FINANCING THE FIRM. SOME ISSUES OF DEBATE

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Abstract

The aim of this paper is first to show the evolution of different theoretical issues in corporate finance and, second, to make an inventory of the current and potential contributions to the financial theory through some financial strategies and decision-making points of view.

Key words: Financial strategy, financial decision-making, capital structure, costs of adjusting.

1 Introduction

The aim of this paper is to propose an analysis of the scenarios formulated by Zingales [Zingales, L., 1998, p. 189] about the fundamentals of financing the firm. Moreover, from hereafter financing the firm and investment will be similar. The consequences of changing the traditional contractual theories (protecting the specific assets) by cognizance theories will be identified. This paper will be searching for new explanations about the role of both proper resources and of the ones provoking indebtedness. Finally, the role played by the financial analysis in such circumstances will be emphasized, especially on its positive side.

A starting point of the concept of the organization’s financing is the Jensen and Meckling’s article named “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure”. On the other hand, Zingales (1998) argues that the traditional financing theory had been formulated to explain the financial behavior of the predominant type of companies in the early 20th century.

The firm’s evolution (see the new examples of conglomerates, alliances development and the human capital assertion) engenders some changes to the traditional view and indicates new basics of the firm financing [Foss, N.Z., 2001, p. 289]. Such a mutation in the thinking of finances considers first their organizational part. Zingales (1998) priorly analyzes the Stock Exchange listed companies. His restrictive approach excludes the traditional dimension of investment financing and the investing decision here results as decisive for the enterprise financing.

Harris and Raviv [Harris, M., Raviv, A., 1996, pp. 1139-1171] notices that the investment concept (and process) had been neglected by the financial research in favor of that of financing. Charreaux’s brief approach [Charreaux, G., 2001, p. 256] starts from Fisher’s model for settling normative rules for the investing decision. These rules search for a selection of decisions on the basis of anticipated data inflows. Thus, the finance topic will become one of evaluations, keeping a limited explanatory power about the investment management methods. The Miller-Modigliani model, in its turn, does not essentially modify

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this aspect, despite its given investment inflows and of aiming their allocation incidence on
the value of the firm.

Jensen and Meckling go even further: the separation between investment and
financing vanishes, in a context assuming that the inflow distribution was able to influence
their total levels. In such a context, however, investment stays subordinated to financing.
Jensen finds the enlargement of firm financing in connection with the latter’s items’
interaction with the management and organizational structure of the firm (see decision
making and evaluating performances). The investment is supposed to be included in the firm
financing and analyzed for the following reasons:

• several theories find the investment opportunities and their afferent identification
  of flow distribution as the main source of value creation;
• the investment opportunities identification will result in a higher attention paid to
  the human factor at the basis of the entity’s capital.

2 A critical view of the firm in the context of specific investment network theory

For Zingales, concepts linking the firm and financial theories associate the three
dimensions of the firm financing, namely the financial structure, management and
evaluation of the firm:

(1) in order to understand the firm’s financial structure, its target and market value
creating mechanism priorily require their own understanding;
(2) the management dimension is understood here as strictly as its hierarchical
authority, here including the latter’s need in this respect;
(3) as for evaluation, the priority is the firm’s concept of entity made clear.

The newly approached investment dimension, including the understanding of
investment opportunities, strengthens the links between financial and organizational
theories. “The focus on financing issues raised by a unique combination between assets and
labor employed defines the firm financing topic. A basic studying stage will be filled by
identifying the causes of this unique combination” [Zingales, L., 1998, p. 152]. The
financing and investment decisions interdependence was introduced by Jensen and
Meckling [Jensen, M.C., Meckling, W.H., 1976, pp. 305-360] in a restrictive view, due to
conflicts of interests caused by the information asymmetry. Problems, as the ones of the
under-investment caused by the losses involved, will thus be identified. The cognizance
approach stresses such interdependence explaining how different financing ways were
performing equal influences on either the investment process, basing the value creation or
exploiting the investment opportunities. As contrary to the traditional approach, this
influence is not compulsory negative, meaning that some ways of financing might bring a
favorable dynamic effect on investment opportunities or on their exploitation.

3 Wording the financing policy between compromise and hierarchy

In his studies about the “financial mobility”, Donaldson [Donaldson, G., 1985, pp. 57-
67] argues that a pragmatic approach of financing rather leads to a hierarchical scheme
aiming the self-financing firstly, indebtedness secondly and thirdly the increase in capital.
The capital control and bankruptcy risks are here determinants. “Irrespective of its social
merits, the financial management implicitly or even explicitly aims at reducing uncertainty
linked to the financial market and to its interference in” [Donaldson, G., 1985, p. 63]. The
traditional marginal reasoning skips such a scheme of thinking, due to its arbitrary position
between indebtedness and proper resources costs.

Assuming the optimum of financing structure as associated to the optimum size of the
firm, the firm enlargement will be connected to developing the same firm’s production
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Assuming that the firm financing is subordinated to the firm enlargement, the optimum financing will be the one clearing the way for a higher know-how and the hierarchical perspective stays associated to the information asymmetry.

4 Financing by proper external funds

This is identified by Myers [Myers, S., 2000, pp. 1005-1037] as a debt affecting the assets, whereas Zingales (1998) saw the firm as a specific investment network: “keeping relationships with partners owing key resources and so ensuring a long-life to the firm.” The solution is associating the capital with the key partners. Such a funding will consolidate the firm entity as the same network of value creation.

This is a view differing from the shareholders’ one, which stays on the side of the traditional financial theory regarding a capital obviously spread amongst. Actually, there occurs the control of dominant shareholders upon the others, and the author highlights the need of shareholders’ control on managers and the low shareholders protection against the large ones’ abuse of domination. Considering the cognizance type of analysis, a global view of the role and composition of the shareholders’ mass will be built.

Holmström and Roberts [Holmström, B., Roberts, J., 1998, p. 91] attributes to the transfer of knowledge (which is the investment process) “a basic role in the horizontal diversification”. It is known that one of the main reasons of the firm to be listed at the Stock Exchange is facilitating its external increase, funded by securities exchanges. The external proper funds will thus become a lever for the firm size increasing and for extending the knowledge base.

Such a view helps the “reevaluation of the role of the proper external funds, which couldn’t be available either through their reduced weights in the total of the firm’s financing funds (about 8%) or through their comparative ratio to the self-financing funds (70%) and through the role indicated by control specialists” [Hansmann, H., 1996, p. 136].

5 The self-financing

“The status of the self-financing in the financial theory is probably due to its approaching methods: as residual of dividend distribution, or as a total liquidity resulted from cumulating internal flows that managers are able to turn into investment funding at distinct moments. As different as the proper external funds, the self-financing is continuously self-forming, following repayments to partners. Finally, the self-financing level will result from the management arbitrage on the dividend policy.” [Charreaux, G., Desbrières, Ph., 1998, pp. 57-88]. Traditional criticism borne by the self-financing cannot be distinct from a traditional representation of the investment as an option extracted from a number of opportunities. The “free cash flow” theory assumes that the manager disposes as such of a number of investment opportunities of which risks and efficiency are preliminarily known, so that they can be easily differentiated. The indebtedness level in such a view allows for the externalization of a “free cash flow” for a high performance and for low investment opportunity levels.

6 Conclusions

The cognizance approach analyses the financing issue in connection with its appropriate link between financial decisions and value creating, and the best financing policy will be the one indicating to managers the value creating opportunities, the production coordinating knowledge and the best solutions to conflicts.
The multiple role of the proper external capital fills an empty space of the traditional theory and comes to explain some phenomena such as the external way of increasing or the managers’ recruitment.

All the above-mentioned show that the option of financing needs a deepening of the relationship between theoretical hypotheses and empirical results of used models. In this sense, the dynamic models applied allow for the improvement of the estimating activity, as related to the capital ownership structure of the enterprise.

References

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