

THE IMPACT OF FINANCIAL STRUCTURE ON CORPORATE GOVERNANCE MECHANISMS

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Abstract: *The theory and practice of corporate finance has allocated over time an important field of study in favor of the main corporate decisions regarding financial structure and its implications over: the shareholders, the debt holders, other stakeholders and on the participants from inside the corporation. The first section of this paper contains a theoretical synthesis of several cornerstone studies on this subject. The second section is a research proposal which can be undertaken in order to materialize theory into practice, by testing these implications on the Romanian corporate environment.*

Theoretical Aspects

The most obvious consequence of financial structure decisions is that leverage increases the variance of the residual cash-flows accruing to shareholders. Simultaneous changes in business risk and financial leverage have the potential to significantly alter managerial incentives and the distribution of financial risk between different corporate stakeholders.

However, recent research has confirmed that markets are often highly inefficient because of bounded rationality and widespread incomplete and costly contracting. Consequently, many of the wealth effects of financial structure decisions will not have been anticipated by stakeholders and many corporate decisions will inevitably involve contractually uncompensated wealth transfers. Then, clearly, leverage decisions will heighten conflicts between shareholders and other stakeholders.

Shareholders offer managers the freedom to exercise whatever decision-making discretion on their behalf. But, as Berle and Means [1932] have shown, the shareholders of limited liability firms may not actually have appropriate incentives¹ to monitor and exercise control over executive decision making. Thus there must be identified means and incentives to discipline and reward senior executives in ways that efficiently align executive and shareholder interests.

Moreover, debt holders have developed a variety of well-established ways of protecting themselves and obtaining financial compensation for any perceived exposure to corporate risks. Also, the employees (with personal holdings of shares or who participate at pension schemes from within the company) are exposed to firm-specific risks.

In practice, not all potential losses to stakeholders can be anticipated and protected by legally enforceable contractual agreements. So, it must be admitted that shareholders may not be the only residual claimants. If the decisions of corporate controllers have the potential to generate negative externalities for groups other than shareholders, then it is more appropriate to view the firm as a “social institution”, with obligations that extend² far beyond its legally enforceable formal contracts.

It is useful to investigate the opinions of finance researchers regarding the financing decision (capital structure) and the way how leverage may impact on firm value and the riskiness of different stakeholder financial claims.

¹ Berle, A. A.; Means, G.C.; *The Modern Corporation and Private Property*, Macmillan Publishing, New York, 1932

² Zingales, L.; “In Search of New Foundations”, *Journal of Finance*, 2000, pp. 1623-1653

The degree in which, in practice, the economic welfare of other corporate stakeholders is significantly influenced by corporate financial structure decisions depends upon how far their financial claims are adequately protected by a set of legal, regulatory and governance arrangements that function in the corporation. However, if we take into consideration that any organization is a risky entity, then it is obvious that the financial claims of shareholders and debt holders, along with the future earnings expectations and occupational pension promises made to employees, all of these are essentially contingent claims that depend upon the long-term financial success and continuity of the risky enterprise.

Many critics of the “shareholder primacy” model brought arguments that sustain the contingent nature of financial claims and suggest alternative models for apportioning stakeholders’ interests, like those utilized in Germany and Japan. Moreover, the changes that took place in corporate policy in the UK (especially stemming from the implementation of EU Directives) provide consistent safeguards in respect of non-shareholder financial claims.

Should a firm require additional external financing, it may choose between equity and various forms of debt (e.g.: bonds, bank loans and short-term credit). On an efficient capital market, the price a firm will expect to pay in order to access these forms of finance will represent a fair return on investors’ capital, given the risk of the security issued by the firm. The price for debt tends to be lower than for equity, since debt obligations are less exposed to corporate risks. In addition, if the firm is unable to honor its obligations (capital repayment and interest), it has the option of default, at which point control over the firm’s assets is transferred to the debt holders.

Interestingly, shareholders can increase their potential returns if they can persuade the debt holders to lend the firm further funds (for example, to convince the debt holders that the cash-flow distribution is less variable than it really is). If the firm defaults, some of these downside losses will be borne by the debt holders (due to the limited liability of shareholders). Conversely, all upside gains will still accrue to the shareholders, because of their smaller equity investment. It will earn them higher percentage returns than the returns of the shareholders of low or no debt firms.

One has to put the question whether financial leverage creates value, increases the value of the firm or simply just increases the financial risks (and fair returns) of the shareholders. These issues have been central to much corporate finance since the publication of the famous irrelevance theorems, by Modigliani and Miller³ [1958]. According to the model proposed by the two authors, in a *perfect and complete market setting*, with no transaction costs or taxes, *the financial structure of a firm will have no effect upon its value*. Therefore, capital structure decisions will merely result in changing the distribution of value between different stakeholders of the firm. These decisions will alter shareholders’ anticipated risk and return, but this will not have any impact on total firm value.

However, this perfect market model is irrelevant for the purpose of establishing a method for choosing the financial structure for the firms in the real world. The model also implies that corporate governance is irrelevant in a perfect and complete market setting, in which all corporate stakeholders can equally contract with each other via market transactions. Empirically it appears that firms typically have fairly stable inter-temporal capital structures. Several post Modigliani and Miller studies have developed models of optimal capital structure which involve maximizing the value of the firm, in the context of a trade-off between the tax shield advantages of debt and the agency costs of equity.

The most influential optimal capital structure model is that developed by Jensen and Meckling [1976]. The model⁴ states that on a market without corporate taxes, but with non-trivial

³ **Modigliani, F.; Miller, M.;** “*The Cost of Capital, Corporation Finance and the Theory of Investment*”, American Economic Review, 1958, pp. 261-297

⁴ **Jensen, M.C.; Meckling, W.H.;** “*Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure*”, *Journal of Financial Economics*, 1976, pp. 305-360

agency costs, ownership and capital structures are not independent of each other, but rather are chosen so as to minimize total agency costs. Jensen and Meckling were pioneers in the development of agency theory and the “optimal contracting” theory.

However, this model is based on a number of strong assumptions: all economic agents are rational contractors and financial markets are efficient. Thus, agency costs are ultimately borne by the shareholders. Agency costs and bankruptcy costs have a negative impact on the current firm value; on an informationally efficient capital market, the present value of these costs will be reflected in the prices that capital suppliers (shareholders, debt holders) are willing to pay.

Corporate governance policy initiatives have concentrated on the agency costs associated with equity. As debt requires the regular payment of interest (and capital repayments) it has been argued that high debt levels can play a disciplinary role in reducing the agency costs of equity, in firms with significant free cash-flows that might otherwise be spent by management on negative net present value investments. These issues are discussed⁵ in Jensen’s [1993] “*free cash-flow*” model.

Other studies have examined other ways in which corporate managers, acting in shareholders’ interest, may attempt to shift business risk onto other stakeholders. One mustn’t forget about the *underinvestment problem*, stated by Myers [1977]: shareholders can lose if the management invests in a positive NPV project and then the firm subsequently becomes bankrupt. Under these conditions, the benefits of the project accrue to the debt holders⁶.

In essence, it can be stated that the corporate governance (the way in which the discretionary actions of executives are exercised onto satisfying the shareholders’ interests) is of economic importance only in a world characterized by both agency costs and incomplete contracts.

Future research

In my opinion, the primary objective of a potential research proposal, in this study area, is to determine the existence of a connection between the financing decisions of a firm, materialized in the capital structure, and the mechanisms of corporate governance. Thus, the starting point consists in the financial data that describe the way in which the firm is being financed, respectively the financial sources (the liabilities from the balance sheet). These data will be collected from the most representative Romanian firms, particularly those whose shares are traded on the Romanian capital market.

The data will be processed in order to obtain an *entry data base*, where data is represented both in absolute values (accounting data or market data) and in relative values (indicators of financial structure and financial leverage). In essence, these values define an explanatory variable which synthesizes the information regarding the financial structure of the firm. By means of mathematical formalization and econometrical instruments, there will be studied the existence of a relationship between the explanatory variable and an explained (dependent) variable, which stands for the governance and strategic leadership of a company. There will be taken into analysis and consideration both quantitative dependent variables (e.g.: firm value, performance, productivity) and qualitative dependent variables (e.g.: rate of management turnover). The dependent variables will be defined by the values contained in the *exit data base*. The financial data can be gathered from the synthetic financial documents, public documents, which are often posted on the internet. The qualitative data will be accessed by means of the appendixes to the financial documents.

⁵ Jensen, M.C. ; “The Modern Industrial Revolution, Exit and the Failure of Internal Control Systems”, *Journal of Finance*, 1993, pp. 831-880

⁶ Myers, S.C.; “The Determinants of Corporate Borrowing”, *Journal of Financial Economics*, 1977, pp. 147-176

The econometric technique that will be used most frequently is the simple/multiple regression. As the analysis develops, other statistical and econometrical instruments will be used, wherever and whenever scientific rigor requires.

An important aspect which must be mentioned at this point is that the qualitative variables that synthesize the corporate decisions regarding management turnover are discrete variables and they can be encoded in the following fashion: 0 (the manager is dismissed, replaced) and 1 (the manager is kept in the governance position). Therefore, the study can be expanded by using binary dependent variables, included in a special regression, modeling a probability which is a function of causative factors and certain parameters. Thus, models with binary choice, like the model of linear probability, the probit model and the logit model, will be taken into analysis in order to verify the degree in which these models pattern with the studied phenomena.

The results of this research are useful both from the ownership point of view and the mandatory management of a firm. The goal of the research would be to detect a link, a connection between the way of gathering financial resources and the purposefulness of the entrepreneurship. This purposefulness can be explained by the increases in the wealth of the shareholders, the increases recorded in the profitability of the business, as arguments in favor of the efficiency that characterizes the functioning mechanisms of the corporate governance, but one mustn't overlook the changes that take place in the structure of the operative leadership (the management). It is highly important to study, on the case of Romania, the degree in which the financing decisions influence the purposefulness of the business, and, moreover, if the performance signals are correlated with the dismissal or the maintaining in position of the managers.

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