

CORPORATE FINANCE THEORIES AND PRINCIPLES: REDUNDANT**R. Malar MARAN***Punjab Technical University, India
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alexandrun@seap.usv.ro***Abstract**

Corporate finance participates in economic development of Romania. There are theories and approaches which shape investment decisions and finance decisions. During the euro crisis these theories and approaches failed to emulate reasonable use of such decisions. Romania has remained robust during the euro crisis. Therefore the investment decisions and finance decisions are independent to theories and approaches during the crisis. Theories and approaches are describing the changes in investment decisions and finance decisions. The explanations are only offered.

Key words: *Corporate finance, investment decisions, finance decisions, theories of corporate finance, and explanations*

JEL Classification: *G21, G22, G23, G28*

I. APPROACHES TO CORPORATE FINANCE

Corporations have independent legal entity and have certain features such limited liability, ownership of others capital, undertaking all the responsibility of managing the capital including the payment of taxes, and functioning as agent and principal for maximizing values with all liabilities. There are three approaches to corporate finance (Franco Modigliani and Merton H. Miller (1958)). The corporate finance expert's approach is the first approach and he deals with the survival and growth of firm. This approach deals with the techniques of raising finance. The second approach is associated with the capital budgeting and planning.

The third approach specifies the investment behavior in terms of micro and macro principles of economy. Thus these approaches deliberate on the cost of capital to the corporate finance. The consequences of these approaches have two value additions to the firms. The first value addition is for expanding marketing and the second is enhancing profit. Corporate finance deals with business and trade. There are capital investments without participating in business and trade. Capital is one of the factors of production and thus its participation in economic growth is important. Sources of capital decide the nature of investment and consequences of investment. Many investments remain dormant and other investments are active. Dormant investments may be several. One of them is the financial debt of long term and short term liabilities. Corporate finance is directly associated with this. It influences the capital structure. Capital structure determines growth of business and trading. Business includes manufacturing and production.

Corporate finance aims to maximize financial competence and value. In order to achieve them there is finance decisions and these decisions based upon the assets and liabilities of its balance sheet. Common sense plays crucial role when the reasoning focuses financial decisions. There are tools available to facilitate reasoning. The reasoning skills can be developed and acquainted over period of training and practice. The reasoning skills may be collective or personal. In the corporate finance it appears to be collective but ultimately it is individual. Top decisions are made by corporate heads and regular working decisions are tabulated for the convenience of working personnel who are managers. There are situations which demand discretionary options to decide under certain conditions. Otherwise there are laid down procedures through Articles of Associations and Memorandum of Associations. In respect of Public Sectors there are public policies and government rules and regulations. Thus the Corporate Finance in Romania is challenging to understand and to analyze in terms of economic growth and development.

II. THEORIES OF CORPORATE FINANCE

Modigliani and Miller (1958) found that the capital structure of a firm remained independent of debt/equity ratio and market value did not have any impact of global value of the firm. These expressions began the modern finance and financial theories. A.Kraus and R.H. Litzenger (1973) introduced the Trade-Off theory and S. Mayers (1985), J.Scott (1977) and R.Pettit and R. Singer (1985) developed it further. Donaldson (1961) made the beginning of The Pecking Order theory. J.Chen (2004) and N. Delcours (2007) improved this theory. M. Jensen and W. Meckling (1976) propounded the Agency theory. The Market Timing theory is the latest in corporate finance.

III. PRINCIPLES AND PROBLEMS

Most of the firms prefer equity self financing (Gaurav Singh Chauhan (2016). There are three core principles in corporate finance such as (i) the investment principle; (ii) the financing principle; and (iii) the dividend principle. These principles shape corporate finance of a firm.

There are three problems that the corporation when it decides to sell equity in the market for investment decisions. One of them is the weak stock market or absence of stock market and it results into fewer options for risk diversifications. The second problem is associated with non functioning of stock market and it will limit the options for financing packages. The third problem is that no information flow will be available to the creditors and investors of competence of the firm in the ineffective functioning stock market (Asel Demirguc Kunt and Vojislav Maksimovic (1996). The Stock market Development is assessed on the basis of size and liquidity, stock market capitalization to GDP, and value traded to stock market capitalization. In Romania the structure of corporate finance reflect more reliance on self finance of 82.04% than bank finance of 24.58% (Daniel URITUP and Alexandru-Emil POPA (2015).

IV. INVESTMENT DECISIONS AND FINANCE DECISIONS

There are important financial decisions which are investment decision and finance decision. Investment decisions are closely associated with finance decisions. Both are important to corporations. The important principles of investment decisions are conditioned by rate of returns, the strength of payback, cash flows, value of money and the risks known and predicable risks. Portfolio theory provides various options to ascertain the returns of various assets. According to the Net present Value investment Rule that the investment decision should be made where there is positive net value of the project of firm. The second most principle of investment decision is the risk premium on financial assets. The historic risk premium may be varying from country to country as found 10.7% in Italy and 4.3% in Denmark but it may be due economic development which has not achieved in all sectors of economy and there may be unstable stock returns (Corporate Finance Compendium (2008), Corporate Finance, Ventus Publishing Aps, ISBN 978-7681-273-7, Free books at BookBoon.com).

The third principle is to achieve rational distribution of risk of stocks to minimize the risk of individual stock. The fourth useful model to achieve investment decision is the Capital Assets Pricing Model (CAPM) for efficient portfolios. The fifth principle is the Alternative Asset Pricing Models (AAPM). The sixth principle is to achieve variation of risk premium and pricing models for better investment decision through Three Factor Model (TFM). This theory is known as Fama-French three-factor Model (Corporate Finance Compendium (2008), Corporate Finance, Ventus Publishing Aps, ISBN 978-7681-273-7, free books at BookBoon.com, p.41). There are two finance decisions on investment and these are internal funding and external funding. Internal funding is its money. In respect of external funding it may be either loan or raising fund through selling equity.

In order to decide the external funding preference it is important to understand debt/loan characteristics. There may be short term debt/loan of one year or less and the long term debt/loan is not less than one year. There are several forms and most familiar kinds of debt/loan are Bank loans, Mortgage loans, Bank overdraft, commercial papers etc. The characteristics of equity of ordinary shares are limited liability, ownership, voting rights etc., and in case of preference shares is priority over ordinary shares, payment of dividends, etc. Now the firm has option of choosing the right combination of loan/debt and equity for making investments for value additions.

There are several theories which suggest options on the mixture or combination of debt and equity to gain value additions to the firm. Miller and Modigliani's theory on cost of capital does not recognize such combination of equity and debt does not value addition. It does not exist in perfect capital market because of the open entry and exit market conditions. However alternative capital structure theories consider the relevance under imperfect market conditions due to taxes, and other costs associated with capital. The trade-off theory admits that the cost of capital and tax savings will decide the corporate finance decision. The pecking order theory of capital structure offers alternative to trade-off theory stating that the professional managers would decide better than owners on finance decision. Murray Z. Frank and Vidhan K. Goyal (2005) while referring to the disagreement of the relevance of these two theories, they have argued that there are differences of opinions on the failings of these theories ("Tradeoff and Pecking Order Theories of Debt", *Working Paper(2005)*, Center For Corporate Governance , Track School of Business at Dartmouth).

V. FAILURE OF THEORIES AND APPROACHES

Neither debt nor equity remain the factors of investment and finance decisions but it provides certain macroeconomic considerations to the firms. Particularly in 2007-8 euro crisis the lessons are different that these theories have failed to establish credibility and reliability. All corporations have funds from debt and equity both directly and indirectly from financial and non-financial. The institutions of finance are banks, insurance companies, pension funds, mutual funds and the non-finance institutions are households, government etc. In USA the sources of debt and equity are from three sources. One of them is non-financial US Corporations and the second is US financial firms. The third is

from the rest of world. During the euro crisis it is found that to strengthen debt and equity for investment and finance decisions the following actions are essential:

- Create more conducive environments for firms and SMEs to have access to loans;
 - Suitable changes and actions are to be initiated to facilitate banks providing loans; and
 - Formulate economic policies suitably for balance sheet adjustment (European Central Bank. (2013).
- The fiscal policies of interest regulation have proved always rewarding during the crisis.

In the pre-crisis period in the Euro Area the equity was the largest liability but it considerably declined during and after the crisis. Belgium, France and Luxemburg are exceptional to it. Most of other countries have shifted from equity to debt. In fact the long term loans increased during the crisis than the pre-crisis. One of the reasons was the reduction in the value of equity and in fact the unquoted equity was 50% of equity. The panic of stock market sentiments contributed more for it. It is found more evident in Greece, Spain, Slovenia and Ireland.

The internal funding increased from the corporate savings, reduction of liquidity buffers, cut in the cost of their employees and less payment of dividends. It, ultimately, resulted in reduction of corporate investment. There is consistency in internal funding during and before crisis in countries like Germany, the Netherlands, Austria and Finland. There are exceptions due to its strong finance. No theory has ever influenced its finance and investment decisions (European Central Bank. (2013). The liquidity analysis precedes balance sheet liquidity since the balance sheet liquidity is reflected annually. The liquidity analysis is carried on short term liquidity and long term liquidity. During the crisis the long term liquidity has been preferred and thus liquidity analysis fails to help balance sheet analysis (Pescal Quiry et al (2005).

VI. CORPORATE FINANCE IN ROMANIA

Theories, Principles and Approaches to corporate finance have remained mute in Romania as the crisis has not affected the economy of Romania. The combination and optional application of debt and equity did not apply in Romania. The capital market is still underdeveloped. The internal finance is higher than bank loan in Romania. The internal and external capital structure in Romania is mostly state controlled despite the liberalization and privatization efforts of IMF. State-owned enterprises are leading sectors of Romanian economy on capital structure point of view and discharging public service obligation even though performance of them is lower than the private and foreign- owned companies. There is reduction of overdue payments on the balance sheets of state-owned enterprises from 5% GDP in 2010 to 3.4% of GDP in 2014 (European Commission 2015).

This is a remarkable achievement. All the post-communist bloc countries including Romania have the bank oriented finance sector. It amounts to 80% of financial system's assets. Recently there is the presence of private pension funds and investment funds (European Commission 2015). In fact Romanian banks carry out traditional financial function and these banks do not give loans to corporate sectors and therefore the corporate finance is evolving slowly. The non performing loan declined from 22.4% in March, 2014 to 14% in December, 2014. Further it declined to 9.9% in November, 2016 and in the same year it declined by 3.6% as per National Bank of Romania (BNR), (Romania- insider. Com. (2017). The corporate loans by banks are EUR 2 billion but during the same period the banks have sanctioned EUR 2.7 billion. (Romania- insider. Com. (2016). The corporate finance emerged slowly when Romania became member of Europe Union in 2007. There was an influence in the lending of loans to corporate sectors during euro crisis but it was very minimal (Valentine Mihai LEOVEANU (2016).

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