

Financial Management as a Tool for Achieving Stable Firm Growth

Svetlana Saksonova¹, Svetlana Savina²

¹ University of Latvia, ² Higher School of Social Technologies

Abstract – The purpose of this study is to show that financial management in the firm is a tool for achieving stable firm growth and long-term firm stability while problems in firm financial management lead to the inability of firms to ensure sustainable growth of their value.

This problem is relevant for firms in all countries. The main objectives of this paper are: to analyse dynamics of value of the largest Latvian firms, to determine the drivers of these dynamics and to establish the main problems slowing the growth of firm value, which are related to the drawbacks in financial management, and to provide suggestions for solving these problems.

This study analyses financial management processes and identifies several key problems in financial management.

Keywords – Financial management, firm value, method of discounted cash flow.

I. INTRODUCTION

The authors believe that financial management in the firm is a tool for achieving stable firm growth and long-term firm stability. The stability of the firm can be defined as the ability of it to function in a sustainable equilibrium under different economic circumstances and to ensure that the firm does not require infusions of external resources to maintain its operations. The history of development of each firm shows that financial management is required to achieve this state quantitatively and qualitatively.

One of the most important ingredients of the management of the stability of the firm is the correctly chosen strategy under the constantly changing economic environment. The authors of this paper define the strategy of firm as a long-term development strategy, which defines a sphere of operation, its means and forms and which is directed towards achieving stability. Designing the strategy allows analysing the future of a firm and planning the objectives, spheres, scales and possible results of its operation by relating them to the sources and costs of resources. A modern firm without a strategy is merely a collection of assets, which are encumbered with liabilities.

In order to relate the management of stability of firms to other, more familiar elements of financial management, one can define a set of strategies, which includes:

- A financial strategy, which is directed to achieve a certain level of value for the firm, improve indicators such as return on equity or assets, increase shareholder value, etc.);
- A marketing or market operations strategy, usually directed to increasing the market share in operations, services or clients;

- A personnel management strategy;
- An information technology management strategy.

A better approach is to direct firm management towards maximising the value of the firm, which includes a variety of elements, such as obtaining profits, potential volume increase of firm operations, increase in the shareholder value and stable dividends.

The above-mentioned targets determine the main quantitative aspects of stability management of the firm:

- Achieving a certain level of profitability, taking into account the acceptable level of risks. This objective necessitates the creation of the system for managing revenues, expenses and profit as well as the volume of assets and liabilities;
- Maintaining firm liquidity, by optimising cash flow and the structure of assets and liabilities. In this case, the tasks of firm financial management are to manage the cash flow, improve the structure and quality of assets and liabilities, control liquid assets and forecast the liquidity position of a firm;
- Maintaining the quality of firm assets by analysing their structure, profitability (Saksonova & Solovjova, 2012).

The importance of designing stability management for firms increases along with globalisation and financial market integration. A successful financial management is the key ingredient of the stability strategy. Financial management strategy involves optimising asset structure and managing asset profitability, which are needed because the environment and industry are rapidly changing due to different factors (one of them is innovation).

The role of innovation as a key factor for competitive success and increasing the value of the firm has been constantly rising as the world economy and business get more globalised and interconnected.

A process of innovation consists of preparing and implementing innovative changes and includes interrelated phases comprising a complex whole. The result of this process (a systemic approach to innovative changes) is an implemented and utilised change in business operations or decision-making – an innovation. It is in this context that this paper places a notion of innovation in financial management of the firm.

A systemic approach stimulates the management of the firm to maintain a necessary equilibrium between the requirements of, e.g., particular departments and the firm as a whole. A systemic approach to management allows firm managers to perform their functions, such as forecasting, planning,

organisation, management, and control more efficiently. It also helps remove causes of making inefficient decisions.

A systemic approach to management creates potential for growth in the value of the firm. This paper argues that only balanced firm development – a certain relationship between profits, assets and their growth rates – can be evidence of effective management of the firm that is the ability to manage firm value.

The essence of firm financial management is that it has to be aimed at increasing the market value of the firm and its shares. In other words, all actions by the firm, analytical methods and management tools have to be directed towards a one single goal – to help the company increase its value, making the managerial decision-making process grounded in key considerations of firm value. Financial management of the firm is based on its economic relationships to the external business environment, market processes, counterparties, potential investors, as well as business owners.

Innovative financial management of the firm, based on a systemic approach and comprehensive use of modern financial instruments and technologies, is the most potent tool capable of increasing firm value in the short term as well as the long term.

The topicality of the statements brought out in the research grows with the growth of firm, introduction of new lines of business, and increase in complexity of products (Leyens, 2011). Firms become increasingly multi-business in their nature. Multi-business firms often experience difficulties in management. In this case, business might eventually become uncontrollable, which in turn can result in loss of competitiveness and exit from the market; therefore, the role of a systemic approach in the organisation of the financial management of a multi-business firm increases (Savina & Kuzmina-Merlino, 2014).

The aim of this paper is to show that financial management of the firm, when viewed as a system, is actually an innovative approach to firm management. In practice, firm management is almost never conducted with a systemic approach in mind, and drawbacks in financial management processes lead to the inability of the firms to ensure a sustainable increase in value; however, turnover and asset size of the firm may be rising.

This problem is relevant for firms in all countries. The main objectives of this research are: to show the significant link between firm value and the stability of its operations, to analyse dynamics of value of the largest Latvian firms, to determine the drivers of this dynamics and, finally, to establish the main problems slowing the growth of firm value, which are related to the drawbacks in financial management, and to provide suggestions for solving these problems.

Despite the growth in assets and net turnover, Latvian firms (businesses) differ considerably in the dynamics of their value. However, any type of business (whether producing goods, providing services, trading, etc.) aims at maximising profit, retaining or increasing market share, long-term development, and increasing its value (Saksonova, 2004). Business strategies in virtually all firms contain such concepts as “value based approach to business management”, “value

management”, “value drivers”, and “increase in value added for firm value enhancement”. All of these concepts have one common goal – determining and further increasing firm value. Therefore, firm value management should be the key function of the financial management.

In many large firms, the ability of shareholders to affect firm value has decreased, while that of firm management has grown; however, the present research shows that management is not always effective. In such circumstances, routine analysis and management of firm value are essential to give shareholders an opportunity to be aware of the efficiency of the invested capital. Previous research has considered a wide variety of determinants of firm value, including, in particular, the role of management, for example, management ownership of shares (Lins, 2003), ownership structure and corporate governance (Lemmon & Lins, 2003; Villalonga & Amit, 2006). This research sheds light on some of the reasons behind the link between firm management and value and provides recommendations for management how to increase firm value.

In the developed markets of Europe, USA, and Japan, firm value analysis and management have already become a customary process, while in European transition economies these processes have been applied only in the past twenty years. Still financial management problems to be solved with a view to increase firm value are common for all firms regardless of the sector or country they are located in.

It is clear that assessing firm value is a time-consuming and subjective process. Analysts and financial specialists can use various approaches, methods, and tools to obtain different valuations of one and the same firm, even in cases when firm value is determined for internal purposes of development and analysis, rather than sales purposes (Chen & Jassim, 2013). There are several reasons for this:

- Modern firms (companies) are complicated structures combining various assets – from real property to goodwill, and different types of assets have their own specific features;
- Companies operate in a rapidly changing environment; therefore, when making strategic decisions they have to consider various external and internal factors (see Section 3). They also often have to act under uncertainty with regard to resource investments and future results (Hasan, Kobeissi & Wang, 2011);
- When assessing financial stability of a firm, one has to evaluate both all of the assets (real property, equipment and machines, inventory, financial investments, intangible assets) and performance – current and future income, development prospects, and competitive environment, as well as to compare the firm considered with other similar firms.

II. FINANCIAL MANAGEMENT AS AN INNOVATIVE APPROACH TO INCREASING THE VALUE OF A FIRM

The rapid development of modern market economies, increasing intra-European and international economic ties, and escalating competition raise the importance of efficient financial management for key decision makers at the firm.

This, in turn, allows shareholders to achieve their strategic goal – increasing firm value. On the other hand, the analysis of changes in firm value suggests the need for improvement of financial management tools and approaches. The range of methods and approaches can be quite extensive, which is also demonstrated by different definitions of financial management, as there is no unified, generally accepted opinion on the essence of financial management in scientific literature.

Instead several definitions and descriptions of financial management have been proposed:

- financial management is an integral part of overall firm management processes (Amoako *et al.*, 2013);
- financial management is associated with attracting financial resources and their efficient utilisation for the achievement of the firm objectives (Maheswari, 2010);
- financial management is an operational activity in business that helps regulate acquisition of assets necessary for an efficient firm operation and effective use of these assets (Massie, 1986);
- financial management is a process of putting the available funds to the best advantage from the long-term point of view of business objectives (Brealey, 2008);
- financial management is an application of general managerial principles to the area of financial decision-making (Howard & Upton, 1953).

All of the above definitions have the acknowledgement in common that financial resources represent the source of economic benefit of a firm; however, neither of these definitions mentions business goals and strategies.

There is no consensus in the literature on the role of financial management of firms in the market and investment economics. The emerging role of the financial management is associated with the formation of a special industry of financial services (Lazonick, 2010) and the necessity of managing firm value (Stanciu, 2013). Fama points out that the market value of firm stock serves as a measure of its ability to generate future cash flow (Fama, 1970). From this point of view, the main mission of firm financial management is to increase its current market value. The need to implement the firm strategy gives rise to the need for the analysis of characteristics and structure of the financial management system, analysis of investment and financing models, using the elements of strategic and operative financial management, the so-called short-run financial management (Gentry, 1988) or the long-term financial management approach (Hill & Sartoris, 1995). Firm management can also take specific decisions affecting firm value, for example, transitioning to services, which can increase firm value, if managed appropriately or diversifying source of financing (Rupeika-Apoga, 2014; Saksonova, 2014).

Researchers belonging to different schools have a shared vision of the role of modern financial management and its main goal expressed in the enhancement of market value of the firm (Atrill, 2002; Brigham & Ehrhardt, 2013); therefore, the basic concept of financial management is firm value

management and prevention of problems in financial management of the firm. The goal of the financial management is to ensure well-being of owners or to increase market value of the firm or value generated by the organisation, as well as sustainable development and long-term solvency of the firm (Brigham & Ehrhardt, 2013; Atrill, 2002). In addition, in the absence of externalities and monopoly, social welfare is maximised when each firm in an economy maximises its total market value (Jensen, 2001). According to all of the authors, problems in the financial management obviously have a negative effect on its value. Therefore, the main concept of financial management is the management of firm value. Practical formation of the financial management should be based upon certain theoretical platform and the author has endorsed view of the role of financial management: financial management of a firm aimed at achieving strategic goals is a specific process of planning, implementation, control and management decision-making, which is aimed at management, administration, and efficient utilisation of funding sources, fixed and current assets at strategic and operational levels to ensure long-term sustainable development and growth of welfare of owners and market value of the firm (Savina, 2014).

Implementation of this basic principle of financial management involves considering of external and internal factors influencing firm performance.

An important factor influencing the result of financial management is risk. The notion of risk means volatility and uncertainty associated with market conditions, macroeconomic processes, etc. It is a generally accepted fact that uncertainty is related to the lack of knowledge and incomplete information. If it is possible to assign probabilities to initial variables, the possible range of results can be determined. This range of results is, to a certain extent, a measure of risk (French & Gabrielli, 2004). In other words, it is the probability that income gained from investing in the firm being evaluated will be higher or lower than expected. Assessing firm value, it is important to keep in mind that there are different types of risks and no investments or transactions in the conditions of market economy can be completely without risk.

Two risk categories influencing firm value can be distinguished in any firm: systemic and non-systemic risks. While systemic risk, by definition, is outside the control of firm owners as it depends on the market situation, non-systemic risk, by definition, is within the control of owners as it is not influenced by market factors. Some risks, such as market risk, are systemic in essence, while others, e.g., risks associated with inventory management, are non-systemic risks. However, many risks can have the features of both systemic and non-systemic risks. These mixed risks can significantly affect firm value. However, there are still discussions about what risks should be considered not manageable and what risks could be reduced with the help of certain measures, and how these risks should be assessed and prevented (Sanginario, 2013).

III. THE ANALYSIS OF FIRM VALUE DYNAMICS OF THE LARGEST LATVIAN FIRMS

In order to discover problems related to ensuring an increase in firm value, in the present research the authors study the changes in firm value of the largest Latvian firms during the period from 1998 until 2014. The present research uses the approach to firm valuation that is based upon current and future income. This approach provides for the use of the method of discounted cash flow (henceforth referred to as DCF). DCF method is widely used in practice and reviewed in scientific literature in the sphere of capital investment planning and firm market value assessment.

This valuation method has the potential to be one of the most precise ones, as different rates can be used as a discount rate, including the weighted average cost of capital (hereinafter referred to as WACC). By choosing the discount rate equal to the price of firm equity, the analyst effectively assumes that the best alternative project is the ongoing economic activity of the firm. DCF analysis first has been conceptually offered by I. Fisher (Fisher, 1930) and John B. Williams (Williams, 2012). Further these methods were developed in the works by T. Copeland, T. Koller, J. Murrin, J. Hirshleifer and A. Damodaran. (Copeland, Koller & Murrin, 2000; Hirshleifer, 1958, 1970; Damodaran, 2012).

The DCF method and the analysis of results are performed in stages (Gordon, 2013). The forecast of cash flow includes identification of its duration and type, as well as the assessment of factors determining the cash flow. Accounting of the potential risk associated with this cash flow can be done using the following methods: risk-free equivalent method (Robichek & Mayers, 1966) or the method of risk-adjusted discount rate (Houng-Yhi Chen, 1967). Each of these methods has its own advantages and deficiencies; however, theoretically both methods should ensure obtaining similar results.

Though the DCF method is only a measuring tool, it allows evaluating and comparing firm market value at different time periods. The resulting firm value forms the basis for making financial decisions. Applying this method, the analyst has to take into consideration interest payments, cost of equity, debt-

to-equity ratio, WACC, earnings before interest, taxes, depreciation and amortization. The indicators above essentially describe the system that is managed by the process of financial management. They represent the objects of financial management. Therefore, the decrease in the aggregate index of firm value calculated with the DCF method reflects the problems of financial management of the firm, as in this case the main goal of financial management is not achieved. Determining firm value, the current WACC of the firms is calculated. In the analysis, the authors consider the firm value as net present value of free cash flow; the selected discount rate is equal to the firm WACC.

All analysed firms were multi-business firms, i.e., they were engaged in various types of business activities. Changes in firm value are associated not only with financial indicators of operations (e.g., net turnover, total assets), but also with the effectiveness of financial management; therefore, changes in firm value are an important parameter that shows the effectiveness and quality of financial management.

Using the data of financial reports of the firms in the Latvian Register of Enterprises for the period from 1998 till 2014, the authors analysed firm value of the largest Latvian firms and calculated the standard deviation of firm value, net turnover, and total assets for ten largest Latvian firms.

In the calculations of firm value of the largest Latvian firms, the authors used the method developed by A. Damodaran (2012), which requires choosing a discount rate equal to the WACC. The authors used the risk-free rate – the interest rate of the Latvian five-year Treasury bonds of the corresponding year – to calculate the WACC, following Damodaran (2012) as published in the official government sources. The country's risk premium has been calculated using Latvia's rating by the Moody's rating agency in the corresponding year (Treasury of the Republic of Latvia, 2014). Unlevered market beta has been used in compliance with the research by Ernst & Young for each firm according to the basic type of activity. Terminal value has been calculated according to J.R. Hitchner method (Hitchner, 2011; Hitchner & Mard, 2011).

The indicators characterising the analysis of changes of firm value of the largest Latvian firms are summarised in Table I.

TABLE I
PARAMETER A OF TREND OF FIRM VALUE, TOTAL ASSETS AND NET TURNOVER, AVERAGE LINEAR, STANDARD DEVIATIONS
OF THE CHANGES IN THE VALUE OF THE LARGEST LATVIAN FIRMS (1998–2014)
(AUTHORS' CALCULATIONS ON THE BASIS OF DATA OF THE REGISTER OF ENTERPRISES OF THE REPUBLIC OF LATVIA)

Firms	Parameter A of trend of firm value	Parameter A of trend of total assets	Parameter A of trend of net turnover	Average linear deviations of firm value, Ls	Standard deviations of firm value, Ls
1. JSC Latvijas Kuģniecība (shipping company)	–86 630	8726 267	3395 156	5545 510	8013 262
2. State JSC Latvijas Jūras administrācija (maritime registry)	–10 086	–382 843	–119 162	115 250	176 961
3. JSC Rīgas siltums (heat supplier)	127 822	4468 797	6160 121	663 731	872 324
4. Lattelecom Ltd. (telecommunications)	127 027	3497 535	499 088	3 039 775	3472 332
5. JSC Latvijas Gāze (natural gas)	384 026	40 573 345	24 300 911	16 848 147	25 345 772
6. State JSC Latvijas gaisa satiksme (air traffic control)	789	756 327	613 301	430 230	611 744
7. State JSC Latvijas Pasts (postal services)	96 752	3180 577	1831 223	981 644	1210 383
8. State JSC International Airport "Rīga"	34 836	4957 637	1755 313	1212 549	1526 714
9. JSC Latvenergo (electricity supplier)	834 090	159 682 850	38 630 094	38 716 519	53 319 234
10. State JSC Latvijas Dzelzceļš (a railway company)	1219 111	30 427 583	16 869 595	7174 380	10 094 987

The analysis of changes in firm value shows that, despite the increase in net turnover and total assets, firm value is rather volatile as shown by high standard deviation (factor of volatility or variability). Based upon the summarised financial data of the firms, trends of the changes in firm value were drawn up. In some cases, these changes show negative trends, which suggests that firms are unable to ensure sustainable increase in their value. The results of calculations show fluctuations of value, which indicate that strategic goal of any firm – increase in its value – is not achieved.

Even in cases when the trends of changes in firm value are positive, the angle of the trend curve is ten times less than the angle of the curves of changes in total assets and net turnover (which is evidenced by the values of the parameter *A* of the trend equation). This means that the rates of growth of total assets and net turnover are tens of times higher than those of the firm value (see Table I).

The fact that an increase in net turnover and total assets does not ensure appropriate increase in firm value reflects the problems in financial management of firm value. As the firm value and indicators included in its calculation represent the basic elements of the managed system, which are influenced by management in the process of financial management, it can be concluded that the decrease in firm value calculated with DCF method reflects problems in financial management.

In order to monitor problems in managing firm value, it is necessary to develop a coherent two-level system of financial indices (Savina, 2010), which would help ensure a well-balanced financial management, i.e., the connection between strategic and operational levels of the financial management. Indices of the strategic level should reflect the strategic objectives of the firm. Indices of the strategic level should be formulated on the basis of a financial part of Balanced Scorecard. Indices of the operational level usually characterise the techniques of achievement of strategic objectives, necessary financial resources, and financial state of the company (see Fig. 1).

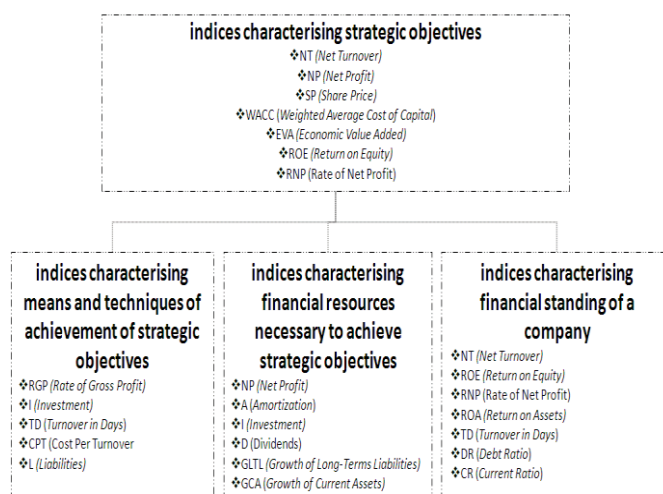


Fig. 1. The system of coherent financial indices (Savina, 2014).

In order to perform a detailed analysis of the problems in financial management of a firm, it is necessary to get access to confidential information of the specific firm. Financial management information is, of course, a commercial secret in the private sector; therefore, the authors, having summarised the financial information and the results of the analysis of financial management of state-owned firms, where more information is publicly available, which was available to external observers (Savina, 2014), have drawn conclusions and offered recommendations for the improvement of the financial management of the firms and provision of increase in firm value, which can be used by all firms.

IV. SUGGESTIONS

Based on the results of empirical analyses, the authors give recommendations for strengthening the firm financial management and firm stability.

The present research argues that the decrease in firm value as show by the DCF method reflects the deficiencies and problems in financial management of the firms. The authors believe that there are the following main deficiencies in the financial management:

- Budget of the firms is constructed without consideration of strategic goals;
- There are contradictions between a functional approach of firm management and business logic, as organizational structure of the firm based upon a functional approach is focused on subordination hierarchy and does not pay due attention to the hierarchy regulating responsibility for the end result;
- The accounting system does not meet the requirements of budgeting and cost value estimation; data for the analysis are received with a delay;
- Insufficient, limited use of methods and tools of financial management;
- Fragmentary nature of activities aimed at the reduction of financial risks;
- Insufficient interaction of individual methods and tools of financial management;
- Intuitive approach dominates when making financial and investment decisions, which, to a large extent, is based upon the experience of firm management and not on the systemic approach;

The authors believe that these deficiencies are pervasive in the financial management of many firms; therefore, eliminating these deficiencies is an urgent issue in the management of any firm. In order to achieve this, the present research suggests the following innovations to firm managers and owners:

- In the course of creation of a system of coherent financial indicators, two levels of financial indicators should be formed. The system of indices provides a comprehensive view of the financial standing of a firm. The analysis of budget performance in such a case turns into the analysis of a limited number of figures.
- All relevant business processes and activities should be identified and classified.

- In the course of formation of financial structure and correction of organisational structure, coordination and approval of principles regulate functioning of the financial structure of the firm.
- The existing tools of financial management should be applied at the stage of verification and analysis of the results, namely:
 - Exploiting all opportunities for the activity-based costing model, including the analysis of customers and profitability of distribution channels;
 - Analysis of performance of business processes and centres of financial responsibility;
 - Monitoring budgetary deviations; specification of deviations by individual parts is a tool for the analysis and assessment of firm performance, informative base for making management decisions on the development of business activities and improvement of the production process;
 - Use of the financial and economic analysis of budget performance indices for the assessment of financial position of the firm;
 - Development of risk management system by making management decisions in accordance with the proposed algorithm: (a) identification of risk areas; (b) complete recording of possible risks; (c) risk assessment and analysis, including evaluation of probability of all risks, determination of the hazard level of each risk and ranking risks by hazard level; (d) determination of possible acceptable risk level; (e) elaboration of measures for the reduction of risk to such an extent that would allow avoiding risk and reducing probability of risk materialising; (f) elaboration of measures for covering possible financial losses.
- Reengineering of business processes, including the following stages:
 - Analysis of the business process;
 - Determination of business processes that require changes according to the previously established criteria;
 - Determination of the procedure of reengineering, including identification of the owner of business process, formation of a working group, analysis of current business process (functional essence and main issues), improvement, and adaptation of business processes or the creation of a brand new business process;
 - Development of recommendations for the improvement, changing, radical adaptation of business processes or introduction of new business processes;
 - Practical measures, performance control;
 - Analysis of the results (verification of conformity of the results with the set tasks).

These innovative measures would improve the financial management of firms and ensure their sustainable development by achieving interconnection between all levels of financial management. This would ensure the achievement

of strategic goals of the firm and a resulting increase in the firm value.

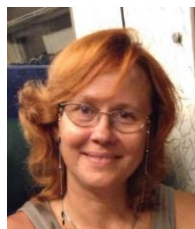
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Svetlana Saksonova is a Professor and Leading Researcher at the Department of Finance, Faculty of Economics and Management at the University of Latvia. Her subjects are Corporate Finance and Financial and Bank Accounting. She has published more than 30 scientific papers and 3 monographs about risk and financial management, bank asset management and firm valuation.
Phone: +371 670 346 25
E-mail: Saksonova.Svetlana@gmail.com



Svetlana Savina holds a degree of Doctor of Management Science (Dr. sc. admin.). She works at Higher School of Social Technologies. Her research interests include managerial economics, financial management methodology and practice, managerial accounting, management decision-making process, budgeting. Professional experience: public and business administration.
Phone: +371 294 221 21
E-mail: Svetlana.j.Savina@gmail.com