FROM CORPORATE FINANCE TO COMMERCIAL FINANCE: COMPARING THEORY WITH PRACTICE

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ABSTRACT: *In this paper we intend to underline the importance of corporate finance rules and principles for conducting a profitable business venture, and we try to corroborate them with specific financial operations which occur during ordinary commerce activity and financial management. The paper focuses on how the profit maximization theoretical paradigm is actually implemented within specific corporate departments, and an important emphasis is put on the risk-return relationship, showing how this is a key aspect, responsible for increasing profitability for different corporate investment projects. We show and analyze the case of British American Tobacco.*

KEY WORDS: *corporate finance, return, risk, commercial finance, shareholder, manager.*

JEL CLASSIFICATIONS: *G30, G39.*

1. INTRODUCTION

The current paradigm of corporate finance and governance requires managers submit their "best" effort in order to maximize profit, and, if one wants to penetrate a deeper understanding of value - employed managers converge their actions for maximizing shareholder wealth. Within this existing framework, theoretical exceptions included, corporations are brought into legal existence and produce cash-flow for the owners during their life-period. Based on those inherent principles, we show how the theoretical framework of corporate finance matches with the practical structure of commercial finance, by bringing evidence extracted from the basic financial documentation and various financial reports.

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2. MAXIMIZING SHAREHOLDER WEALTH

Suppose an entrepreneur decides to start a company to produce some sort of goods. In order to achieve this he hires managers to buy raw materials and also he assembles a workforce that will produce and sell finished goods. In the language of corporate finance, he is making an investment in assets such as inventory, machinery, land and labor. The amount of cash the entrepreneur invests in assets must be matched by an equal sum of cash raised by financing. When the investor begins to sell the finished goods, the firm will start to generate cash. This is the groundwork of value creation. The purpose of the company is to create value for the owner. The value is encapsulated in the framework of the firm's *balance sheet model*.

The corporation is a fictitious legal person created by the state. It does not stem from a natural right but it exists only by the indulgence of the state (Samuelson, 1970, p.85). This entity, as distinct from its owners, can be sued in court and can sue. Any manager of the corporation is strictly limited in his legal ability to act as agent for the owners and commit them financially.

It is important to emphasize the idea that the sole objective of a company is to produce value and wealth for its owners. So, to this respect, any other operational objectives are subject to ***maximizing shareholder wealth***. Any activity involving sponsorships, donations, extra benefits given to employees, etc. will be carried out conditioned by this major objective of corporate finance and governance.

Profit maximization would probably be the most frequently cited objective, but it inherently implies inaccuracy. Are we discussing this year's profit? If so, then we should consider reducing maintenance routines, letting inventories run down, and other short-run cost-cutting measures that increase current profit. But none of these options are viable for long-term corporate development. Therefore, based only on basic observations, it would follow that the financial manager acts in the shareholders' best interests by making decisions that increase the *market value of the stock*. This should be the appropriate goal for financial management: ***maximizing the current value per share of the existing shares*.**

For starting a business venture, a relevant question is in what type of long term assets the firm should invest. This question concerns the left side of the balance sheet. The types and proportions of assets the firm requires are given by the nature of the business. In order to describe the process of making and managing expenditures in long term assets, financial theory and practice uses the term *capital budgeting*. Ideally, all the investment projects that enhance shareholder value should be pursued by the corporate management.

The subsequent question would be how the firm can raise cash for required capital expenditures. This question concerns the right side of the balance sheet. The answer to this question involves the company's *capital structure*, which shows the proportions of the firm's financing resources (Ross, et al., 2010, p.46) from long term debt, and stockholder equity, to current banking loans.

A fundamental characteristic of a balance sheet is that the total sum of assets always equals the total of liabilities plus shareholder equity. The totals of the two sides of the balance sheet are always equal because these two sides are merely two views of the same business property (Meigs & Meigs, 1989, p.21). The total claims of the owners plus the total claims of the creditors equal the total assets of the business, namely the projects of this business venture.

From financial analysis perspective, short term cash-flow issues stem from a certain mismatching. A huge issue the financial managers have to deal with is short term operating cash-flows management. Because there is often a mismatch between the timing of cash-inflows and cash-outflows during operating activities. Furthermore, the amount and timing of operating cash-flows are not known with certainty. Financial management must attempt to manage the gaps in cash-flow. From a balance sheet perspective, short-term management of cash-flow is associated with a company's *net working capital*, which is defined as current assets minus current liabilities.

In large enterprises, i.e. corporations, financial activity is usually associated with a top officer of the firm, such as the vicepresident and chief financial officer, and some smaller officers. The treasurer and the controller are reporting to the chief financial officer. The treasurer is responsible for managing cash-flows and capital expenditure decisions, and for constructing financial plans. The controller handles accounting functions, which include cost and financial accounting, information systems and taxes.

3. RISK AND RETURN. THE DUAL PARADIGM

The simplest approach to return, involving company finances, is related to capital structure, namely corporate stocks. Usually, for capital market fundamental analyses, financiers compute the *expected return* of specific stocks. One of its important determinants is the industry in which a company operates. This is the return that an investor expects a stock to yield over a given period. Of course, because this is only a prediction, the actual return may be either greater or smaller. As concrete quantification, an individual's expected return may simply be the average return per period, earned in the past. Alternatively, the expectation may be based on detailed analysis, on some computer-based model, or on inside information.

A similar methodology is applied when financial managers need to appraise assets' value in capital budgeting. The expected return may consequently serve as the *opportunity cost of capital*. Nevertheless, corporate return itself (historical and expected) is determined for various financial analysis purposes. The mathematical method is pretty much the same in all the cases. The calculation implies dividing the yield (or result, profit, etc.) by price (investment, cost, etc.). The most utilized form of corporate return is the ROA, i.e. the return on assets. It is commonly used by firms and notably by banks (Gherghina & Crețan, 2012, p.172).

In any market economy, obtaining the best results with the available means is the key issue of any economic agent, i.e. the main goal pursued in the development of any activity, and therefore investment. This objective increases in value and importance when, in parallel with the continuous growth of society's needs, we witness a normal process of diminishment of available material resources. Therefore, an important part is always played by the concept of *economic efficiency* through which we envision the link between the resources allocated for the performance of activities, and obtained results (Vasilescu, et al., 2000, p.76).

The other facet corporate economic efficiency has to factor in is the *risk*. This is normally defined as the volatility of performance indicators, or of return itself. Risk is the variability, namely the volatility, of any economic result. One of the most common approaches to risk is *variance*, which is a measure of the squared variability of a specific return value (of a stock, for example) from the expected return. And there is also the *standard deviation*, computed as the square root of this variance.

With regards to specific stock return and risk, there is a statistic measuring the interrelationship between two stocks, i.e. the *covariance*. Alternatively, the same relationship can be translated in terms of the *correlation* between stock returns (Stancu & Stancu, 2012, p.87). Also, to address the volatility relationship between any stock and capital market in general, the *beta coefficient* is computed. In this area, financial theory and practice offers multiple optimization models for portfolio asset allocation (market model, Markowitz model, CAPM, etc.).

Furthermore, the revenues of some companies are quite cyclical. That is, these firms perform very well in the expansion phase of the business cycle and perform poorly in the contraction phase. Empirical evidence suggests high-tech firms, retailers, and automotive firms fluctuate with the business cycle. Companies in industries such as utilities, railroads, food, and airlines are less dependent on the business cycle. Because the beta coefficient measures the receptiveness of stock return to market return, it is not surprising that highly cyclical stocks have high betas (Ross, et al., 2010, p.455) However, it is beneficial to stress that cyclicality is not the same as variability. They are different concepts, both involving risk.

4. STAKEHOLDERS AND FIRM VALUE

The corporation stands for a distinct way of organizing the economic activity of many individuals. This is in fact an evolved form of economic activity. A basic problem of any company is how to raise cash. Cash will eventually stand at the base of the company's value, especially if we are to point out the most natural means of computing corporate value: the *discounted cash-flow method*. This requires predicting *free cash-flows* and opportunity cost.

The corporate form of conducting any business, namely any business which is based on organizing the firm as a corporation, is in itself the standard arrangement for solving problems encountered in raising large amounts of cash. The value created in the corporation, i.e. the total value added, will subsequently be shared between all the stakeholders who participate in the economic life of the enterprise. If we ignore employee remuneration, then all the other stakeholders will receive cash based on the EBITDA margin (Stancu, 2007, p.727).

An interesting case for discussion is a particular form of organizing the business, the cheapest form in fact, i.e. the *sole proprietorship*. Raising cash will imply some peculiarities. It may be useful to analyze differences between a corporation and a sole proprietorship. The latter: pays no corporate income taxes; has unlimited liability for business debts and obligations, as no distinction is made between personal and business assets; its life is limited by the life of the sole proprietor; and because the only money invested in this venture is the proprietor’s, the cash equity that may be raised by the sole proprietor is limited to the proprietor’s personal wealth.

Notably, all of these peculiarities do not apply to a corporation, so raising money will imply greater effort in this case. Because of size, a corporation will usually use more debt credit to finance part of its investment projects, namely the ones that imply lower risk. For high risk projects, equity financing will be the solution.

The corporation manages collaborative relationships with a multitude of stakeholders: employees, creditors, stockholders, suppliers, clients, etc. They all "participate" in the economic process of producing goods and value. Therefore they influence firm value and "value" should "return" to them by various cash-flow forms. In previous studies, we had shown that, among all corporate stakeholders, the employees play a crucial role in value creation, as they are responsible for sustaining genuine value-adding activities (Stănculescu & Mitrică, 2015, pp. 93-96). This is also supported by the co-determination model of corporate governance which accepts employees as defining a distinct corporate governance level. In another study, we emphasized the need for a new paradigm (Stănculescu, 2018, pp. 45-48) in corporate finance and corporate governance, one that focuses mainly on cash-flow, the manner it is generated and by which stakeholder category.

5. CASE STUDY: BRITISH AMERICAN TOBACCO

To illustrate the principles and rules of corporate governance mentioned above, we present the commercial finance of British American Tobacco.

British American Tobacco as we know it today, was founded in 1902 by joint venture between UK’s Imperial Tobacco Company and the American Tobacco Company of the United States. James ‘Buck’ Duke becomes the first chairman of the new company with corporate development strategy meant to raise de company by having a superior product, hiring the best people, pricing it as low as possible and mechanizing the production (www.bat.com).

British American Tobacco (BAT) is one of just 13 companies to be recognized as a Global Top Employer 2018 by the Top Employers Institute. “The Group’s 2018 annual and sustainability reports underline BAT’s commitment to ‘transforming tobacco’ by offering an unrivalled suite of potentially reduced-risk products to adult consumers” (www.bat.com). In 2017, BAT acquired Reynolds American Inc. and thus becomes the second largest tobacco company in the United States. The purpose of analyzing British American Tobacco financial statements is to observe the following points:

- how did the company acted in order to grow the shareholders wealth;
- cash-flow;
- shareholder return;
- stock price evolution.

As mentioned early in the paper, the sole objective of a company is to grow its wealth for the shareholders by using different growing strategies that can depend on several factors like: the *leadership team*; the *dimension of the business* and *market trends*.

Based on each company's strategies there can be several options to grow the business:

- **vertical growth** – the company takes complete control over one or several steps in the production or distribution of a product;
- **horizontal growth** – the company takes over business activities that are at the same level of the value chain in similar or different industries (https://www.mbacrystalball.com).

The actions taken to grow the company can be several, like: product innovation, market penetration or gathering good work force. They may be measured, from a financial point of view, by observing the particularities of the balance sheet. Any balance sheet follows the same rule: Assets = Liabilities + Equity. This general rule can determine several important points for a company, like: asset structure, how much indebted a company is and how much remains for the owners after subtracting all the debt from the assets.

British American Tobacco is a multinational business with a total asset of 146,324 MN GBP (from 2018 Balance sheet). Looking at the 2018 balance sheet provides us a much clearer view over the company's assets, since IFRS 16 was implemented in 2019. By analyzing the asset structure, one observes the company has 133,687 MN GBP worth of non-current assets, out of which 124,013 MN GBP represents intangible assets (www.bat.com). This means that over 92% of the total non-current assets and over 84% out of the total assets are intangible assets.

According to David Post, leader of Sustainable Accounting Standards Board's (SASB), the intangible assets are a direct driver of company value. While a couple of years ago, intangible assets were filling around 20% of the balance sheets, today's markets have proven that both the investors and an organic growth are responding better to a bigger share of the intangible assets thus resulting in increasing this percentage to over 80%. This represents the value created by the company through intellectual property, brand, research and development and the list can go on (www.forbes.com).

From 2017 to 2018 the company had increased the total assets value from 141,054 MN GBP to 146,342. This implies a 3.74% increase of total assets, out of which intangible assets increased with 5.28% and the non-current assets with 5.19% (www.bat.com).

This shows that *British American Tobacco is focused on value creation and increasing the shareholders' wealth by performing on a competitive and regulated market.* All the value growth shows only a small picture out of the company's objectives and purpose; besides "rewarding" the investors, a business should be capable of having a constant and suffice cash-flow to cover all the expenses including, but not limited to: current expenses, rents, overheads, bills to suppliers, research and development, and many others.

How is the ability of the company to generate cash measured? By looking at the available free cash-flow from the cash-flow statement. This is a measure of how much cash a company will still receive, after accounting for the necessary working capital and capital expenditure, thus showing the company's financial performance and health (www.wallstreetmojo.com).

British American Tobacco has 7,684 MN GBP free cash-flow reported in 2018, with 10,295 MN GBP from Net cash generated from operating activities and -2,661 MN GBP composed of: dividends paid to non-controlling interest, net interest paid, net capital expenditure, trading loans to third parties and others (www.bat.com). This represents a growth of 120% of free cash-flow from 2017 to 2018, from 3,500 MN GBP to 7,684 MN GBP, explained also by the acquisition of Reynolds American Inc. (RAI), which was consolidated into the group reporting and not reported as a joint venture.

All of the above data will eventually be summarized by the investors and shareholders into one financial measurement: dividend per share. Once the company has managed to have retained profit and decided (based on management and board decisions) not to reinvest it all, it pays dividends. This metric shows if the investment was a profitable one or not, the amount paid by the company through dividends will translate into shareholder income.

We observe the dividends per share increased to 203 p, that means 4% prior to last year. This is the sole purpose of an investor, same as the company is looking to increase the wealth of the shareholders, the investor follows the same approach: to increase the value of his/her portfolio. British American Tobacco is growing both shareholders' value and business dimension by using in 2018 a horizontal strategy and by buying Reynolds American Inc., managing to generate sufficient cash to operate the current activity and to get the market's trust. This is translated into share price, which decreased in 2018 affected by acquisition of RAI, but with a rapid growth of 10%, from 2479 GBP/Share on the 2nd of Jan '19 to 2767 GBP/share on the 3rd of June '19.

6. CONCLUSION

To conclude, by taking any example of corporation, be it BAT, detailed financial analysis will prove the fulfillment of corporate finance principles, by means of the actual "figures" provided by commercial finance. The balance sheet analysis, the free cash-flow reporting, the dividends paid, etc. all of these financial data will reinforce the current corporate finance paradigm. To this respect, we had shown basic financial insight of British American Tobacco and explained its growth from the commercial finance perspective.

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