FINANCING DECISION AND CORPORATE GOVERNANCE

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Abstract:
This paper sustains the existence of a biunivocal link between a company’s financing decision and the corporate governance. On the one hand, the financing decision has an impact on corporate performance, which has been confirmed. According to the agency theory, the financing decision will contribute to solving interest conflicts between shareholders and managers. On the other hand, the corporate governance mechanism provides the proper contractual framework for attracting financing resources. The decision makers of profit-oriented organizations should take these correlations into account.

Keywords:
financial structure, financing decision, shareholder, manager, corporate governance, average weighted cost of capital, conflicts of interest.

JEL classification: G32

The companies’ financing decision is one of the most debated fields of the corporate finance theory. The theoretical models on which it is based are subject to continuous improvement and the financing theories’ application at company level is limited. The identification of the optimum capital structure should take into account the analysis of financing policy determinants: the opportunity cost of capital, the tax policy, the agency costs etc.

The financing decision can be defined as the way of choosing a company’s financing resources, namely choosing both the available resources and their mix in order to obtain the major objective in finance, i.e. the maximization of shareholders’ wealth. In taking financing decisions, a company’s management uses efficiency financial criteria, such as the financing duration and the autonomy provided by certain financing sources. The selection consists in choosing between equity and borrowed funds. Despite these criteria, the most important element determining the financing decision and the financial structure is represented by the cost of providing these resources. The management targets the reduction, and even the minimization, of the cost of capital. From a methodological point of view, the cost of capital is an average weighted cost of the different financing resources of a company.
Most of the papers regarding the optimization of the relationship between capital structure and shareholders’ wealth emphasize the necessity to minimize the average weighted cost of capital. The other requirements of an optimum financial structure are also taken into account in the literature: maintaining an adequate level of liquidity, assuring the flexibility needed for financing the investments of strategic importance etc.

This is due to the fact that investors always require adequate remuneration for their capital, namely superior to returns offered by the other opportunities of the financial market (e.g. risk free rate, bank deposit rate, the average return of the activity sector etc). Given the fact that managers are subordinated to the investors’ interest, they will pursue the reduction of the cost of capital.

The average weighted cost of capital is the opportunity cost for financing the economic assets. From an investors’ point of view, this cost represents the minimum level of the global firm profitability, the average rate of profitability required by shareholders and lenders. The actual calculation of the opportunity cost of capital is difficult, as it needs both the estimation of the cost of each financing source and the discrimination between the accounting value and the market value of capital, in order to determine the weighting coefficients.

As a result of establishing a certain capital structure, borrowing funds influences, within certain limits, the performance and the value of an enterprise. At the same time, the reduction of the cost of capital is also achieved, given the fact that borrowed funds are less costly than the external equity funds. The Modigliani-Miller model sustains\(^1\) the impact of the borrowing policy on the equity cost of capital, in the sense that increasing the long-term financial debt leads to the increase of financial leverage, which will determine the increase of the return on equity, given an economic profitability higher than the interest rate. This is the financial leverage effect.

If the model accepts the existence of the tax on profit\(^2\), then levered enterprises will have an advantage over those unlevered (that haven’t borrowed funds), due to the tax savings generated by the tax deduction of interest. These fiscal savings increase the net profit of the indebted enterprise. The interest paid by the levered company to the creditors represents the interest after taxation, while the difference is borne by the state, which will receive a diminished profit tax in its budget.

The agency theory has brought substantial improvement in the theoretical field. According to this theory, the enterprise is no longer addressed only from the perspective of shareholders and their wealth maximization, as the theory tries to offer solutions for harmonizing the stakeholders’ interests. In performing their activity, the decision makers of a company will have to take into account the conflicts that arise from bringing together several interests. If these conflicts are not recognized and properly regulated, they can jeopardize the efficiency and lead to the reduction of the company’s market value. As a natural consequence, the conflicts of interest\(^3\) generate agency costs. The Jensen-Meckling model illustrates that the agency costs can be reduced through leverage.

According to an overview from the literature\(^4\) in the field, the agency costs are defined as those costs borne to motivate the entrusted managers to maximize the shareholders’ wealth instead of acting in their own benefit.

The most important conflict of interests, from the point of view of the impact on corporate value and performance, is the one between the owners and the managers of the company. The agency theory sustains the manager is not concerned only with maximizing the owners’ wealth, given the fact that he has his own utility function to maximize. Consequently, the influence on corporate performance and value, as well as the impact of leverage on the reduction of agency costs, both support the idea that the financing method is correlated to the organization of the business, with specific relations between the different persons implicated in the business, i.e. concerning the management or the corporate governance.

The concept of corporate governance refers to the coordination of the interests of different stakeholders of the enterprise: the shareholders, the managers, the employees, the creditors, the clients, the suppliers, the state etc. In every enterprise, there is an assembly of specific relationships between the physical or juridical persons that have a stake in the business. The studies concerning corporate governance focus on the way in which the suppliers of corporate capital make sure that their investments bring them benefit. The evidence that debt can serve as an instrument to discipline managers to avoid the inefficient consumption of a company’s resources is vital for the literature regarding corporate finance. A high number of well-known analysts have developed this evidence. Moreover, the managers themselves sometimes choose, on a voluntary basis, the debt instruments to limit their own plans and financial constructions, thus trying to prevent changes in corporate control. Due to this finding and in order to support the idea that both leverage and well designed corporate governance structures represent solutions for reducing agency problems, we would expect the companies in which the corporate governance mechanism functions properly to have a lower debt ratio.

In this respect, the results of the studies in the field confirm the idea according to which the progresses in the corporate governance area limit the role of debt as a disciplinary mechanism, as the analyzed companies have significantly diminished their leverage.

In the context of the relationships created between the owners of interests within an enterprise, but taking also into account the role of debt in disciplining managers, we find sufficient reasoning to argue that the corporate governance mechanisms are correlated to the selection of a firm’s financing resources.

**As a conclusion, the functioning of corporate governance mechanisms is linked to the financing decision in the sense that it ensures a framework of relationships (between stakeholders) favorable for the attraction of financial capital. The other way around, the financing decision will influence performance and will contribute to solving conflicts of interest. There is, therefore, a biunivocal relation between the financing decision of an enterprise and the corporate governance mechanism.**

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BIBLIOGRAPHY
