A Model to Analyze the Financial Decision-Making of a Corporation; Case Study KESH SH.A

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Abstract

In order for corporations to operate effectively, it is necessary to emphasize the importance of financial decision-making in the stability of corporate governance. This paper is based on addressing two main issues. First, focusing on the key decisions of financial executives whose work should focus on maximizing corporate value or minimizing the cost of capital. Second, deepening the impact of the auditor's characteristics on the performance of the corporate governance so that the audit creates added value for the entity.

It aims to give a fresh perspective of the treatment of financial decision-making in corporations, arguing every step through the empirical analysis of the DuPont model where we rely to compare the performance over the years under review of the KESH sh.a (Albanian Electro-Energetic Corporation).

The difference between the ordinary and the extraordinary is made by practice and financial decision-making is a topic that is both beautiful to deal with and difficult to analyze in information. We are all witnesses of the economic situation of our country. On the one hand we have a transition economy that is growing at a normal pace and on the other hand we have a community whose business is already trying to move to *a consolidated stage becoming more competitive. Only in this way can corporations in Albania survive the demanding conditions of the global economy.*

Key words: Financial Decision-Making, Corporate Governance, Maximizing Corporate Value, DuPont Model, Corporate Audit Efficiency, Globalization.

Introduction

The current moment in which we live is a challenge to the international economy. In a professional world that comes and goes from competition, every professional feels the necessity to update his theoretical and practical knowledge. In the case of corporate governance and financing, the actualization of knowledge requires a development of skills, techniques and efficiency in solving managerial-financial problems.

Due to all the above factors, the goal of finance in the future will be not only maximizing current profit, but also future. An ambitious and far-sighted goal. Also Jean Tirole, Professor of Economics in France and at the same time the winner of the Nobel Prize in Economics from the Royal Swedish Academy of Sciences for 2014, claims that the corporation is the most important part of the reality of the economy and the market in general and this element should be studied with details.

Corporate governance is a broad field of ongoing study, but it can be summarized in two key decisions made by financial executives: investment decisions and financing decisions. Good corporate governance is a need and necessity in providing the values required by stakeholders and auditing as a special service that provides security significantly affects corporate governance as a supervisor, internal valuer and foresight promoting efficiency of its operations.

According to Brealey, Myers, Marcus and Mateos (2010) the financial aspect of corporations is an important, interesting, as well as difficult issue. Important, because capital investment decisions determine valid agreements for the life of a corporation. Also the success or failure of a corporation depends on the capacity it has to find the capital it needs. Finances are interesting for many reasons. Often, financial decisions are involved in decisions that include large sums of money, such as investment projects, acquisitions of other companies, mergers with international companies. Money should not be the primary goal in the life of individuals and businesses, but a motivating tool to seek the best in the days to come. Finances, on the other hand, are difficult because the financial markets in which corporations operate change with the speed of the wind. Relatively good financial executives can solve routine corporate problems, but only the brightest minds of financial executives can adapt to market changes with monetary intelligence, which translates into more profitable for the corporation.

Study Goal and Research Question

The purpose of this paper is to provide a fresh perspective on the treatment of financial decision-making in corporations, arguing each step through empirical analysis of a model, namely the DuPont model where I am based to compare the performance over the years under review of the Albanian Electro-Energetic Corporation. I aim to encourage thinking differently about the financial aspect of corporations by explaining the basic concepts related to them, through the most important ideas and instruments that exist for finance and the application of theoretical knowledge in comparative analysis in practice.

Research question:

What are the indicators or ratios that influence corporate financial decision-making and what role does auditing play in corporate performance and good governance?

Assumptions

a) "Return on Equity is the ratio where the attention of financial managers should be focused".
b) "Financial leverage indicator has a dominant effect on the decision-making process in the organization."
c) "Liquidity is an influential factor in the development of corporate financial performance".
d) "Audit increases the efficiency of corporate governance by positively affecting the achievement of its objectives."

Methodology

Methodology (logo of the method) plays a key role in the paper, as through it the conception of the whole study is realized. The methodology used to conduct this research is rich and in function of the objectives and goals set. The financial statements published from the official website of KESH sh.a. have been used, so we are dealing with secondary data and quantitative analysis. The theoretical material has been addressed through elite books describing financial decision-making, governance and corporate auditing, mainly in Albanian, English and Spanish. The elite of the Albanian financial thought has also been used, through the publications of the most productive economists of the time as well as the results of the controls carried out by the Supreme State Audit in private and public operators, numerous and concrete information from the National Business Center.

Literature review

This paper presents a review of the literature and theoretical aspects related to financial decision-making as a process of high importance, addressed through the key role of the financial manager and his main tasks. Special attention is paid to the structure of corporate organization, how we can approach effective governance and the need for auditing to ensure that the organization is adding value to the corporation, that risk management systems, governance processes and internal control are operating properly.

The lack of a clear, common consensus on why a corporation exists, where financial executives are responsible, and what criteria should be used to make decisions is a significant hurdle in increasing the effectiveness of corporate governance, points out Kluyver (2012). When boards operate with tacit assumptions about their objectives and loyalty, hidden disagreements arise, which make the decision-making process difficult on complex issues, such as what qualifications a CEO should have, or how to evaluate and compensate senior management or related to the financing aspects of the joint stock company itself.

Adam Smith in 1776 in his book "The Wealth of Nations" made a comment about the management of the company that would resonate across the ages: "The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company". This is why good governance arises as a need and necessity for corporation and for Organization / Corporate Governance, the OECD (2004) considers that the core principles or values of good governance are: (1) honesty, (2) responsibility, (3) transparency and (4) accountability.

The Corporate Finance Institute (2020) claims that in the 1920s, management at DuPont developed a model called DuPont Analysis, which is nothing more than a summary of the most important financial ratios centered on ROE (Return on Equity). Financial ratios are a useful way to summarize large amounts of financial data, compare corporate behavior, and identify its strengths and weaknesses.

Drake (2011), Xhafa & Ciceri (2014), Gillinghan (2015), Carlson (2019) among others point out the following 4 categories of Financial Ratios as the most important in corporate decision-making:

A. Liquidity Ratios → provide information on the corporation's ability to repay its short-term liabilities.
B. Efficiency Ratios → also known as activity financial ratios, are used to measure how well a company is utilizing its assets and resources.
C. Debt/Leverage Financial Ratios → provide information on the extent of a company's financing obligations and its ability to pay these financing obligations.
D. Profitability Ratios → measure whether corporate activities are profitable or not.

Hargrave (2019) points out that there are three main financial metrics that drive return on equity (ROE): (1) corporate operating efficiency, (2) asset utilization efficiency, and (3) financial leverage. Let us break down ROE below:

$$ROE = \underbrace{\left(\frac{Net\ Income}{Sales}\right)}_{(1)} * \underbrace{\left(\frac{Sales}{Average\ Total\ Assets}\right)}_{(2)} * \underbrace{\left(\frac{Average\ Total\ Assets}{Average\ Shareholders'\ Equity}\right)}_{(3)}$$

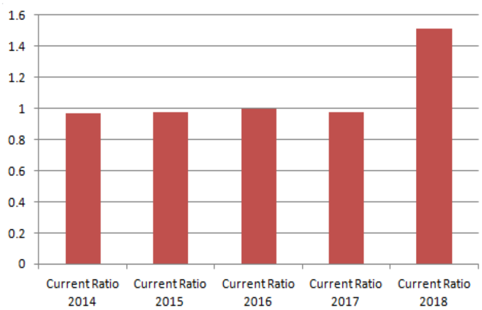
The DuPont model is a useful analysis to understand the relationship that exists between financial statements, to explain ROE and its components. This paper started by addressing the final goal of the corporation which is to maximize shareholder wealth and this is shown by the ROE report. That is why this analysis is headed by this ratio, Return on Equity. At this point begins the journey to conclude that hypothesis (a) "Return on Equity is the ratio where the focus of financial management should be focused" is completely true regarding the above arguments. So, the DuPont Model identifies the way in which the corporate is moving towards achieving its final objective. Unfortunately, there are no fixed formulas for approving capital structure decisions. In some cases, debt may be preferred for the capital structure, but in other cases it is not. However, financial managers need to think about at least four aspects: corporate taxes, risk, type of assets and the possibility of bankruptcy.

Data Analysis: KESH sh.a as a case study

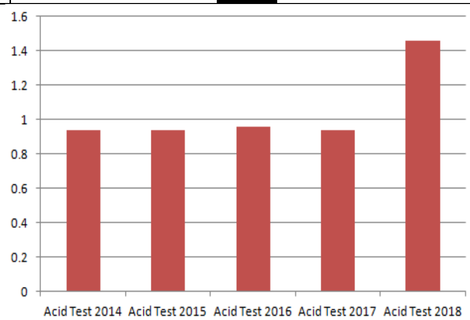
KESH sh.a is a joint stock company with 100% owned capital by the Albanian State (represented by the Ministry of Energy and Industry according to the founding act dated 17.10.1995). The rights and obligations of the General Assembly are exercised by the sole shareholder of the company, which is the Albanian State. The following is the calculation of the ratios for each category, the presentation in graphic form, the commentary for the comparison over the years of the performance of KESH sh.a:

*→ Symbol used for the year with the worst performance & ___ → for the best performance.

LIQUIDITY RATIOS		
Year	***Current Ratio*** $= \dfrac{\textit{Current Assets}}{\textit{Current Liabilities}}$	***Acid Test*** $= \dfrac{\textit{Current Assets} - \textit{Inventory}}{\textit{Current Liabilities}}$
2014	**0.970***	0.937
2015	0.978	0.940
2016	0.998	0.959
2017	0.973	**0.935***
2018	**1.514**	**1.460**



Graph 1. Evolution of the Current Ratio



Graph 2. Evolution of the Acid Test

(Source: Author)

The comment:

→ 0.9 < Current Ratio for KESH sh.a (years 2014, 2015, 2016, 2017) <1

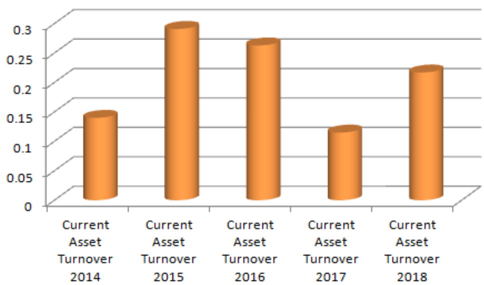
So short-term liabilities are larger than short-term assets, an improved situation in 2018, where this ratio=1,517 times. KESH sh.a has been able to afford the short-term liabilities more efficiently in 2018 compared to other years.

→ Quick Ratio (Acid Test) focuses only on the most liquid assets, which is why it excludes inventories from current assets. In KESH sh.a this ratio has been in approximate values during the years 2014-2017, then 2018 is presented to us as the year with the highest Quick Ratio, with a value of about 1.46 times.

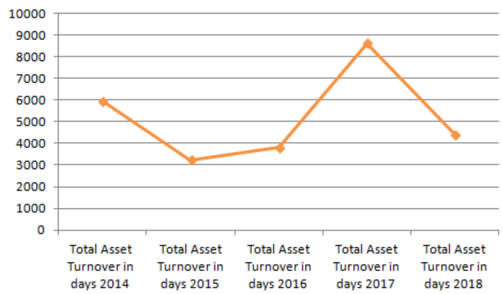
→ Liquidity ratios are one of the main tools for decision making. Uncertain business environment, the more likely it is that the corporation will keep its Current and Quick Ratio at higher values. Conversely, when cash flows are continuous, predictable, relatively lower levels are targeted. The right balance must be struck between the liquidity risk caused by a low ratio and the risk of a loss caused by a high ratio.

Hypothesis c) "Liquidity is an influential factor in the development of corporate financial performance" is confirmed in the above arguments.

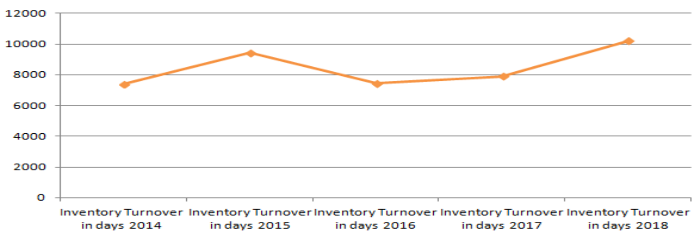
EFFICIENCY RATIOS					
Year	***Current Asset Turnover***	***Total Asset Turnover in times***	***Total Asset Turnover in days***	***Inventory Turnover in times***	***Inventory Turnover in days***
	= Sales/ Average Current Assets	=Sales/ Average Totat Assets	=365/Total Asset Turnover in times	= Cost of Goods Sold/Average Inventory	=365/ Inventory Turnover in times
2014	0.140 times	0.0611 times	5978 days	**0.0493 times**	**7404 days**
2015	**0.291 times**	**0.1124 times**	**3247 days**	0.0387 times	9440 days
2016	0.263 times	0.0956 times	3819 days	0.0489 times	7458 days
2017	**0.115 times***	**0.0423 times***	**8635 days***	0.0462 times	7909 days
2018	0.217 times	0.0829 times	4400 days	**0.0358 times***	**10204 days***



Graph 3. Evolution of Current Assets Turnover



Graph 4. Evolution of Total Assets Turnover in



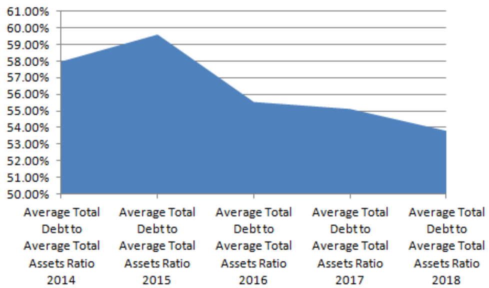
Graph 5. Graph 4. Evolution of Inventory Turnover in days

(Source: Author)

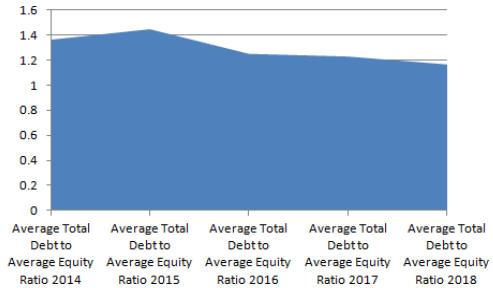
The comment:

→ The way of managing the assets of KESH sh.a. has changed during the years under review, due to the fact that different policies have been followed in the use of current assets, total assets and inventory.

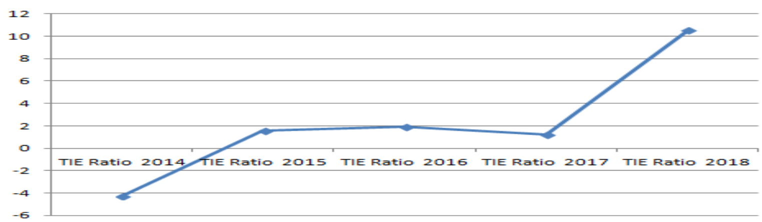
DEBT / LEVERAGE FINANCIAL RATIOS			
Year	***Average Total Debt to Average Total Assets Ratio***	***Average Total Debt to Average Equity Ratio***	***Times Interest Earned (TIE) Ratio***
	$=\frac{Average\ Total\ Debt}{Average\ Total\ Assets}$	$=\frac{Average\ Total\ Debt}{Average\ Equity}$	$=\frac{Earnings\ Before\ Interest,\ Taxes}{Interest\ Expense}$
2014	58.01%	1.3631	**-4.286 ***
2015	**59.63% ***	**1.4471 ***	1.5698
2016	55.57%	1.2508	1.9087
2017	55.15%	1.2296	1.2449
2018	**53.83%**	**1.1660**	**10.5146**



Graph 6. Evolution of Average Total Debt to Average Total Assets Ratio



Graph 7. Evolution of Average Total Debt to Average Equity Ratio



Graph 8. Evolution of TIE Ratio

(Source: Author)

The comment:

→ The ratio of average total debt to average total assets of KESH from 2014 - 2018 has been below 100%, indicating that the corporation owns more assets than debt.

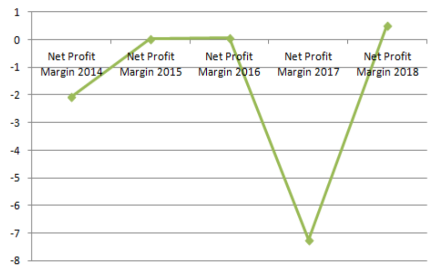
→ KESH sh.a has a high ratio of average total debt compared to the average capital owned by its shareholders in the five years under review. So debt financing in KESH sh.a. is in larger numbers than financing with share capital.

→ The corporation's ability to pay its debt obligations has been improving. In 2018, the ability of KESH sh.a to cover financial expenses has been in more favorable conditions compared to previous years.

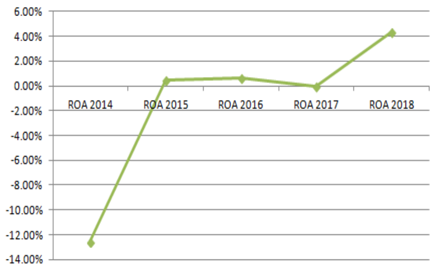
→ Debt is an important tool that corporations use to grow. Through the ratio of average total debt to average equity, investors recognize how the corporation is managing its capital structure, its approach to risk, and the dilemma of whether the corporation is ideal for investing or not. Generating cash flow to make principal and interest payments as well as avoiding bankruptcy depends on the JSC's ability to generate profits.

Hypothesis b) "The indicator of financial leverage has a dominant effect on the decision-making process in the organization" is confirmed.

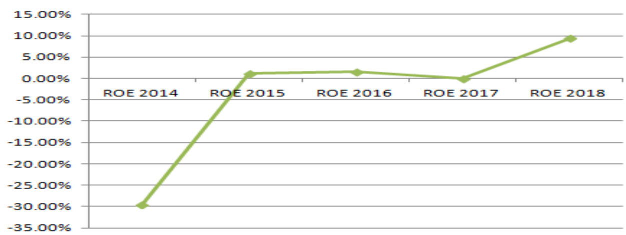
PROFITABILITY RATIOS			
Year	***Net Profit Margin***	***Return On Assets***	***Return On Equity***
	$= \dfrac{Net\ Income}{Sales}$	$= \dfrac{Net\ Income}{Average\ Total\ Assests}$ $= \dfrac{Net\ Income}{Sales} * \dfrac{Sales}{Average\ Total\ Assests}$	$= \dfrac{Net\ Income}{Average\ Shareholder\ Equity}$ = ROA*Equity Multiplier
2014	-2.0532	**-12.54% ***	**-29.46% ***
2015	0.0413	0.46%	1.15%
2016	0.0702	0.67%	1.51%
2017	**-7.2330***	-0.031%	-0.068%
2018	**0.5219**	**4.33%**	**9.38%**



Graph 9. Evolution of Net Profit Margin



Graph 10. Evolution of ROA



Graph 11. Evolution of ROE

(Source: Author)

The comment:

→ The performance of net profit margin in 2017 is not only declining compared to 2016, but also has significant losses. Improved situation in 2018.

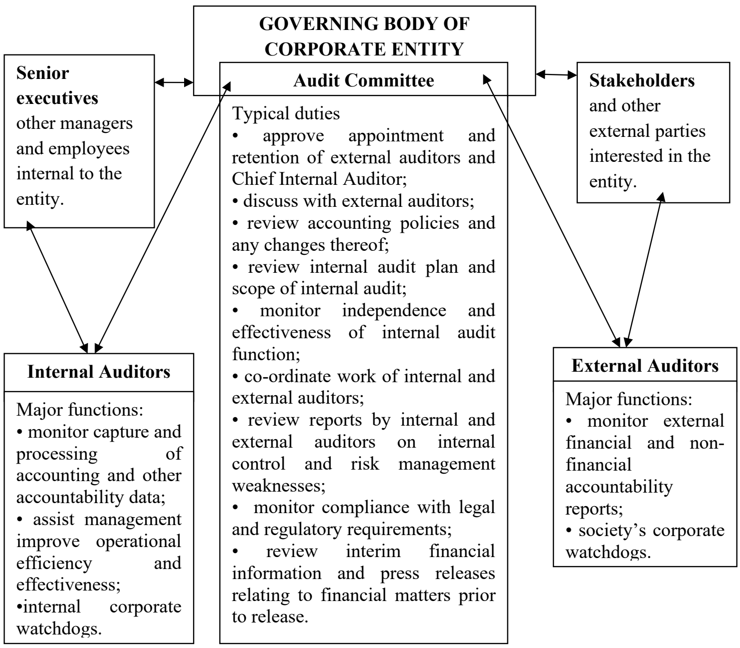
→ The year 2018 appears to be the most successful among the years taken in the analysis, where ROA not only achieves a positive value, but also a significant percentage of 4.33%.

→ For KESH sh.a we conclude that ROE has fluctuated over the years. 2014 is the year with the weakest value (-29.46%) and 2018 is the year with the highest value (9.38%).

→ Unlike other financial reports, ROE is a profit ratio from the investor's point of view, not from the corporation. This report calculates how much money is made based on the investments of investors (shareholders) in the corporation, not the corporate investment in assets or something else. Investors want a high ROE because it shows that the corporation is using its shareholder funds effectively. Using equity in calculating ROE instead of equity helps to trace the corporation's ability to maintain a positive profit trend.

Hypothesis a) "Return on Equity is the ratio where the attention of financial managers should be focused" is fulfilled according to the above arguments.

FIGURE 1. Relationship between External Audit, Internal Audit and the Audit Committee; Audit Trinity



(Source: Porter (2008) "The role of the tripartite audit function in securing corporate accountability", page.23)

× The biggest drawback of the DuPont Financial Model is that it relies on accounting equations, financial statements and data that can even be manipulated. At this point comes the treatment of hypothesis (d) "Audit increases the efficiency of corporate governance by positively affecting the achievement of its objectives." The audit process has a substantial impact on the provision of the assurance service that the financial statements are free of misstatement and are constructed in accordance with International Accounting Standards.

- Corporate governance → network of relationships between the corporation and its stakeholders.
- CFO → responsible for decision making in order to increase the efficiency of corporate governance.
- Audit → service through which reasonable assurance is provided that the organization's governance processes are functioning and that the corporation is operating in order to achieve the objectives.

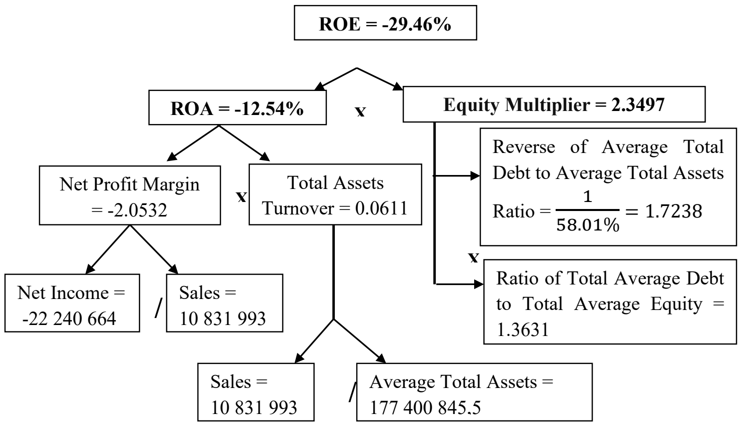
For the achievement of objectives, policies and goals in accordance with the responsibilities set out in Article 9 of Law no. 10296, "On Financial Management and Control", KESH sh.a. has drafted and is implementing the document on the Internal Control System. Internal Control System of KESH sh.a. offers reasonable, but not absolute, guarantees of effectiveness. This is an ongoing process, built, according to the instructions of the Ministry of Finance - to identify and rank risks according to their priority in relation to achieving the policies, goals and objectives of KESH sh.a., to assess the level of materialization of these risks as well as the impact they would have as well as for taking measures for their effective, efficient and economic management.

The Internal Audit Department in KESH sh.a plays an essential role for the functioning of the company, whose duties are defined by Law 114/2015. The purpose of the audit is to use the corporate financial resources as efficiently, effectively and economically as possible, as well as to avoid misuse and misuse of assets. The activity of the Audit Department is based on the principles of legality, independence, impartiality, confidentiality of the data that are verified and not exceeding the cost versus the expected benefits.

Results

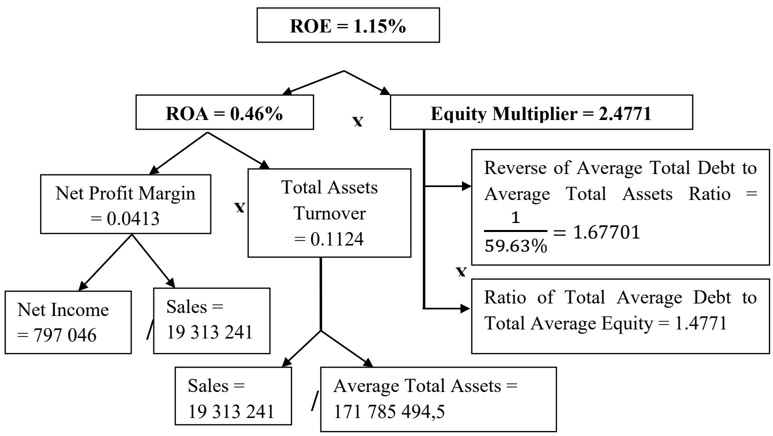
DuPont analysis uses the Income and Expenditure Statement and Balance Sheet to perform the model. The method goes beyond the individual calculation of financial reports, increasing the complexity and depth in logic, to understand how efficiently the assets of KESH sh.a. are generating sales and how well it is using the debt to produce additional returns.

FIGURE 2. DuPont Financial Model applied for KESH sh.a. (year 2014)



(Source: Author)

FIGURE 3. DuPont Financial Model applied for KESH sh.a. (year 2015)



(Source: Author)

FIGURE 4. DuPont Financial Model applied for KESH sh.a. (year 2016)

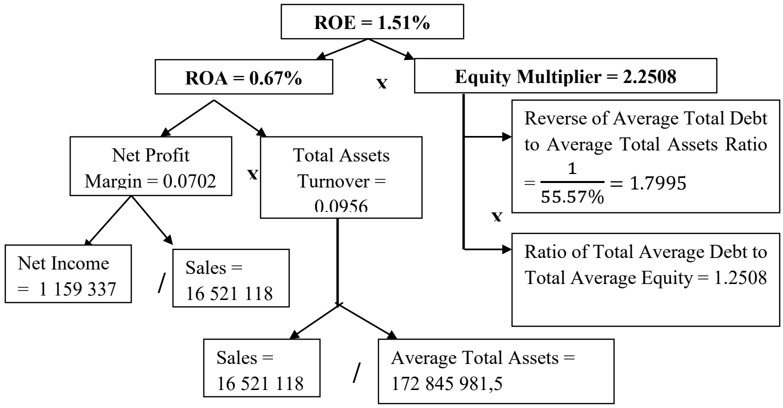


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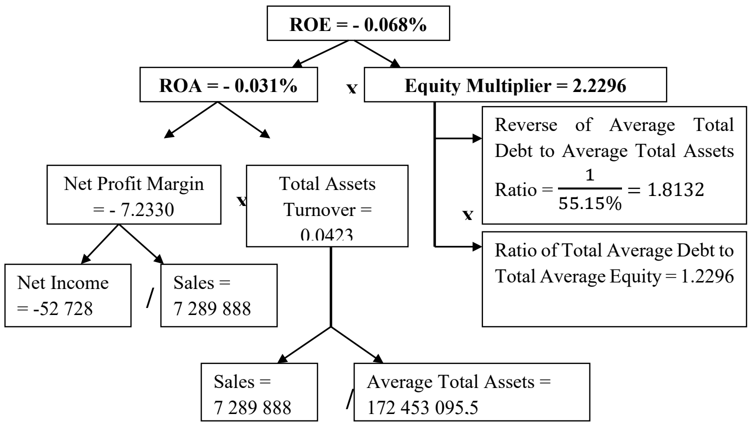
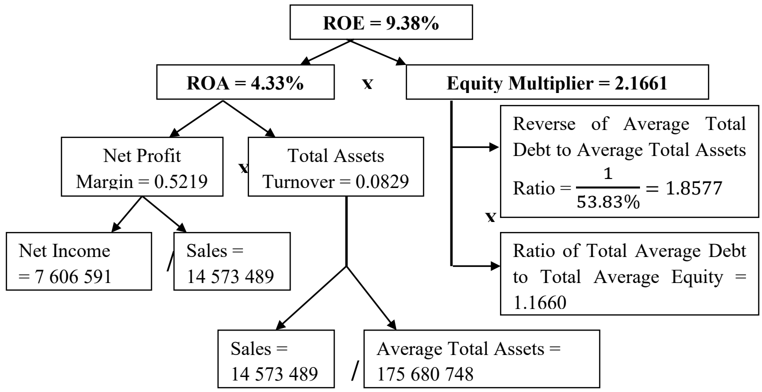
FIGURE 5. DuPont Financial Model applied for KESH sh.a. (year 2017)



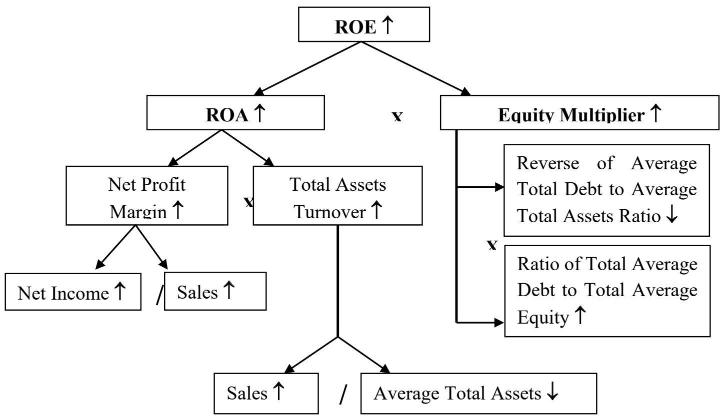
(Source: Author)

FIGURE 6. DuPont Financial Model applied for KESH sh.a. (year 2018)



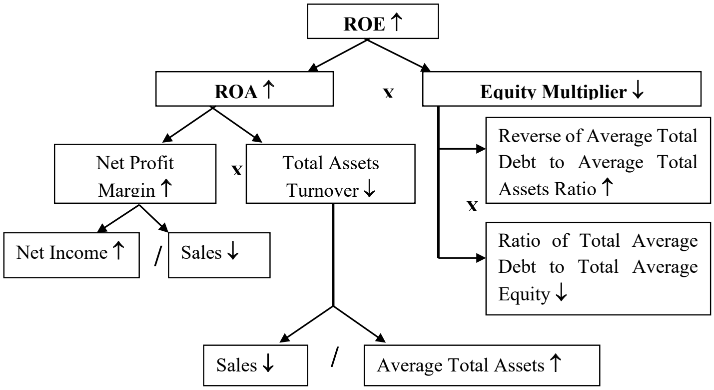
(Source: Author)

FIGURE 7. DuPont Financial Model applied to KESH sh.a. (comparison 2014-2015)



(Source: Author)

FIGURE 8. DuPont Financial Model applied to KESH sh.a. (comparison 2015-2016)



(Source: Author)

FIGURE 9. DuPont Financial Model applied to KESH sh.a. (comparison 2016-2017)

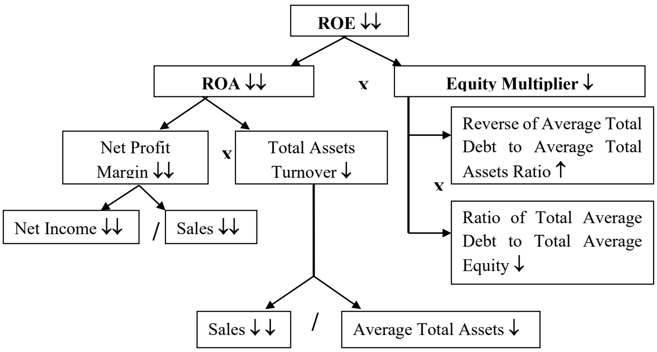


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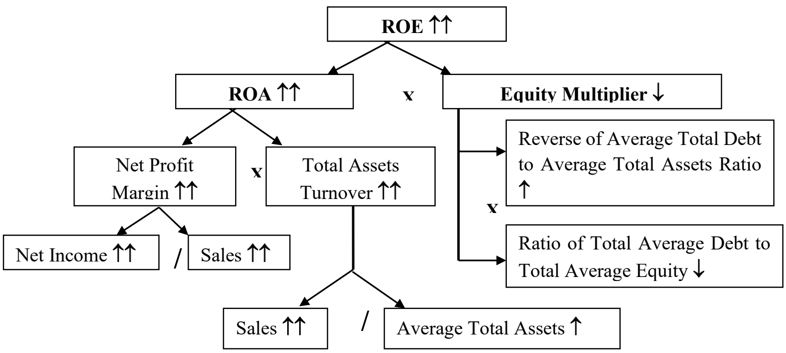
FIGURE 10. DuPont Financial Model applied to KESH sh.a. (comparison 2017-2018)



(Source: Author)

Conclusions

This paper began by asserting that decisions regarding corporate finance are important, interesting and difficult. After addressing the main ideas, concepts and assertions about corporate decision making we are convinced of the veracity of this expression. On the other hand, theoretical knowledge alone is not enough, but it is necessary to know how to apply it in real life. Corporate finance deals with all the financial activities of an entity, it concerns the administration of money in a joint stock company, the right from the receipt of funds to the administration of the use of funds.

Blumentritt (2011) notes that globalization, internationalization and cross-border activities are part of the structure of modern corporations. The CFO is responsible for important decisions regarding corporate investments and financing. Investment decisions relate to decisions to invest in tangible or intangible assets. The decision to choose between debt financing or equity in the long run is called a decision on the capital structure or financing. Financial planning is needed to carry out these decisions.

Through the analysis of financial ratios and the DuPont Model, the financial manager highlights based on the Financial Statements for the corporation strengths (to understand if they will be used for the right advantages) and weaknesses (to take corrective action). This analysis was treated above for the case study KESH sh.a. Financial indicators report mainly on past years' situations, but may also be predictive of potentially problem areas that the corporation may face in the future.

The research question points out the financial indicators that influence corporate decision making such as: aspects of profitability improvement, liquidity, financial structure, reorganization, financial leverage and interest coverage.

The second part of the research question automatically relates to an essential issue in corporation, that of corporate governance and audit efficiency in this process. Globalization has made it necessary to follow good corporate governance practices, which means recognizing the principles and codes of governance, enforcing laws and creating the right culture of corporate governance and management. Corporate governance is not just an issue, either right or wrong - it's more colorful than that (Ad Myburgh).

Significant attention has been paid to the 'members' of the audit trinity function - external auditors, internal auditors and the audit committee, each of whom has an individual role in corporate governance, but together provide assurance that corporate governance is carried out with maximum accountability.

Attention was also paid to addressing the role of the chief financial officer in the corporation and the legal responsibilities of auditors in cases of failure to provide accurate information to the public, based on the laws of the Republic of Albania.

The role of the CFO and auditors in the corporation is essential and they are held accountable in cases of failure to provide accurate information to the public.

Of course, in addition to the hypotheses considered and the research question considered in the paper, many other questions remain to be studied, as corporate financial decision-making is an issue that is enriched day by day by expanding its complexity. Making financial decisions is the process of weighing the pros and cons, advantages and disadvantages, as it is directly related to the use of money. It sounds very simple, but the practices of financial analysis, of report analysis show a dynamic reality. Referring to Henry (2020) just as achieving any personal goal in life, effective corporate financial decision making begins with identifying goals. Goals move plans. Plans produce intelligent action. Intelligent action over a period of time produces results. That is why I find it appropriate to quote a very apt expression that the well-known poet Thomas Stearns Eliot wrote: "To reach an end means to reach a beginning."

Studies of this paper have broadened my horizons around the field of finance in terms of financial decision making, the impact that auditing brings on corporate governance. Aspects that Albania is a bit lacking at the moment, but the global future is inevitable and in the near future we will realize that suddenly the number of private companies with private capital will increase in our country as well. However, international corporations are not a new concept for our country, but it creates new challenges. That is why the choice of paper for treatment is related to this topic, to precede my further studies in scientific degrees and higher academic titles…

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