

# OVERVIEW OF THE COMPANY'S FINANCIAL STRUCTURE

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## Abstract

*The purpose of the paper is to highlight the fact that the company's financial structure is, empirically speaking, the parent entity from which starts all the activities that generate the self existence of the company. The company's financial structure also known as the company's capital structure conducts directly the organizational and inter-organizational behavior and indirectly the classification on the market of the referred economic agents.*

*This paper aims to describe the factors that influence the company's financial activity, it's direct and related sources of funding used to maintain or increase a satisfying turnover and the theories that conduct the company's capital structure.*

**Keywords:** *financial structure, company, economic agents, capital, turnover*

## Introduction

The financial structure of the company reflects the composite formation of the capital that can be borrowed and represents the ratio between the short and long term financing.

The financial structure of the company generated countless disputes along the theories of classifications of companies in the market, theories regarding the financing resources of an enterprise and the organizational and inter-organizational behavior of the direct participants in the economy.

Over the time informational frames were formed regarding the necessary theories for companies classification in the market, theories regarding the financing sources and also debates, critics and additions to the financing decisions as in practice and in theory.

The first economic representation of a company has been shaped by the neoclassic model and started from the ideas promoted by Adam Smith in 1776 regarding the fact that individual focused interests pursuit should lead to a common interest. The neoclassic theory regarding the economic balance, partial and global, as Prof. Ion Stegaroiu said, is considered to be the best finalized representation of market economy functioning, where the company has the central role.

The traditional model includes a number of significant features of the analyzed environment, as follows: the description of balance conditions in the perfect competition context, characterized by the atomicity of participants (the existence of a high number of buyers and sellers whose volume of individual exchange is negligible compared to the overall volume of trade), the product homogeneity (the suppliers trade identical goods, so the buyers are indifferent to the identity of the seller), free and transparent market entrance (the traders are perfectly informed regarding the price and quality of products) and the individual rationality principle.

In the neoclassic theory, the company is seen as an entrepreneur expressing its own will (the atomicity feature) who, eventually, will seek the maximization of profit (rationality feature), promoting its product (the homogeneity feature) to a group of perfectly informed buyers (economic transparency feature).

The neoclassic reasoning has many advantages and has been considered over time to be eloquent and relevant. The advantages are extremely important and regarding the theoretical possibility of seeing the optimal conditions thorough which the producer has at disposal an important analyzing mechanism that adds to its management instrument (break-even, elasticity, productivity, etc.) that permit the identification of maximum profit opportunities.

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The neoclassic theory has been often criticized and labeled unrealistic, bringing the argument that the existence of a platform which has all of the offers and requests centralized is rarely seen. Another argument brought is that the theory is dedicated to the market efficiency issue, without considering the cost of its operation.

Despite the criticism, the issues addressed by this approach cannot be totally rejected. Over time the assumptions were reconsidered, retreated, adapted to the existing market model, leading to other theories that have been guiding the competitive environment and the economic activity both to microeconomic and macroeconomic level.

Goods homogeneity assumption was shaped in a different manner by E. H. Chamberlin who proposed a monopolistic competition analysis through which “every supplier has absolute monopoly over his product, but it is subjected to competition by more or less substitutable goods”<sup>1</sup>.

The assumptions of individuality, subjected to a new analysis by A. A. Berle and G. Means highlighted the property exclusion from the company’s management.<sup>2</sup>

The principle of rationality has known a conceptual retreatment proposed by H. Simon<sup>3</sup> namely the addition in the neoclassic model of the bounded or procedural rationality concept over the perfect rationality, starting from an economic behavior analysis implicated in decision taking processes, given the substitution of the profit maximization principle with the satisfaction principle, so, the individual can be pleased with a satisfactory decision and not necessarily with an optimal decision so it is taken to consideration that the individual does not seek the higher earning but the acceptable solutions.

Comparing the perfect rationality with the bounded one, we can observe that the perfect rationality is founded both from decisional processes results and objectives and the means to achieve them aprioristic, while the bounded rationality is based on decisions taking procedures and the objectives and means to achieve them are settled as reference base and as research results.

Based on the new framework created by the introduction of new notions used above, J. G. March and H. A. Simon (1958)<sup>4</sup> and R. M. Cyert and J. G. March (1963) proposed a contractual and behavioral model of the company as a productive organization which consisted in a coalition of individuals that contribute to the well functioning of the organization in exchange of a satisfying payment. By combining the production elements and highlighting the managerial art involvement, the organizational practices are highlighted and they lead into a more general model that takes into account the economic efficiency, to the contractual theory. The purpose of this theory consists in describing the exchange relationships between the parts taking into consideration the institutional and informational restrictions that govern them.

As alternative approaches to the attempt to eliminate the contractual theory’s inadvertences, the conventions economy and the evolutionary economy emerged.

The conventionalist approach states that the company is a conventional framework, therefore a convention that defines working in common and the market as a qualification convention that defines the exchanges trough which the consumer has the role of expressing its wishes and the company has the role of answering to them.

The evolutionary approach tries to settle the way that different behavioral model are perpetuated over time and aims to decipher and understand the processes involved in all the evolutionary stages both at technological and organizational level.

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<sup>1</sup> E. Chamberlin, *The Theory of Monopolistic Competition: A Re-orientation of the Theory of Value*, Harvard University Press, 1933, 1965, 8th ed.

<sup>2</sup> A. A. Berle and G. C. Means, *The Modern Corporation and Private Property* (2nd edn Harcourt, Brace and World, New York 1967).

<sup>3</sup> Simon, Herbert, *Bounded Rationality and Organizational Learning*, *Organization Science* 2 (1): 125–134.

<sup>4</sup> March, James G., *A Primer on Decision Making: How Decisions Happen*. New York: The Free Press.

This kind of evolution led to the renewal of microeconomic analysis instruments, as the finality to the new theory emerged – The Theory of Games.

The Theory of Games was introduced into economy by John von Neumann and Oscar Morgenstern<sup>5</sup>, both of them defining the game: “the game is simply the totality of the rules which describe it”. Taking into consideration that this description can be applied to any type of phenomenon, the Theory of Games has found a series of uses in both the social and economic domains, distinguished from other theories by the pronounced mathematic character.

The base assumption of the Theory of Games is the assumption that includes the rationality of players, according to whom each player has as purpose the maximization of his own earnings. These earnings depends both on his and others decisions. The main approach consists of the assumptions and questions that each player will ask himself: what will others do? This is the only question available because another essential assumption of the Theory of Games is based on the fact that each player has a complete set of information: each player has information on the game and other players – common knowledge, except for their decisions, the only issue being the right anticipation of these decisions. Theoreticians signaled situations where the players do not take into consideration various characteristics of the game, this being the complete informing situations. If the information is not completely defined, in its minutest details, then the theory is not relevant.

The result of the Theory of Games and economic information lead over time to the contractual theories that have as purpose the description of inter-agents exchange relationships taking into consideration all the institutional and informational restrictions in which they fit at evolutionary level. Punctually, the contractual theories can be used to describe the applied strategies in negotiating contracts, as in substantiating the finance, management, marketing and other decisions. In these theories, the company is considered a perfect framework that incorporates a perfect network of contracts, policies and agreements between the component individuals. Inside the contractual theories we also find the Positive Theory of the Agency based on the article “Theory of The Firm: Managerial Behavior, Agency Costs and Ownership Structure” published by M. C. Jensen and W. H. Meckling in 1976<sup>6</sup>. Founder’s initial concern of the Positive Theory was to show to the managers an analysis pattern that will allow understanding the degree of the organizational structure involvement in the performance in order to shape the actions and the decisions in this way.

The presentation of the above mentioned theories aimed to highlight the initial microeconomic framework, which trough the adhesion at a dynamic economic environment in a continuous evolution scale, emerges to new approaches of the important issues of financial microeconomics, namely the issues regarding the company financing and optimal capital structure selection.

In 1985 M. Miller and F. Modigliani<sup>7</sup> sustained the famous theory under which the value of the company is independent from the means of financing, theory criticized for its restrictive assumptions that, over time has been enriched and as a result brought in foreground the reflections centered on the financial structure selection throughout the systemic principle of arbitration between costs and advantages of different financing sources.

New microeconomics theories have removed two hypothesis of the classical scheme: the symmetry of information for all agents and the identity of their interests (income maximization or company’s value). Regarding the financing principles, the Theory of Signals shows that the level of indebtedness can serve as a signal from the managers to their external partners, fact that can

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<sup>5</sup> John von Neumann and Oskar Morgenstern, *Theory of Games and Economic Behavior*, Princeton University Press (1944).

<sup>6</sup> Jensen M. C., Meckling W. H., *Theory of the firm: Managerial behavior, agency costs and ownership structure*, Journal of Financial Economics, vol. 3, 1976.

<sup>7</sup> Modigliani, F.; Miller, M. (1958), *The Cost of Capital, Corporation Finance and the Theory of Investment*, American Economic Review 48 (3): 261–297.

determine the balance for each financial structure. The Theory of Agency states the indebtedness as a solution to the conflict of interests between the managers and shareholders mentioning that it can also cause other conflicts (between the managers and shareholders on one hand and creditor on the other hand).

The classic company financing scheme, with the perfect market assumption and maximizing company's value behavior for the financial market can be highlighted through two essential ideas. The first idea refers to the fact that enterprises do not use self-financing for net investment but the depreciation fund installments for the corresponding amount for replacement investments, distributed as dividends for shareholders and use external capital to finance their net investments. The second idea underlines the fact that companies have two external sources of financing: increase of share capital by shares issuing and credit indebtedness<sup>8</sup>. The issue of finding the advantageous financing sources was brought up, thereby the answers to M. Miller and F. Modigliani's theorems. The first theorem can be enounced as follows: for the given class of economic or exploitation risk, the market value of the company (the sum of equity and expenses) is independent to the financial structure, in these conditions the average weighted cost and company's value are constant. The second theorem states that the investment decisions are independent to the financing decisions.

Criticisms of the classic scheme are presented as three aspects: the purpose of self-financing, heterogeneous character of external financing sources and the real issues of indebtedness<sup>9</sup>.

The purpose of self-financing refers to the fact that depreciation funds allow financing a part of the growing investments by the game of multiplication effect – Lohmann-Rüchti effect and by keeping a part from the net result inside the company, underlining the important part of self-financing in financing the growth and replacement investments.

The heterogeneous character of external financing sources refers to the heterogeneity of loaning or cash intake from shareholders. About the increase of share capital method of external financing, it has been observed that unlisted companies cannot use the same conditions used by the listed ones.

The issues of real indebtedness limits that are referred in the theorem of independent company value in relation to its financial structure is knowing why the companies are not totally indebted and why in reality certain companies indebted more than other, even if belongs to the same class of economic risk. M. Miller and F. Modigliani solved this problem, proving that companies choose to maintain a certain capacity of indebt to benefit from flexibility.

Empirical studies showed that the classic scheme doesn't provide answers to lots of questions that are subject to actual concerns at company's financing, but financial neoclassicism, through the Theory of Agency and the Theory of Signals brings not only answers but real solutions to solving the optimal financial structure issue. The Theory of Signals begins from the assumption that markets are rarely in balance and the obtained information has a defined cost criteria conducting to different delivery times to the managers. Having this theory as basis, the managers of a company can have access to information that investors cannot, hence the interest of obtaining information before others do. This activity can sometimes be misinterpreted because of manager's opinion, unfounded and exaggerated optimism leader of hidden advantages. The signal is actually a financial decision with negative consequences for the one launching it, in this case the one who tries to send erroneous message. The Theory of Signals analyses the company's financial decisions – financing policies, dividend distribution policies, indebtedness policies, repurchase of shares policies, etc., as signals from managers to investors.

Indebtedness policy explains why an increase of liabilities means an increase in the company's risk. Managers of companies from this situation send information that authorizes the market to believe that the company's performance will allow reimbursing this debt without

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<sup>8</sup> *Encyclopédie de gestion*, vol. II, Economica, p. 1223, 1989.

<sup>9</sup> Perez R., *Grande entreprise et système de financement*, in Mélanges offerts à P. Vigreux, Toulouse, 1981.

difficulties. If the signal is false, the following sanctions can even discharge the managers if taking into consideration that the company will be in difficulty at the reimbursement time, this means that the managers are stimulated, most of times, to send correct signals.

The dividends distribution policy transmits information regarding several studies that demonstrate the managers are reluctant to decrease of paid dividends. Distributions of dividends is interpreted as a positive signal sent to market, centered on the idea that managers believe that the performance evolution of the company will allow to maintain current dividends in the following years, or even increase the amount. Otherwise, a decrease of dividends has a negative signal impact, noticing unclear perspective to the evolution of the company.

If the Theory of Signals reconsider the classic premissis regarding the uniform spread and accessibility of information, the Theory of Agency reconsider the premissis by which the company has as sole representative the share holder manager, claiming that the company can solve conflict by completing a contractual relationship network, company's behavior being now incomparable to the market's, meaning it represents the result of a complex balancing process.<sup>10</sup>

### Conclusions

The financial structure of a company will always rise issues of specific capital components, of their nature, considering that from the first theories until present, their studying will know a large expansion in interest granted by the factors influencing the financial structure - meaning the assets structure, sales stability, manager's behavior, internal climate and the financial market conditions, taxation and low trust in banking institutions.

The own funds/borrowed funds controversy, developed by finance theoreticians who tried to find the optimal liabilities structure is vaguely found in the practice because the practitioners are more interested in the conclusions of the Theory of Signals, for which a viable enterprise borrows and manages to repay at term<sup>11</sup> and the conclusions of the Theory of Agency who's originality consist of rejecting the convergence assumption in the interest of all partners of the company.

Concluding, the traditional approach shaped by M. Miller and F. Modigliani resumes to the fact that in the presence of income tax, the value of an indebted company is equal to the value of a company without loans with the addition of the economy of income realized from indebtedness. The Theory of Agency approach reflects on the fact that the optimal financial structure results from a compromise between various ways of financing that allows solving those conflicts of interest, considering that indebtedness and equity attenuates some conflicts and starts other ones.

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<sup>10</sup> John von Neumann and Oskar Morgenstern: *Theory of Games and Economic Behavior*, Princeton University Pres, 1944.

<sup>11</sup> M. Glais, *Le diagnostic financier de l'entreprise*, Paris, Economica, 1984.

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