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Chapter 4 - Financing of Corporations

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Abstract

This review evaluates the four major theories of corporate financing: (1) the Modigliani–Miller theory of capital-structure irrelevance, in which firm values and real investment decisions are unaffected by financing; (2) the trade-off theory, in which firms balance the tax advantages of borrowing against the costs of financial distress; (3) agency theories, in which financing responds to managers' personal incentives; and (4) the pecking-order theory, in which financing adapts to mitigate problems created by differences in information.

These theories are conditional, not general. It is easy to find examples of each theory at work, but otherwise difficult to distinguish the theories empirically. Large, safe firms with mostly tangible assets tend to borrow more. Firms with high profitability and valuable growth opportunities tend to borrow less. Each of these tendencies is consistent with two or more of the major theories of financing. It may be possible to devise sharper tests by exporting the theories to developing economies, where agency and information problems are more severe.

Further progress in understanding corporate financing decisions will require a deeper understanding of agency issues when value-maximizing operating and investment decisions cannot be observed or verified. But managers are not just temporary agents motivated by immediate pecuniary compensation or perquisites. Managers specialize their human capital to the firm. Some recent research suggests how financing can support the co-investment of human and financial capital.

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Keywords

corporate financing; capital structure; trade-off theory; pecking-order theory; agency costs; financing

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