERR)
CFD -> FV	4.843866
FP -> FV	1.730132
FS -> FV	3.811900
PD -> FV	6.658705

Table 4-2. Outer Model T-Statistic

	CFD	FP	FS	FV	PD
TAT		6.046436			
CR		1.889995			
EPS				7.625774	
ITAX	23.656480				
NFFC	18.277072				
NIFC	19.480904				
NOFC	27.243980				
NPM					12.506766
NROI	12.863743				
NT		5.340471			
NWC		3.182060			
P/E				3.807340	
QR		1.452614			
ROA					3.490962
ROE					6.384793
WC		8.935823			
log assets					
P				10.782388	
Q Tobin				0.947385	

The reformed SMART- PLS model by eliminating negative factor loadings of the indicators can be used to improve the model. In Figures 5 and 6 you can see the modified model of research.

Table 5. Latent Variable Correlations (Corrective model)

	CFD	FP	FS	FV	PD
CFD	0.897401				
FP	0.424226	0.692355			
FV	-0.812809	-0.331460	1.000		
FS	0.337624	0.654846	0.029665	0.809187	
PD	-0.097290	0.573058	0.286745	0.731798	0.723003

The results of modified structural model has been shown in figure 5. Examining the path coefficients (Latent Variable Coefficient LVC); the numbers on the screen enable us to determine that CFD and PD have strong effect on firm value (.756, .503). Also the effect of FP on firm value is strong (.237), Moreover, the model constructs explain that 79.6% of the variance of the endogenous latent construct firm value ($R^2 = 0.796$).

Table 6. The standard Estimate in Corrective model

Table 6-1. R Square

	R Square
CFD	
FP	
FS	
FV	0.796334
PD	

Table 6-2. Path Coefficients

	CFD	FP	FS	FV	PD
CFD				0.756286	
FP				0.237312	
FS				0.578679	
FV					
PD				0.503451	

Table 6-3. Outer Models (Weights or Loadings)

	CFD	FP	FS	FV
CR		0.605838		
EPS				0.905580
ITAX	0.872480			
NIFC	0.838652			
NPM				
NROI	0.975412			
NT		0.731581		
QR		0.455269		
ROA				
ROE				
WC		0.898834		
log assets			1.000000	
p				0.960122
Q Tobin				0.471639

From the Path Coefficient Figure after modifying model (figure 6) showed that FP has significant positive but strong influence on FV with t-value 3.315 (1% level of error). The influence of PD on FV showed significantly positive and strong with t-value 5.779(1% level of error). Positive and strong significant influence also appeared between CFD on FV with t-value 6.108(1% level of error).

From the Path Coefficient Figure of modified model (figure 7) showed that FP has positive and strong significant influence on FV with t-value 3.315 (1% level of error). The influence of PD on FV showed significantly positive and strong with t-value 5.779(1% level of error). Positive and strong significant influence also appeared between CFD on FV with t-value 6.108(1% level of error).

Table 7. Parameters Significantly in Corrective model

Table 7-1. Path Coefficients (T- Values)

	T Statistics (O/STERR)
CFD -> FV	6.107947
FP -> FV	3.314778
FS -> FV	5.378518
PD -> FV	5.778927

Table 7-2. Outer Model T-Statistic

	CFD	FP	FS	FV	PD
CR		3.383753			
EPS				9.271212	
ITAX	11.018252				
NIFC	9.414031				
NPM					13.434169
NROI	16.263814				
NT		6.251292			
QR		2.688685			
ROA					4.989122
ROE					8.094715
WC		14.804906			
log assets					
p				13.137503	
Q Tobin				2.865178	

7. Assessment of the indices fitting model:

To check the quality or validity of the model used from quality test measurement model and the structural model. Indicator for measurement model is subscription index or CV-com. SSE is Sum of Squares of Observations for each latent variable, SSO is Sum of Squared Errors of prediction for each latent variable, that the ratio between SSE and SSO is CV-com. Also, we used redundancy index or CV-red to ensure the quality of the structural model. Positive values of parameters indicate the acceptable and suitable quality measurement model and the structural model (Mohsenin and esfandiyani, 2013).

In figures 8 and 9 the results of the PLS Blindfolding Algorithm indicators for each latent variable have been showed, that is positive and significant for the pre-corrective and corrective model latent variable.

$$CV-com = \frac{sse}{sso}$$

$$CV-Red = 1 - \frac{sse'_j}{sso_j}$$

Table 8. The subscription and redundancy indexes (pre-corrective model)

Variable	CV-com	CV-red
FP	.204	.204
PD	.110	.110
CFD	.753	.753
FV	.226	.362

Table 9. The subscription and redundancy indexes (corrective model)

Variable	CV-com	CV-red
FP	.105	.105
PD	.089	.089
CFD	.554	.554
FV	.568	.449

5. Conclusion

Financial diagnosis is a set of methods and tools that can help to assess the financial position and performance of the company. In fact, it helps to understand the past, present and future planning of company. According to studies, it appears that the five factors of financial diagnosis offer appropriate approaches for the correct

direction to financial situation of companies; these five factors are important because they include wide range of parameters that need to examine the company's financial statements.

Here we had overview of a few of these indicators and effect of them reviewed on the firm value that is an important factor for investment in companies. The results show positive and significant relationship between the components of financial diagnosis and the firm value.

Although this study did not consider all the components of financial diagnosis. For this reason, future research should examine all factors of financial diagnosis and look at the more operating and detailed to financial diagnosis system.

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