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THE VALUE - CREATING FINANCIAL MANAGEMENT

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ABSTRACT *- Nowadays, the creation of value represents a new creed for the managers of the great companies, in parallel with constituting a means for the estimation of their success in financial management activities. The paper aims at localizing the concept of the value creation within the modern financial theory, by discussing the origin of value creation for the shareholders, and the modalities of its quantification, by means of indices viewed as performance standards in financial management.*

Key Words: creation of value, modern financial theory, performance standards

REZUMAT – Gestiunea financiară creatoare de valoare. *In prezent, crearea de valoare reprezintă o nouă responsabilitate pentru managerii din marile companii, în paralel cu constituirea unui mijloc de evaluare a succesului în activităţi financiare. Lucrarea are ca scop localizarea conceptului de creare de valoare în cadrul teoriei financiare moderne, privind originea creării de valoare pentru acţionari şi modalităţile cuantificării acesteia prin intermediul indicilor, consideraţi standarde de performanţă în managementul financiar.*

Cuvinte cheie: crearea de valoare, teoria financiară modernă, standarde de performanţă

INTRODUCTION

In the second half of the years 80, because of the differences noticed between the potential value of some companies and their quotation on the real market, the theory of creating value for the shareholders issued. The explanation for such differences was the inefficient management of the capital entrusted by shareholders, and the fact that the managers were firstly preoccupied to increase their prestige and authority, the development of the company representing only a secondary concern (Pivato et al., 2004).

This theory urged the companies to adopt new decisional systems and value-based management, so that each activity and decision on investment and

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financing problems should create value for shareholders and be warranted by the increase in the value of company.

MATERIALS AND METHODS

The study synthesizes the investigations and comparative analyses presented in numerous national and international bibliographical sources approaching the theme under discussion. For attaining conceptual elucidation and for its further progressive approach, the critical analysis has been combined with the synthetic approach, which allowed an original perspective on the quantification methodology of the created value, proposed by the modern financial theories.

RESULTS AND DISCUSSION

Starting with the ̒90, the globalization of the capital markets, in parallel with the intensification of privatization processes in Central and Eastern-European countries, resulted in asserting the concept of value creation for shareholders in Europe. In many advanced European economies, this theory has influenced not only the company process of management, but also favoured the evolution and modernization of the financial markets and of their regulations in force. Companies have been encouraged to enter the exchange market, and to reorient considerable parts of the private savings towards investments in shares. Consequently, nowadays, the creation of value for shareholders represents the new "*credo*" of the managers from important firms (Dallocchio, Salvi, 2004), as well as the most efficient tool for measuring the success of a company in the field of financial management.

The theory of value creation and orientation towards a value-creating management has not only supporters but also, disparagers, who consider the company as an organization within which values, aspirations, expectations of all the "actors" involved in its activity are mingled. Or, an excessive orientation towards shareholders' payment, to the detriment of the other shareholders, may compromise, on long term, the company's survival capacity, knowing that not always the creation of value for shareholders automatically brings the increase in the company's value, a higher motivation of its employees or economic and social development over the territory where the company is active. The partisans of the creating value theory support the concentration on the shareholders interest, once they assume the highest risk by investing their capital, for a future, uncertain profitableness. The creditors of a company required a safe, not risky remuneration for the invested capital. For limiting as much as possible the risk they took, they required allowances and warrants. In fact, exclusively the shareholders took the risk. The higher the obligation, the higher the risk. Creation of value for shareholders induces a pro-active, competitive mentality, which inspires a long-term balanced development of the company, oriented towards finding new opportunities for value creating and controlling risks.

The speciality literature mentions that the origin of value creation for shareholders lies essentially in a suitable management of the profitableness - risk of the investment projects. The company follows a safe development if promotes efficient investment projects, resulting in considerable treasury flows, able to generate benefit for shareholders, because of selecting the most advantageous combination of financing sources.

The investment process assumes a clear-cut separation between the two types of flows, namely: the negative financial flows, materialized in the "at present" made expenses, for launching the investment project (acquisition of immobilizations and the necessary circulating funds), on one side, and the positive financial flows materialized in the cash flows "of the future", on the other. This temporary difference creates several difficulties in the estimation of the future profitableness of the investment projects, which assume correct previsions of the future *cash flows*, as well as updating of the flows involved. The higher the actual value of the future cash flows (V_0), comparatively with the initial expenses for investments (I_0), and the higher the internal profitableness ratio of the investment project (RIR), comparatively with the cost of the invested capital (r), the more efficient the investment project is, and the lower the risks are, which are related to its acceptance to financing. Consequently, the investment projects for which the net updated value (VAN) is positive, and the internal profitableness rate, by which the actual value of the future cash flows and the initial capital expense ($V_0 = I_0$) become quite close, is higher than the cost of the capital, will grant the highest possible increase of the owners welfare, as follows:

$$VAN = V_0 - I_0 = \sum_{t=1}^{n} \frac{CF_t}{(1+r)^t} + \frac{VR_n}{(1+r)^n} - I_0$$

$$I_0 = \sum_{t=1}^{n} \frac{CF_t}{(1+RIR)^t} + \frac{VR_n}{(1+RIR)^n}$$

where: CF_t - future, available cash flows; VR_n - residual value or cash flow estimated after the period of the investment exploitation is over (by selling/turning to good account of the components resulted from cassation, etc.).

The creation of value for shareholders does not derive exclusively from the development of some new, profitable, low-risk investment projects, but equally from de-investment actions, which, if not performed at the right time, would exhaust the company capacity of creating value or would affect the shareholders' welfare. They are called strategic investments, which create value for the shareholders.

Another source of value creation for the shareholders is the manner in which the company is financed, i.e., the good management of the financial structure - cost of the company capital. The impact of the unit financial structure on its value and on the cost of the capital constitutes a topic of high interest for researchers in finance domains. For evaluating the profitableness of the investment projects and knowing exactly whether the investments create value for the shareholders, one should know the rate at which the aleatory future cash flows will be updated. According to the financial theory, the answer lies in the average cost of the company capital. To calculate the cost of the company capital, one should know its financial structure and the cost of each financing source (Albouty, 2003); the financial structure is calculated according to the market values of own capitals and of financial debts. For the Exchange-quoted companies, the value of their own capitals is given by the Exchange capitalization (*i.e.*, the shares rate of exchange multiplied by the number of issued shares), or by the average value of the exchange capitalizations when significant fluctuations are recorded. In the case of non-quoted companies, the value of own capitals is determined by evaluation processes, based on the value of the re-evaluated assets and of the possible goodwill. In the case of financial debts, the knowledge of their market value assumes different methods, as depending on the nature of the loans. Thus, for the bond loan, the calculation is simple, involving consideration of the market value of the obligations. In the case of loans to be paid over a longer than a year period, one should calculate the actual value of such debts, by updating the flow of the reimbursements, the financial expenses included, as a function of the interest ratio at that moment. The debts to be paid over a shorter than a year period do not intervene in the establishment of the capital cost, being calculated exclusively for the determination of the necessary circulating fund - which represents an utilization of funds for investment projects.

The specialists in management usually apply two main approaches for measuring the creation of value for shareholders, which are standards in the estimation of the performances of a company financial management:

- updating the free cash flow index, viewed as a direct application of the modern financial theory;
- economic value added and market value added, concepts based on the notion of "economic profit", as developed in the economic theory by Alfred Marshall.

Calculation of the free cash flow starts from the information provided by the anticipated profit-and-loss account, established from the expected results of the investment projects. The profit and loss account estimates the sales of products and/or services, as well as the possible additional expenses caused by the investment exploitation. Calculation of the free cash flow is the following:

Turnover
- Variable costs
- Fix costs
- Liquidation
= *Profit from exploitation*

- Tax on profit
= *Profit from exploitation after taxes*
+ Liquidation (Am_t)
= *Cash-flow from exploitation* ($CF\exp_t$)
- Variation of immobilizations at the end of the year
- Variation of the necessary net circulating assets
= *Free cash-flow* (CF_t)

Calculation of the exploitation cash flow leaves aside the financial expenses, the cost of the capital being considered when the updating ratio is selected, which permits to evaluate the profitableness of the investment project independently of its financing mode. The free cash flow expresses the remuneration degree of both shareholders and creditors, after covering the economic growth generated by the investment project. The economic growth (CE_t) or the investment cash flow ($CFinv_t$) is the sum between the variation of immobilizations at the end of the year (ΔIm_t) and the variation of the necessary net circulating assets (ΔACn_t) with the exploitation needs ($D\exp_t$), which achievement made use of certain funds. To calculate the value of shareholders capital, the market value of the financial debts is deduced from the company actual value.

The economic value added (EVA), which is a value-creating index, may be determined from the following models:

$$EVA_t = Ci_{t-1} \cdot (ROI_t - CMP_t)\,;\ EVA_t = NOPAT_t - CMP_t \cdot Ci_t$$

where: Ci_{t-1}- invested capital (net immobilized assets plus the necessary circulating fund), at moment $t-1$; ROI_t- rate of the invested capital profitableness (the $NOPAT_t / Ci_{t-1}$ rate); NOPAT - the net operating profit after taxes;

The economic value added is positive, which means that the company creates value for its shareholders, when the exploitation profit after taxes (NOPAT) is higher than the remuneration expected by the financers.

The companies that take lower risks on the financial market will have a capital cost lower than that of the companies following a more risky investment strategy. The economic value added represents an annual index of managerial performance; consequently, one may not assert that a significant economic value added expresses a long-term creating value policy. The economic value added index represents an efficient criterion for estimating the increase of value for shareholders only when the company is capable of producing value in a regular way. By updating the economic value added, for the whole period, *t,* of the time horizon under consideration, the total value produced by the company for its shareholders, defined as market value added (Dallocchio, Salvi, 2004) may be measured according to the model:

$$MVA = \sum_{t=1}^{n} \frac{EVA_t}{(1+CMP)^t} = \sum_{t=1}^{n} \frac{NOPAT_t - (CMP \cdot C_i)_t}{(1+CMP)^t};$$

Considering the manner in which the two indices are determined, it is obvious that the manager has only a few alternatives for increasing the value of the stakeholders capital, such as: increase in the exploitation profit after taxes (NOPAT) and in profitableness (NOPAT/CA), by a better organization of the activity, introduction of innovative technologies, higher flexibility of the company to the market requests, application of new informational technologies for reducing the administrative costs, as a result of the achievement of new products and activities; a better control of the capital invested in exploitation, more exactly a more reduced need for circulating funds by a more efficient management of the existing stocks, which influences the suppliers payment terms and the clients cash terms; better utilization of the immobilized assets, by borrowing instead of buying non-strategic immobilized assets; minimization of the average cost of the capital, which means optimization of the company financial structure.

CONCLUSIONS

According to the traditional accountancy concepts, the value of shareholder capital was represented by the value of the net capital that is the difference between the total assets and debts, which is an old-fashioned notion. The modern financial outlook considers the value of the stakeholders' capital as being represented by the value of the economic capital, *i.e.*, the updated sum of the benefits the company has to grant to its shareholders.

A sustainable maintenance of the equilibrium specific to the management of a company (*i.e.*, the balance between the incomes and the expenses of the exploitation activities; the balance between the structure of the investments and the financing sources; the monetary balance) represents the condition of maximizing the enterprise value and the equity value.

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