Purposes and contents of Corporate Finance

"Business is a profession that often requires almost as much knowledge and as many skills, such as knowledge of law or medicine, but it also requires that one possess money" - Walter Bagehot (1826-1877)

Summary

1. Finance

1.1. The word "Finance"

It has entered the vocabulary of each of us due to a film production that associates the world of finance with the "screaming enclosures" of the stock exchanges, bank *vaults* , Wall Street skyscrapers as well as bank managers with cigars and gaiters. In addition to these references, which come from the world of entertainment, we also often associate it with the Guardia di Finanza which represents, "most of the time", an unwelcome visitor and a real "bogeyman" for the business community. This handout does not deal with entertainment finance or even with the Financial Police. Instead, it deals with "Corporate Finance", which is not only a theoretical but very operational discipline because the entrepreneur's abilities and hopes to do his job by "optimizing money management" are based on it. In summary, Corporate Finance is "the set of techniques and skills that every company dedicates to the management of money resources".

1 .2. What is Corporate Finance?

Suppose you decide to create a hotel. For this purpose you will have to organize a workforce that allows the provision of the hotel service. In the language of Corporate Finance you are making an investment in assets such as warehouse stocks, machinery, equipment of various types, personnel, etc. The amount of money invested in such activities must coincide with the money raised through financing. When you start providing the service, your company will start generating cash. This is the basis of "value creation". The purpose of the business is to create value for your benefit, i.e. for the owner's benefit. The value emerges within the simple balance sheet framework of the company.

Suppose we want to take a look at the financial situation of the company and its activities at a certain point in time. Figure 1 shows a graphical conceptualization of the balance sheet and will help us to penetrate the world of Corporate Finance.

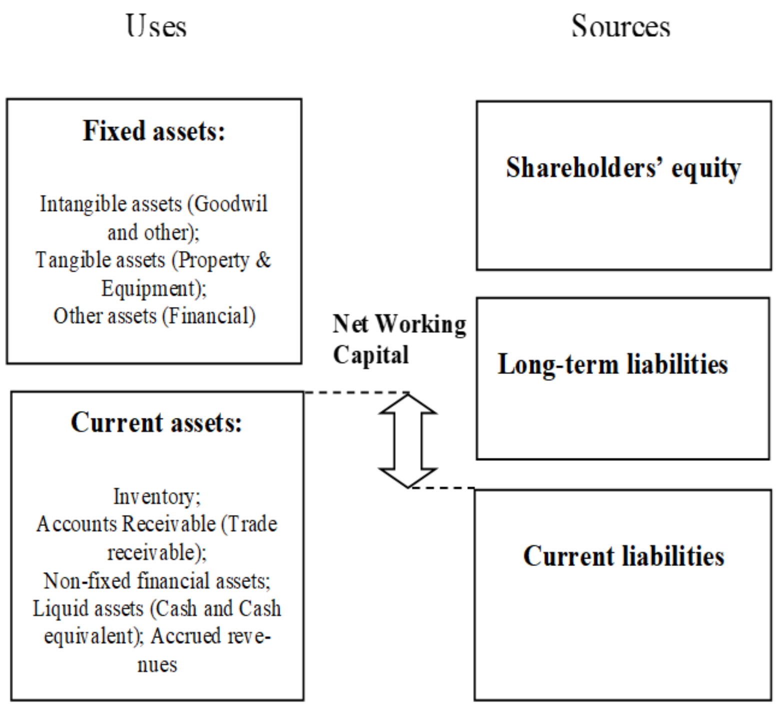

Figure 1. Graphic conceptualization of the balance sheet

The company's assets (Use) appear on the left of the balance sheet and are divided into fixed and circulating. The first are those destined to last over time, such as real estate. Some of these fixed assets are tangible, such as plant and machinery. Others are intangible, such as patents, trademarks and the quality of its management. The other category of assets, working capital, is made up of short-lived ones, such as warehouse stocks (inventories). For a company, such as one operating in the tourism sector, inventories are mostly represented by production factors rather than the finished product (as for companies operating in traditional sectors) as they provide services.

Before a company can invest in a business, it must have raised the necessary capital for the investment. The forms of financing are indicated on the right side of the balance sheet (Sources). A business will issue (sell) certificates called *debt* (loan agreements - bonds) or equity securities (or equity shares, if partnerships). Alternatively, the company can turn to the banking sector. Just as assets are classified as short or long term, liabilities are also divided according to the same criterion. Short-term debt is called a current liability and consists of loans and other obligations that must be paid off within a year. Long-term debt is debt that does not need to be paid off within a year. Share capital represents the difference between the value of the company's assets and debt. In this sense we speak of a residual right on company activities.

From the company's balance sheet it is easy to observe the reasons why Corporate Finance can be seen as the study or, better yet, the answer to the following three questions:

1. In which long-term assets should the company invest? This question concerns the left side of the balance sheet. Naturally, the nature of the business tends to influence the proportion of various asset classes it requires. We use the term “capital budgeting” to describe the process of selecting and managing long-term investments.
2. How can the company obtain the money needed to cover the investment? This problem affects the right side of the balance sheet. To answer this question, it is necessary to call into question the financial structure, i.e. the division between short and long-term debt (Debt) and equity (Equity).
3. How to manage short-term operating cash flow? The issue affects the upper part of the budget. There is a different temporal sequence between monetary income and expenditure during the normal activity of the company. Furthermore, the amount and timing of operating cash flows are not known with certainty. The company's *Chief Financial Officer* (CFO) must try to best manage cash flow imbalances. From an accounting perspective, short-term cash flow management is associated with net working capital, defined as the difference between current assets and liabilities.

The issues just listed therefore explain the decision-making content of the finance function:

« *Finance is the corporate function that deals with the acquisition and use of the capital necessary for carrying out the production process and for the realization of long-term investments, choosing, among the available forms of financing, the least onerous and most appropriate to the needs of the company* ".

Therefore, the finance function carries out support activities in the evaluation and monitoring of capital dynamics (Acquisition and Lending) and such as to allow financial choices to be appreciated in compliance with the conditions of lasting economics.

«The conditions of "lasting functionality" of the company can be observed according to different evaluation perspectives within which, despite significant conceptual and methodological differences, some fundamental parameters can be identified with respect to which decisions concerning the dynamics can be evaluated of capital. These parameters must allow us to appreciate the financial choices in relation to:

1. Their ability to produce wealth,
2. Their long-term financial viability,
3. To short-term financial equilibrium."[1]

1. Regarding the ability of a specific decision, regarding the use or provision of financial means, to produce wealth for the shareholder (member), it is necessary to introduce the concept of an *accounting approach* rather than a *value (or economic) one* . In fact, if the first (accounting) measures the change in shareholder wealth in terms of changes in net balance sheet capital, the value (or economic) approach takes the value of risk capital as the cornerstone of business decisions. ; this takes the form of considering the *time factor* and *risk as discriminating factors, in the evaluation of the aptitude of capital to produce wealth* . These concepts will be explored in depth in other handouts.

2. If the ability to produce wealth is an essential requirement in the evaluation of capital dynamics, the choice of the financial structure is equally fundamental, i.e. the composition, i.e. the "weight", of the individual sources of financing: Liabilities (Debt) and Net Worth (Equity). In order to obtain the optimal financial structure it is necessary to connect the opportunities offered by the financial market with the structural and functional characteristics of the company. Determining the optimal structure requires examining several variables:

- The company's sector of activity;
- The legal form;
- The dimensions;
- The characteristics of the production cycle;
- The opportunities offered by the financial market;
- The cost and tax treatment of the different forms of financing;
- The type of requirement to be financed.

In choosing sources of financing, a very important variable is the analysis of the type of requirement to be financed and, in particular, the analysis of the existing relationships between uses and sources of financing. In fact, in order to guarantee management balance, the financial resources (those used) must be "homogeneous" with respect to the type of requirement to be covered. If the requirement is intended for short-term investments, the sources from which the company draws must be "homogeneous" with respect to the type of requirement to be covered. If the requirement is intended for short-term investments, the sources used by the company must be correspondingly

[1]Source: Brusa, Guelfi, Zampogna, *Finanza d'impresa*, Editore ETAS – Seconda Edizione, 2001.

short-term. If, however, it is intended for the purchase of capital goods (e.g. fixed assets), the sources must be long-term.

3. As anticipated in the second point, temporal homogeneity is a relevant variable in the evaluation of capital dynamics, both long and short term, and an essential condition for the company to survive. Figure 2 represents the interdependence between Uses and Sources.

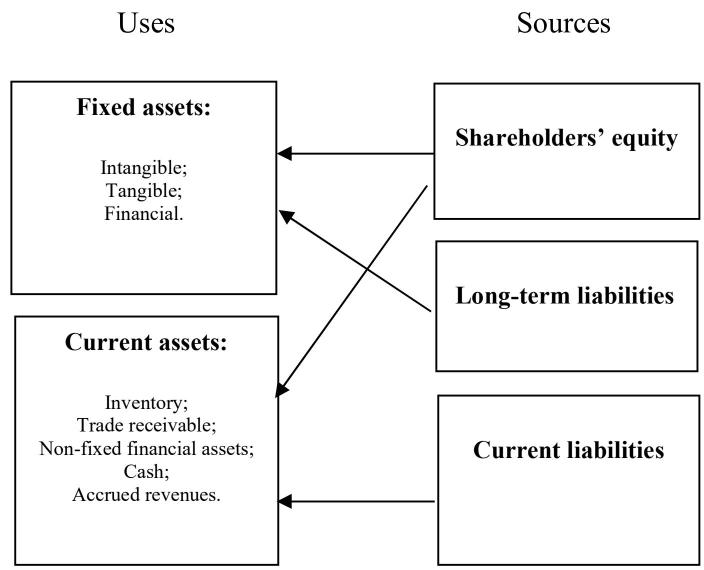

Figure 2. Sources-Uses interdependence

1.3. Financial strategies

« *They represent the long-term decisions and actions that the company carries out in choosing forms of financing, taking into account the financial resources available within the company itself and the opportunities offered by the financial market, in accordance with the company mission* » .

The financial strategy of a company depends on numerous variables, such as: the structural and functional characteristics of the production combinations created, the relationships between the ownership structure (shareholders), management and company objectives, the availability of financial resources and relationships with external financiers.

For each strategy it is possible to identify an *object* and an *objective* .

The object of financial strategies are choices regarding debt, support of investment processes, remuneration of invested capital, management of liquid assets.

The objective is, however, depending on the financial and economic situation of the company:

- ✓ *The achievement of financial balance* , represented by the ability to meet with one's income the payment obligations undertaken and the investment needs that arise over time;

- ✓ *The recovery of financial equilibrium* , if the company is temporarily unable to meet its commitments with the financial resources at its disposal;
- ✓ *The long-lasting maintenance* of financial balance;
- ✓ *The optimization of financial-asset management* , in the event that the company generates surplus liquidity that must be temporarily invested.

Financial strategies, despite having the optimal management of financial resources as their main purpose, increasingly concern the making of decisions that involve the entire company system.

According to the theory of creation of economic value, they must be aimed at guaranteeing competitive returns to own capital through the evaluation of production combinations, separating those that generate value from those that destroy it.

From a value creation perspective, the company must be able to generate profits (returns) higher than the cost of the capital used to make investments in productive activities. By operating in this way, the company increases the economic value of the capital and creates wealth for the subjects who provide *their own capital* (entrepreneur or partners). An indicator capable of measuring the value performance of the company is the EVA (*Economic Value Added*)[2]. This ratio indicates whether the return on the capital used by the company exceeds the cost of the capital itself.

Financial strategies must therefore have the optimal allocation of financial resources as their objective: strategic areas that create value will be developed (those that use less expensive resources compared to the return they produce), while investment projects that destroy value will be eliminated (those for which the cost of capital is higher than the return).

2. Why is Corporate Finance important?

2.1. How to respond

To answer this question we must first outline two types of problems encountered in the financial field:

1. First, the entrepreneur in running his business spends money to purchase various types of real assets, such as factories, plants and machinery. Decisions regarding which specific assets to buy (or which to invest in) are “investment decisions”.
2. The second type of problem concerns the way to obtain the money or credit necessary to make the investment. There are various ways of accessing money. The entrepreneur can borrow it, by arranging for a loan with a bank or by placing debt securities (long-term bonds) on the market, or he can raise it by

[2]EVA is a company performance indicator capable of measuring the company's ability to generate profits. Therefore, this ratio is consistent with the company's objective of maximizing shareholder value. This parameter is obtained by subtracting the cost of invested capital from the operating income produced by the company. In other words, EVA represents the difference between a company's net profit and the cost of capital invested to generate that profit. This measure is useful for evaluating whether a company is generating added value greater than the cost of invested capital. A positive EVA indicates that the company is creating value for shareholders.

issuing new shares of stock against money. In both cases the entrepreneur gives up sheets of paper (called financial liabilities) the value of which is based on the rights they confer on the profit generated by the company's real activities. Decisions relating to the methods of raising money are "financing decisions".

The problems mentioned and relating mainly to two important decision-making moments for the survival of the company, reveal the importance of Corporate Finance in business management. In fact, corporate finance studies the dynamics of capital in the context of business management, carrying out the task of orchestrating the entire problem relating to the investment (Use) and acquisition (Sources) of financial resources. In this regard, Figure 3 provides a summary description of the dynamics of capital.

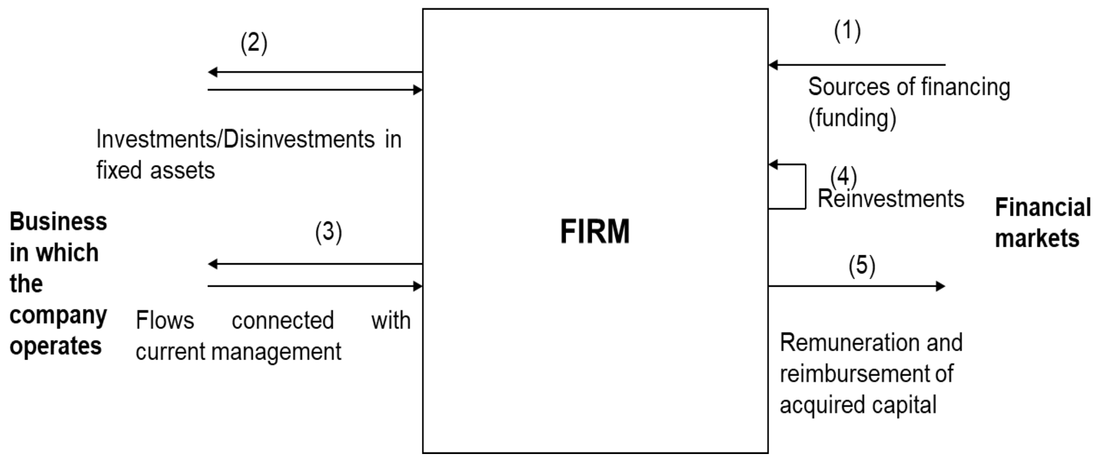

Figure 3. The components of the dynamics of capital (***Source*** **: Brusa, Guelfi, Zamprogna, 2001,** ***op. cit.*** **).**

Business management is, therefore, a system of capital flows, structured as follows:

- *FLOW 1 – SOURCES* . Procurement of financing means (shares, bonds, mortgages, etc.).
- *FLOW 2 – USE* . Investment in fixed assets (tangible, intangible, financial).
- *FLOW 2 – SOURCES* . Disinvestment of fixed assets (tangible, intangible, financial).
- *FLOW 3 – USE* . (Capital) resources generated by current operational management, the latter understood as a set of repetitive operations linked to the typical activity of the company (liquidity, trade receivables, receivables from the treasury, inventories, accruals and deferrals , etc.).
- *FLOW 3 – SOURCES* . Capital resources absorbed by current operational management, the latter understood as a set of repetitive operations linked to the typical activity of the company (trade debts, debts to the treasury, debts to employees, debts to social security institutions, severance pay fund, etc.).

- *FLOW 4 - INCOMING* . Net inflow originating from the positive operating result which is reinvested in the company.
- *FLOW 5 - OUTPUT* . Net outflow originating from the positive operating result which is intended to remunerate and reimburse previously acquired capital.

In light of the above, la Finanza Aziendaleit is a discipline to support those (managers of the finance function - CFO -, administrators, entrepreneurs etc.) who must make decisions concerning:

- ❖ The volume and composition of the means invested (USE);
- ❖ The provision of financial resources (SOURCES);
- ❖ The choices relating to the distribution or reinvestment of the flows produced by management;
- ❖ The balanced governance of SOURCES flows and USES flows.

To this end, la Finanza Aziendaleit provides a series of assistive tools in making decisions relating to the governance of capital and which can be aggregated in two fundamental logics, one inspired by the accounting model of business management, the other inspired by the value model.

The first, of an accounting type, examines the balance sheet, the cash flow statement and the income statement in the evaluation concerning the dynamics of capital, while the second, that of value, takes into account the financial value of time and risk.

3. Corporate finance. How is it studied in business schools today?

3.1. Five fundamental themes

Business schools provide their corporate finance courses today focusing on five, let's say dominant or fundamental, topics, broken down as follows:

1. Business investment decisions.
2. Corporate financial structure decisions.
3. Business & capital market.
4. Business evaluation.
5. Risk management.

Topics, those listed, that any CFO must know and make their own. Let's see them in detail.

3.2. Business investment decisions

To begin, I can state that companies make multiple decisions, including those of acquiring new businesses/assets to achieve growth objectives.

In Finance, investment decisions concern how a company's funds should be invested in different assets with the aim of obtaining the maximum return for investors. In other words, investment decisions concern the company's assets and its investments in fixed and working capital. The idea is that the “sources of enterprise value” are in investment decisions. In this context, long-term investments, especially investments in fixed assets, are fundamental as they guarantee long-term growth. Investment decisions are affected by a series of factors such as rate of return, period, cash flow and so on. The discussion of corporate investment decisions, particularly investments in intangible assets, has attracted the attention of many corporate finance scholars. Over the last decades, studies on investment decisions have focused on intangible assets as they generate greater value for the company. This trend is linked to multiple events/factors, most recently the "digital and ecological transition", which have seen the world of finance and businesses formulate value judgments based on the returns and levels of risk associated with investments in intangible assets . On the "institutional investors" side, investment decisions appear to be increasingly integrated with ESG factors. In this context, ESG integration can be perceived as a compromise between promoting ESG objectives and risk-adjusted financial returns. Indeed, many empirical and academic studies find mixed evidence on the effect of ESG integration on financial returns. For example: 1) The integration of ESG factors can reduce the diversification of portfolios and, consequently, increase risk; 2) ESG factors in investment decisions can have a non-negative or even positive effect on financial returns and risk measures. Generally speaking, institutional investors are expected to act according to the principles of transparency and financial consumer protection, and therefore communicate whether ESG factors and risks are taken into account in their investment decision-making process. A relevant strand of literature has also focused on the impact of ESG scores on the cost of both equity and debt capital, as well as on the related risk, highlighting that companies with good sustainability standards enjoy a lower cost of debt and capital just significantly lower. Therefore, greater attention to ESG factors seems to represent a way of minimizing corporate risk.

3.3. Corporate financial structure decisions

In Finance, companies' financial structure decisions follow the principle of the optimal financial structure which is intimately linked to the concept of cost of capital. The cost of capital is therefore a useful indicator for measuring the value created by the combination of "equity" and "debt". In other words, the optimal financial structure is the one that minimizes the weighted average cost of capital and, therefore, maximizes the value of the company's economic capital. In the literature we find many theories suitable for interpreting the capital structure. I am thinking, for example, of the Modigliani-Miller theorem, the trade-off theories, the pecking-order theories and the market timing theories. In particular, in the literature there are many determinants of the financial structure of companies. For example: taxes, financial distress, agency conflicts, information asymmetries, company size, ownership structure and others. Each of these determinants is proposed by the literature in relation to their ability to maximize the value for the company's shareholders and the company as a whole. I believe that there is no universally valid theory that is able to provide indications on the optimal financial structure. It involves examining the relative advantages of different financial instruments depending on the conditions in which companies operate. In a recent monograph of mine [3]I highlighted that intangible intensive companies are self-financed or resort to equity capital markets rather than banking. This is because banks are not equipped with rating systems suitable for capturing soft information. Looking ahead, financial education, the technological transition and the ecological transition will be crucial in determining companies' financing choices. It is inevitable that the well-known capital risk parameters will be revised precisely in relation to the ability of companies and financial partners to grasp the changes taking place.

3.4. Business & capital market

The capital market can be divided into two broad typologies: public and private. On the public side, there is a lot of debate today about subsidized financing and in particular about PNRR funds. It should be noted that public interventions prove to be concretely useful and effective if addressed only to companies that demonstrate strong resilience, convincing business models and valid income and market prospects. The risk is that of finding ourselves after public support interventions with companies whose post-money value is largely lower than the value of the interventions themselves. On the private side, in recent years the yield crisis, the rise in rates and the disintermediation phenomena have seen the explosion of the so-called alternative finance, such as Private Equity, Venture Capital, Club Deal, Crowdfunding. Personally, I believe that the Italian public segment is undersized compared to that of the main European countries, thus failing to fully play its role as a driving force for the competitiveness of Italian companies and the country in general. The private market, however, is too fragmented, with a prevalence of small operators and an offer that does not cover the different phases of the business life cycle. As a result, companies with strong growth ambitions and significant potential struggle to find investors capable of supporting them, both financially and in the development of industrial projects, especially in the most delicate phases of company growth. I can add that the business credit system still depends to a large extent on bank loans and the use of the capital market is still limited. This is due both to the underdevelopment of non-banking finance and to the limited propensity of companies towards venture capital segments. I believe that these factors hinder the further development of the production system. A more diversified financial system and a more balanced mix of corporate financing sources can help stimulate the economy's potential growth. Equity financing, which takes a long-term approach, can support long-term investments and development plans that carry higher risks. It can also cover investments in intangible assets, such as research and development or innovation, which are strategic for the competitiveness of companies.

3.5. Business evaluation

Company valuation is a fundamental topic of corporate finance. There are many methods, from income and patrimonial ones to financial ones. We all draw from the precursor models of company value analysis in the shareholder vision perspective. I

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[3]QUINTILIANI A. (2016). I*nternal Rating Systems e Soft information. Il ruolo degli intangibili e del contesto territoriale nella valutazione del merito creditizio delle PMI*. Collana di Studi e Ricerche aziendali, Franco Angeli, Milano.

am thinking, for example, of the "Shareholder Value Approach" by Rappaport (1986), or the "McKinsey Approach" by Copeland, Koller and Murrin (1990), or the "EVA" formulated by Stewart (1991), or the " Total Shareholders Return" and the "Total Business Return" of the Boston Consulting Group (1995-1996). No less important are the pioneers of the classical theory of finance. I am thinking, for example, of Hirshleifer's (1958) model of "Net Present Value" or Irving Fisher's "Internal Rate of Return" (1930s). All these models are based on the logic of Discounted cash-flow which stands as the undisputed technique of any movement oriented towards company valuation. I believe that business valuation is strategic not only during well-known extraordinary operations, but also with a view to the continuity of the business. The pandemic has raised levels of attention on the topic of company valuation: owners of shares and debt securities are driven by the desire to quantify the return and level of risk of their investments while companies demand reliable estimates of the value to fulfill its responsibilities towards stakeholders. But the extraordinary volatility of the stock markets and public debt securities, together with the exponential growth of margin debt, have made the processes of estimating enterprise value even more challenging compared to the pre-pandemic period. The value analysis approach has many advantages (pros), but I believe that the "Discounted Cash Flow" (DCF) model needs to be rethought in light of the Covid event. First of all, it must be placed within the strategic business plan; furthermore, it must prove instrumental in quantifying the enterprise value in the various evolutionary scenarios of an uncontrollable exogenous crisis. I believe that the value analysis approach is focal and strategic in this historical moment. Addressing the crisis path by moving "exclusively" from current financial and accounting parameters is risky as these parameters do not necessarily express the merit of the company. Personally, I believe that the company should equip itself with a CFO 2.0, i.e. a manager who does not aseptically deny budget analyzes but who aims to complement the alert indices with future-oriented evaluation metrics, which, as such, they are better suited to capturing company value and, consequently: 1) the sustainability of the business model; 2) the causes of the difficulties that the company is experiencing at the current date; 3) the environmental conditions necessary for the recovery of economic and financial balance; 4) the relationship between pre-money company value (before recapitalization or refinancing interventions) and post-money company value (after interventions).

3.6. Risk management[4]

"Risk management" is one of the corporate processes that aims to protect the company from possible threats, internal and external, capable of jeopardizing its stability.

We are talking, yes, about a process - moreover a continuous, constant process, which accompanies the company's activities starting from its first moments - whose relevance is on the same level as other management paths, such as that of treasury or accounting. "Financial risk" represents the category of risks most immediately per-

[4]QUINTILIANI A. (2021). *L'impresa ai tempi del Covid-19: Pianificare è meglio che sanificare*. G. Giappichelli Editore, Torino.

ceived by companies, also thanks to the recent entry into force in Italy of the new Business Crisis Code. Financial risk, in turn, includes:

- market risk,
- liquidity risk,
- credit risk.

Market risk concerns the performance of markets, which can lead to unexpected price changes.

Even *credit risk* can be said to be, in a certain sense, unpredictable, although in this case with careful management of the customer portfolio - for example - it is possible to mitigate it. Credit risk, also known as insolvency risk, consists of the possibility that the debtor does not fulfill his obligations to repay the capital or pay interest to his creditor within the established deadlines, even if only partially.

Liquidity risk (or cash flow risk) concerns the difficulty in finding the monetary resources needed to meet all the expenses related to business management.

The state of the art sees risk management suffering for the most complex reasons; among these, its limited diffusion in businesses (especially SMEs) and its clearly uninspiring narrative.

I believe that the low diffusion of risk management in companies can be attributed to the mistaken but unfortunately widespread belief that risk analyzes are an obstacle to innovation.

It is worth pointing out that even large companies are far from integrating risk management into their core processes. To give an example, there are still very few large companies that attribute bonuses to CEOs (Chief Executive Officer) based on risk-adjusted performance indices (e.g. "risk-adjusted EBIT"), and the percentage is also very low. of medium-large companies that explicitly adopt risk management models in their capital budgeting processes and in the formulation of the WACC (Weighted Average Cost of Capital).

Following what has been argued so far, I believe that the risk manager must also be called upon to carry out his functions in strategic planning.

Having acknowledged that the change "is the new normal", it is clear that the CFO (Chief Financial Officer - Financial Director) must be highly sensitive to risk issues. In partnership with the CRO (Chief Risk Officer - risk manager) or independently, if this figure is not present in the company, the CFO (Chief Financial Officer - Financial Director) will have to develop predictive models, of a qualitative nature, capable of capturing and mitigate exchange rate risk, interest rate risk, commodity price risk, the risk represented by impaired loans, etc.