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# BUDGETING AND ITS INFLUENCE ON THE COMPANY`S VALUE

**Abstract.** This article provides an analysis and evaluation of modern trends in company valuation. The main focus is that budgeting system based on the careful financial planning has a positive impact on company`s performance and, as a result, company valuation.

The article begins with an explanation why this topic should receive wide coverage nowadays and presents several arguments proving this thesis. The author claims that the key to success lays in a detailed planning and budgeting system implementation. Among various investment valuation models, the author pays her attention to a widely known one – the free cash flow model. In the scope of free cash flow valuation model there are also discussed some difficulties that can be overcome with the help of company analogue usage.

The research done throughout the article has a practical importance not only for financiers, but also for top management.

**Keywords**: investment value, budgeting, models for evaluation.

## Introduction

The question of company`s evaluation is quite a live issue. Answer for this question allows the owner to know not only how much his business will cost in the case of sale, but also to know how profitable it is. The models used for investment evaluation give an opportunity to discover the required return rate, compare it with an actual one, and make optimal strategic decisions about further investing and earnings allocation. In this article we will highlight how budgeting could impact on the business` value, and what are the key advantages in favor of using budgeting system in companies.

**Modern Approach to the Company Valuation**

Nowadays a lot of studies have been conducted, but all of them discuss how to solve this problem from the viewpoint of the stakeholders` and shareholder`s theories. However, there are also some disagreements.

On the one hand, considering the issue about the company`s value, we, firstly, think of its market capitalization, i.e. its share price. However, this thesis, firstly, can be applied only to the publicly traded companies. Secondly, this idea is not supported and confirmed in the modern world because it primarily implies that the aim of any business is profit maximization and increasing of the shareholders` wealth. On the other hand, Stout in his article indicated that the focus only on the shareholders` interests can lead to undesirable consequences for a business (Stout, 2013).Today fewer people are guided by this theory, and the focus is shifting away from maximizing a share price to satisfying interests of all stakeholders in corporations. Despite the fact that famous economists had argued the profit maximization for owners is the only proper goal of any business, studies have not confirmed the shareholder primacy might have positive impact on and even enhance corporation`s performance. In the scope of the law, Stout claimed that the shareholder primacy is a choice of management rather than a requirement needed for execution. There are three main misconceptions connected with this: ownership, residual claim right, and the power to control over the executives and directors in corporations. According to this concept, Stout presented the idea that to serve different interests another approach should be used. Thus, if managers, executives, and shareholders follow the same goal and take efforts for making the company flourishing in the long run, the profitability certainly will be achieved, and the stakeholders' personal interests will be satisfied as well.

**Budgeting and Company Value**

Despite the strong arguments for the stakeholder theory consistency, there are other factors that could influence the final result of investment valuation. In the scope of four main functions of management (planning, organization, motivation, and control), the budgeting refers to the fundamental one – planning (figure 1).

Since planning is a basis for other business processes, it should not be ignored by the company`s management. Based on the stakeholder theory, the main goal of any business is maximization of its stakeholders` wealth, but primarily its owners. According to this, the owner always wants to know what are the cash inflows and outflows; thereby, budgeting system could give a clear answer for this. Having planned the revenue and costs, we find out the sum of forecasted income or loss within considered time span. This information will be a fundamental one for preparing a cash flow statement.

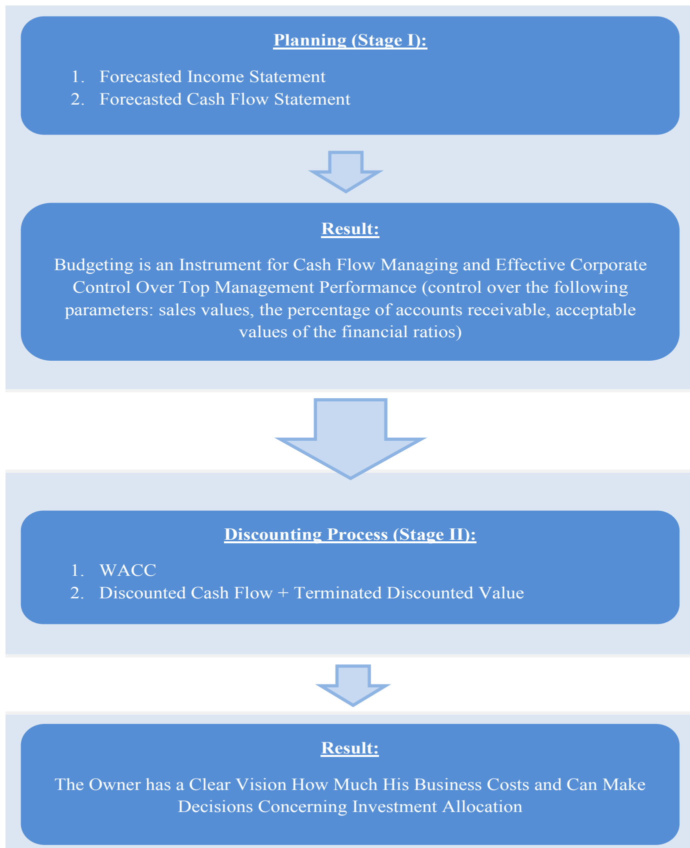


Figure 1. Connections Between Budgeting and Company Value

According to Damodaran there are three main approaches to calculate company`s value regardless of its business sphere, sources of financing etc.: cost based method (net asset value), free cash flow models, and market based valuations (Damodaran, 2008). One of the widely used investment evaluation models is free cash flow model. According to this, in order to know how much money the company will bring to its owners, we have to pay attention mainly to the total sum of cash (general formula: retained earnings plus inflows from financing and investing activities). Having analyzed forecasted cash flows and discounted them to a certain time moment, we gain an understanding how much this company costs. However, it is also necessary to remember that forecasted cash flow should be divided into two ones: cash flow considered within a planning horizon and terminated cash flow that takes into consideration future growth beyond set time frames. To calculate a discount

rate it is necessary to define the company`s capital structure. In most cases companies raise both equity and debt, so the discount rate should include required return rates on equity and debt (Brooks, 2013).

Since the WACC equation is presented in the following way:

$$WACC = \frac{Equity}{(Debt + Equity)} \times R_E + \frac{Debt}{(Debt + Equity)} \times R_D \times (1 - Tax), \quad (1)$$

where Equity = market value of the firm's equity;
Debt = market value of the firm's debt;
Re = cost of equity;
Rd = cost of debt;
Tax = corporate tax rate.

The main problem is connected with calculations of the required return rates for both equity and debt ($R_E$, $R_D$). While computation of debt cost does not bring any major difficulties, we should take a close look at required rate of return on equity. For example, finding the required return rate on equity can be done by using the capital asset pricing model (CAPM). The CAPM will require that three main inputs will be found:

- Risk-free rate;
- Beta;
- Expected market return rate.

If the company is not traded on a stock exchange, we have to look for a similar company (analogue) to discover unlevered beta value (the value excluding capital structure of the analogue) and then make an adjustment for a necessary capital structure (compute relevered beta for considered organization) (Figure 3). Thus, it is one of the methods to calculate the value of the company that is not a publicly traded one.

$$\beta \text{ unlevered} = \frac{\beta \ levered}{(1 + \frac{Debt}{Equity})}, \quad (2)$$

$$\beta \text{ relevered} = \beta \ unlevered \times (1 + \frac{Debt}{Equity}), \quad (3)$$

Then, when the final value will be found, top management based on it could make further strategic decisions.

**Conclusion**

The concept of investment valuation recently achieved great popularity.

Despite the number of approaches for investment valuation, one of the most important is that refers to the free cash flow evaluation because it dis-

covers the sum of money that stakeholders can earn after meeting all liabilities (Jordan, Miller, Dolvin, 2012).

Budgeting is not only a useful instrument for cash managing, but also it is great tool for top management to control employees` effectiveness. Proper long-term planning is a key factor in making optimal strategic decision for company`s owners, and, as a result, it is one of the most significant factors that could finally have an impact on business` evaluation.

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