GHEORGHE SANDU
AUREL BURCIU

NEW APPROACHES IN THE ENTERPRISE FINANCING THEORY

1. Introduction

Determining the financial structure of the firm has been making the subject of numerous articles for forty years now. The existence or the non-existence of a most propitious financial structure is an often-asked question.

The Modigliani and Miller model of 1958 is the first rigorous theoretical construction having as object of study the determining of the firm's financial structure. In the supposed existence of a perfect capital market, the value of firms does not depend of the financing structure, given the conditions of a risk class. Modigliani and Miller admitted that their model lacks realism, due to the multiple imperfections existing on the market.

Thus, contrary to traditionalists, they have built a rigorous methodological theoretical construction, serving as background for subsequent reference papers. The relinquishing of certain hypotheses, that is the introduction of imperfections on the financial market will provide this model more realism and will explain the notion of most propitious financial structure.

2. The theory of compromise

The hypotheses of the Modigliani and Miller models of 1958 (the absence of fiscality, of bankruptcy cost, conflicts of interests, of the lopsided scatter of information) were progressively abandoned. This aroused several theories that we can differentiate according to the reference, more or less explicit, made to the notion of most propitious.

The principle of compromise is traditionally used to explain the ways through which a firm can reach an optimal degree of indebtedness. The object of this theory is to explain how a most propitious financial structure

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may be reached with the purpose of enlarging the firm's value: in other words, the fiscal economies tied to the interest's costs would allow the firm to be indebted in the way in which the marginal profit of these economies would compensate the loss very likely to come out of the costs of a critical financial situation.

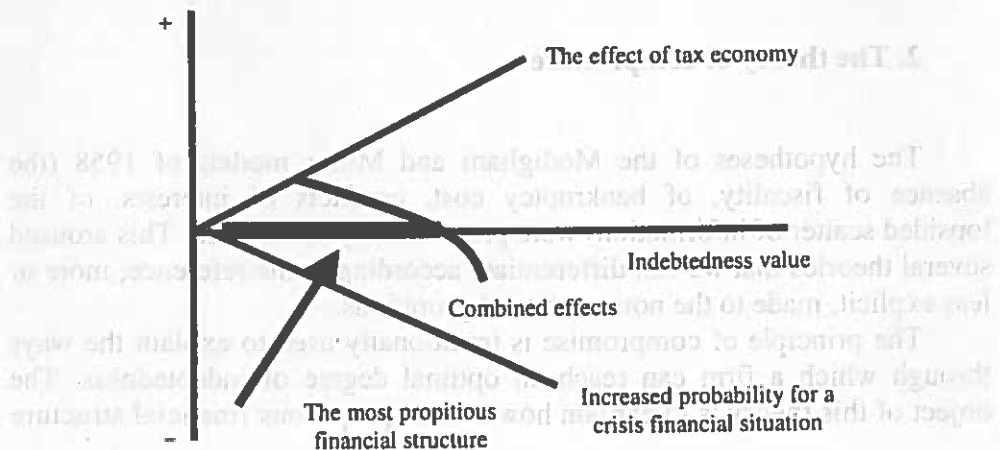
According to the initial hypotheses of Modigliani and Miller model of 1963, a firm is interested in maximum indebtedness in order to benefit from the tax economies, in the situation where the critical financial situation does not require additional costs. But, if the last suppositions are eliminated, the more indebted the firm is, the more it risks not to be able to pay its creditors, creating a procedure through which the shareholders might lose everything in the end.

In order to maximize the global value of the firm (or to maximize the objectives of different partners of the organization) the manager is determined to take into account both the advantages and the possible costs of indebtedness, in the determination of the financial structure. To be more precise, he will choose a financial structure, which will maximize the wealth of shareholders. To conclude, the formula, which sums up the "stricto senso compromise" theory, will be presented:

The value of an indebted firm =
The value of the firm entirely financed by capitals +
The value of tax economies –
The value of additional costs caused by the critical financial situation.

The determining of the most propitious financial structure according to the "stricto senso compromise" theory is plotted in the following figure:

The Effect of the Indebtedness on the value of the firm



The most propitious structure according to the compromise theory

Jensen and Meckling (1976) consider the "stricto senso theory" as incomplete, since it implies the fact that "no indebtedness process can be taken into account in a tax free universe and in the context of no additional costs determined by a critical financial situation".

We also consider that indebtedness had been currently used long before the possibility of creating economies associated to financial expenses was taken into account and, consequently, this theory does not explain the important determinatives of the financial structure. Neither the costs of the critical financial situation, nor the existence of fiscal economies explain the use of certain preferential actions, which do not present any fiscal advantage.

3. From the theory of counterbalanced markets to the theories based on firm problems

The theory of counterbalanced markets allows global thinking but completely evades the particular interest of different considered parties, even if up to one point they share a common interest.

We consider as incomplete the theory of counterbalanced markets in order to explain the financial relations of the enterprise with those who provide them with capitals.

More original, more complex and more profitable ways of thinking allow the perception of financing practice of enterprises and the analysis of the financial structure's formation. We are talking here about the agency theory and the signal theory. These trends came out in the 70's.

The agency theory problems consist of the integration of the diversity of organizing ways and decisions in the enterprise in order to explain the formation of its value and the selection of the financing ways. The signal theory differs from the agency one in that it does not take the diversity of decision power organizing ways for an explanatory variable of financial decisions. In general problems entirely subscribe to the neoclassical frame and consist of the analysis of inefficiencies caused by the imperfection of economic and financial information and also its asymmetry concerning the repartition between internal agents of the enterprise, especially managers and also external ones, particularly investors.

There is also a third trend (the pecking order theories), even more recent than the agency and the signal theory, trend that clarifies the enterprise financing. According to this trend, enterprise financing is

analyzed starting with the industrial and commercial "characteristics" of the firm, allowing a connection (link) between the industrial organization of the firm and the choice of finance.

Thus, just like the agency theory, the "organizing way" variable is considered as an explanatory factor of financing decisions; but it does not only concern the ways of organizing executive and control functions of these enterprises; but are taken into discussion the industrial structures and the strategic choices considered in order to explain the financing sources. Therefore models increase the influence on the enterprise financing of variables concerned with competition strategy, of the negotiation power concerning suppliers and/or clients or the specificity or non specificity characterizing the financed industrial assets.

With this final approach, the theory of transaction costs interferes to explain the choice of financing ways concerning the interdependence between investing and financing choices. And here we find that the preoccupations of this thinking trend combine with those of the agency and signal theories.

4. Conclusion

These trends are essential in solving the hiatus (existing) between the neoclassical financial theory's predictions and the practice of enterprise financing. They allow seeming contradictions to be solved and the theory of enterprise financing neutrality to be overcome, but without raising the problem of the foundation of hypotheses in financing neutrality.

References

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