The assessment of companies for external and internal purposes

Hodnocení podniků pro externí a interní účely

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Abstract: This article presents holistic concepts of companies' assessments intended for two basic groups of users: internal and external. Companies' assessments concentrated only on financial perspective are very single-track and already obsolete and therefore, further perspectives are used to complete companies' assessments. Among concepts intended for internal assessments, the so-called balanced scorecard approach has developed since late nineties. This concept helps in company's strategic management. Moreover, there is a concept of EFQM Excellence model introduced at the beginning of nineties for assessing applications for the European Quality Award, but has become widely used for company assessment and management. The third mentioned concept is intended for credit risk assessment is credit rating. The development of methodology of the holistic assessment of Czech farm businesses may be a good tool for different external and internal users.

Key words: business assessments, balanced scorecard, EFQM Excellence model, credit rating, scoring, farm businesses

Abstrakt: Článek se zabývá ucelenými koncepcemi hodnocení podniků určených pro dvě základní skupiny uživatelů: interní a externí. Hodnocení podniků zaměřené pouze na finanční stránku věci je velmi jednostranné a dnes již překonané, a proto se hodnocení podniků rozšiřuje o další perspektivy. Z koncepcí určených pro interní hodnocení se v 90. letech rozšířila tzv. vyvážená soustava ukazatelů, která pomáhá zejména ve strategickém řízení podniku. Další koncepcí je např. EFQM Excellence model, který vznikl začátkem 90. let pro udělování Evropské ceny kvality, ale rozšířil se jako nástroj pro hodnocení a řízení podniku. Třetí uvedenou koncepcí hodnocení stránky úvěrového rizika podniku je úvěrový rating. Tvorba metodiky uceleného hodnocení zemědělských podniků pro české podmínky by byla vhodným nástrojem pro různé externí i interní uživatele.

Klíčová slova: hodnocení podniků, vyvážená soustava ukazatelů, EFQM Excellence model, úvěrový rating, skoring, zemědělské podniky

This article deals with holistic concepts of companies´ assessment for various external and internal users. These concepts take into account different aspects of company management.

The article concentrates on:
– the importance of company assessment for various users,
– the models of internal assessments for management purposes,
– external company assessments, mainly credit ratings that take into account credit risk: the ratings in France and the credit ratings provided by Standard & Poor´s are paid attention.

In the conclusion, some ideas are presented how to utilise comprehensive assessment for farm businesses.

THE IMPORTANCE OF COMPANIES´ ASSESSMENTS

The main objective of an entrepreneurial activity is to achieve profit and/or to achieve a maximum shareholder's value. The profit or shareholder's value is only a top measure that reflects various aspects of management (production, investments, finance and economics, strategy, management and organisation). Basically, it is necessary to recognise how these partial aspects affect the top measure and whether they are comparable to other businesses in the region, country or other countries.

The above-mentioned partial aspects can be measured by various measures. The financial measures have had a long tradition. There have been developed a lot of comprehensive measurement systems, either parallel or pyramid. Moreover, many overall financial indices have been developed that express the business financial situation as one relative number. The individual financial measures (such as profitability or liquidity) are inputs into the overall index.

The pure financial measures are usually extended by non–financial, qualitative measures, for instance the information on management, length of existence, goodwill, market position, quality of accounting etc.

The contribution presented at the International Conference of the RIAFE Praha (Sedmihorky, October 2–3, 2003).

The users of these assessments include:
– investors (owners) or potential investors,
– managers,
– creditors,
– employees,
– other subjects (e.g. governmental agencies, public).

These users are either external or internal and, therefore, there are different assessment concepts for different groups of users.

INTERNAL ASSESSMENTS

The concepts of internal assessment are very closely linked to the recent trend in business management. One of these concepts, the so-called "*Balanced Scorecard*", has become very popular in many firms since the end of nineties. Professor Robert Kaplan (Harvard Business School) and David Norton developed the concept in the early nineties. It is both measurement and management concept. It provides feedback around both the internal business processes and external outcomes in order to continuously improve strategic performance and results.

The balanced scorecard views the organisation from four perspectives, and develops metrics, collects data and analyses it relative to each of these perspectives:
– the learning and growth perspective
– the business process perspective
– the customer perspective
– the financial perspective.

In each perspective, 2–4 key measures are selected so that the whole system includes 10–15 key measures of strategic objectives. Traditional financial measures are retained but they form only part of the feedback. A comprehensive set of measures or indicators tied to customer and/or company performance requirements represents a clear basis for aligning all activities with the company's goals.

Another concept that was developed at the beginning of nineties is the so-called *EFQM Excellence Model*. The concept was originally intended for external assessment for the European Quality Award that needed it. However, the model is also used as a self – assessment tool for internal management purposes. It is a flexible model, which is being developed by practice. It has also a holistic character and concentrates on 9 areas which include both conditions of value creation, performance indicators and moreover, innovation and learning – see Figure 1. An effective organisation is viewed both from the maximum shareholder's value perspective and from the satisfaction of customers, employees, and society (including ecological aspects) perspective.

EXTERNAL ASSESSMENT

In external assessment, it is highly necessary to look for the mutual comparability, availability of different measures and their creditworthiness. It is generally recognised that automatic comparison of financial results does not provide good conclusions.

Therefore, some efforts to objectify the assessments for external users have developed. The intention is to reflect different aspects of business and at the same time make the assessments comparable. One of these efforts was primarily intended as a service for investors and started to assess credit risk aligned to a specific issue or issuer. As a result of these efforts, credit ratings emerged. Credit rating is a relatively comprehensive assessment of credit risk. It is based on:
– judgmental process of ranking and classifying credits into different levels of risk categories. Each of these

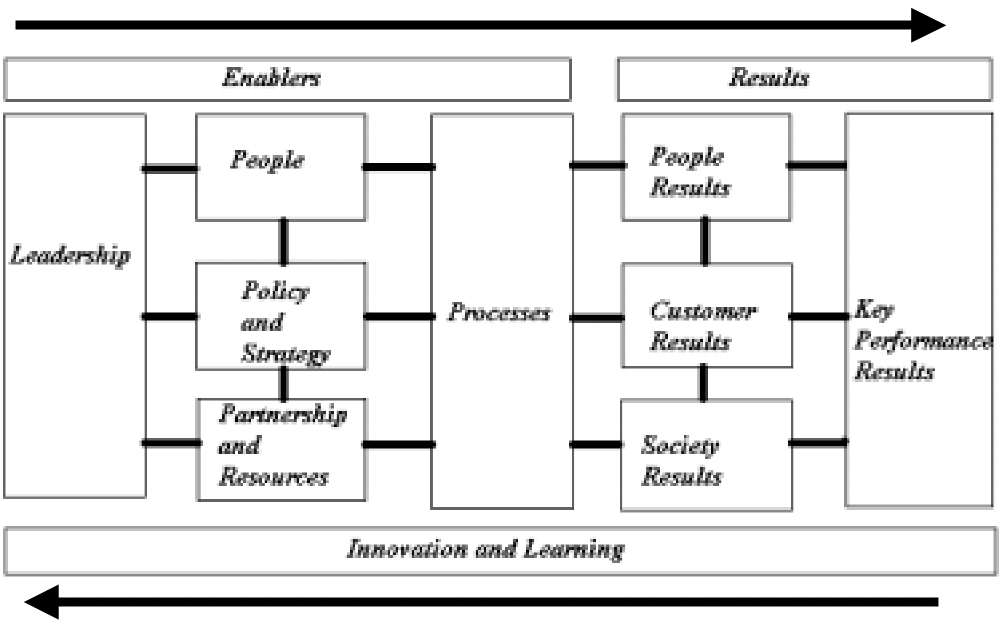

Figure 1. Scheme of EFQM Excellence Model

categories represents a clear and precise statement of creditworthiness of the rated firm
– predictive process using observable and current information to project potential future outcomes (e.g. future loss)
– key ingredients are both *quantitative analyses* (e.g. ratio, cash flow, industry, sector, macroeconomic analyses) and *qualitative analyses* (e. g. financial strength, management and corporate governance).

The credit ratings are in principle publicly available (in some cases it is necessary to pay fees). The first credit ratings appeared in the U.S.A. at the beginning of twentieth century and developed in twenties and thirties. Since the time, they have had an important role in the market.

CREDIT RATING

Credit rating reflects the credit quality of an obligor (issuer) or a specific obligation (issue), in other words, the better is the rating the lower is the probability of default. The importance of rating has been growing. It is a result of growing interest of many subjects (firms, banks, and municipalities) to finance itself at the capital market and to reach good reputation generally. Recently, the interest in ratings has been underlined by the trends in the banking regulation that have been brought by the so-called New Basel Capital Accord[1] (Basel II). The new rules should come into force from 2007. These rules will bring new ways of capital adequacy calculation and actually, they also strengthen the transparency, objectivity and the best practices in risk management generally. Credit rating under new rules is taken as one of the more objective measures of credit risk. The credit ratings, however, must be provided by an external credit assessment agency (rating agency) recognised by competent authorities.

Nevertheless, there are only a few renowned and generally accepted global rating agencies even though their reputation has been shaken by the recent scandals. Standard and Poor's, Moody's and Fitch Ratings represent them. Other rating agencies are mostly of local or regional importance. In the Czech Republic, there is the CRA Rating agency, which has two branches in Slovakia and in Hungary.

The rating agencies express their assessments in several rating grades, usually marked by alphabetic symbols, such as AAA or BB. The first part of the rating scale represents investment grades, the second part speculative grades. However, to receive a rating of a renowned agency is not cheap. Firms usually undergo the process so as to have better chance of financing themselves on capital markets. The firms have to reveal a lot of internal information (financial data, firm's strategy, information on management and accounting) to the rating analysts. The rating process leads to the final rating grade assignment and to credit rating report.

There is no single rating; the main types of ratings are as follows:
– issue or issuer specific
– short-term or long-term
– foreign currency or domestic currency.

The rating agencies carefully keep the detailed methodology confidential and avoid its potential misuses. It is one of the roads to their success. The renowned rating agencies, nevertheless, make available the general methodological principles and measures on which the assessments are based. Generally, the rating agencies deny single aggregation mechanism and confirm the role of expert judgement.

In some of the developed European countries, the central banks have tradition in providing ratings. These countries consider these assessments to be highly independent. We can find them for instance in France, Germany, Spain and Italy. The range of users, however, is limited. They serve for the central bank itself (analytic and/or supervisory purposes), for banks and for the assessed firms. It is not generally intended for public. Moreover, there are the so-called export credit agencies (ECA), which also provide ratings according to the OECD methodology, especially for sovereigns.

On the other hand, it is necessary to distinguish rating and other types of credit assessments, mostly based on accounting data processed by statistical methods without expert judgement. These are scoring based tools and/or some types of ranking (e.g. EVA – economic value added – ranking). These tools are much faster and much cheaper but do not reflect all individual features of the obligor or obligation. The producers of these scoring/ranking-based assessments in some cases call them ratings to improve their prestige.

THE TRADITION OF RATINGS IN FRANCE

Let us elaborate on the ratings in France. The ratings provided by the Banque de France (BdF) have had a long tradition of more than 30 years. BdF has collected large sources of data on businesses through its extensive branch network. The database (called FIBEN) contains the complete set of information on approximately 180 000 companies (financial statements, information about owners and managers etc.). The share of these companies' credits in the total outstanding credit to corporates is about 45%.

The BdF's purposes of the rating methodology and collecting data include: assigning eligibility/non-eligibility status to trade bills and other corporate debt instruments, the prudential review of banking portfolios, monetary policy analysis, or bank internal risk management analysis. In addition, the users include commercial banks (for internal risk management purposes) and the assessed businesses. The assessed companies, however,

[1] Basel II is a document issued by the Basel Committee of Banking Regulation as a recommendation. These recommendations, however, are in most countries (including the European Union) accepted as a rule.

receive only their own assessment. Furthermore, BdF intensively processes its data into various commercial products (e.g. financial analysis packages).

The rating system is based on a comprehensive assessment, which is disclosed through a three-position code.

Each position stands for:
– the size,
– the overall credit quality, and
– the regularity of payments to vendors and banks.

The credit quality rating is completed by:
– management quality rating assigned to individuals acting as general managers and based on public information
– supplementary "transparency indicator" *T*, awarded to companies that have agreed to an information exchange with their bank creditors and that have given them updated
– indicator *R*, that points out companies that do not comply with the legal financial disclosure framework, such as late filling of financial statements.

The final rating is based on combination of computational tools and judgmental approach. The computational tools are based on a scoring model derived by the method of discrimination analysis. The raw results of the scoring consist in distinguishing the failed and non-failed companies and are enhanced by calculating the posterior probability of failure. The quality and the objectivity of the rating is ensured by the significant volume of human and technical resources allocated to companies' ratings, including automatic controls and warning devices.

Secondly, it is worth mentioning that the businesses´ assessments in France have had also a long tradition in agriculture. These assessments are the common product of the French Ministry of Agriculture, research institutions and farmers' representatives. These assessments are used in France mainly as an objective decision-making tool for assigning various subsidies from budgetary sources.

EXAMPLE OF STANDARD AND POOR´S (S&P) RATING PROCESS AND METHODOLOGY

Credit rating is opinion of the general creditworthiness of an obligor, or the creditworthiness of an obligor with respect to a particular debt security or other financial obligation, based on relevant risk factors. It does not constitute any recommendation (to purchase, sell or hold a particular security) and does not comment on the suitability of any particular investment.

The rating process is standardised (see Figure 2).

S&P's *evaluation (rating) methodology* divides the analytical task into several categories including both fundamental and financial analysis. Each category is then scored and there are also scores for:
– the overall business risk profile (industry characteristics, competitive position, management)
– and the overall financial risk profile (financial characteristics, financial policy, profitability, capital structure, cash flow protection and financial flexibility).

But the way of scoring is not unified and different analytical teams may choose different ways and there are no formulae for combining scores to arrive at a rating conclusion.

It is important to mark that the evaluation methodology is based on both financial data (history) and forward-looking prospective. The assessed subject is compared to its peers and undergoes scenario and other types of analyses. Judgements are always part of the evaluation. Corporate ratings on publicly distributed issues are monitored for at least one year and they are reviewed (and possibly updated) no later than within one year. However, the acquirement of a specific rating grade is not suggested as a good firm's strategy. The rating agencies themselves recommend companies to concentrate on business objectives and let the rating follow.

CONCLUSION – THE POSSIBILITIES OF USAGE OF FARM ASSESSMENTS

Further ahead, agricultural economists should think about the development of a comprehensive assessment methodology of farm businesses and about its application. We can work on the assumption that traditional financial analysis of companies has become a thing of the past. The real issue of assessing farm businesses is their small scale in comparison to other businesses (farms are mostly involved in the group of small and medium enterprises) and high competition in the market (approaching to the perfect competition). In addition, the shares of farm

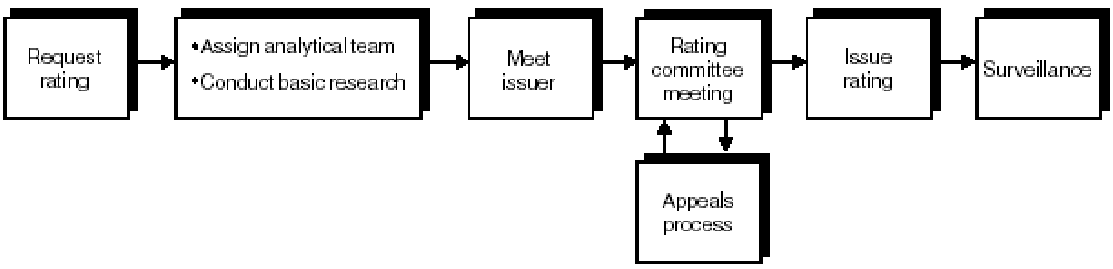

Figure 2. Standard & Poor's rating process

businesses are not traded publicly and, therefore, there are no explicit market prices.

A widely held opinion that the author of this article has been receiving is that objective and independent assessment of farm businesses may be useful for various purposes – either for the businesses themselves or for further users: governmental bodies (subsides allocation), creditors (banks, guarantee funds). There are even first examples of companies in agribusiness that have been assigned a rating from a rating agency. This is usually related to their export activity and efforts to establish themselves as good companies.

The proposal to establish a comprehensive farm assessment in the Czech Republic may be a good idea to be further worked out by research and scientific workers. It is also necessary to discuss it with the potential users and adjust it to them. These methodologies could at least find inspiration in any of the above-mentioned concepts. The author of this article invites for further opinions on this very topical issue.

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Arrived on 13th February 2004

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