

The influence of financing decision on the value of the firm: the relevance of accounting information

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Abstract: This study aims at developing a theoretical approach on the effect of different debt-equity ratios on the firm's market value. It also aims at discussing the relevance of the role of accounting as a source of information about the capital structure and the different costs of capital it includes. Several studies demonstrate that, despite the lack of consensus among theoreticians on the relevance of capital structure in determining the value of the firm, in practice, the firms tend to manage their sources of financing so that they can get a lower cost of capital and, consequently, a higher return. The studies also indicate that accounting, by providing relevant information on the capital structure and the costs required from the company by the capital (money) suppliers, appears to be important for the decision-making process, allowing a rational decision in order to maximize the value of the firm.

Key words: Financing Decision. Cost of Capital. Accounting Information.

A influência da decisão de financiamento no valor das empresas: a relevância da informação contábil

Resumo: Este estudo tem como objetivo efetuar uma abordagem teórica a respeito do efeito que diferentes proporções de capital de terceiro e capital próprio pode apresentar no valor de mercado da empresa. Tem como objetivo, também, discorrer sobre a relevância do papel da contabilidade com fonte de informações sobre a estrutura de capital e os diferentes custos de capitais que a compõe. Os estudos demonstram que apesar da ausência de consenso dos teóricos sobre a relevância da estrutura de capital na determinação do valor da empresa, na prática as empresas tendem a gerenciar suas fontes de financiamento a fim de que obtenha um menor custo de capital e, conseqüentemente, um maior retornos para a empresa. Os estudos indicam, também, que a contabilidade, por meio da informação contábil a respeito da estrutura de capital e dos custos exigidos pelos fornecedores de capitais (dinheiro) à empresa, mostra-se relevante na tomada de decisão, permitindo a decisão racional que maximize o valor da empresa.

Palavras chaves: Decisão de Financiamento. Custo de Capital. Informação Contábil.

INTRODUCTION

In order to perform their activities, companies usually need capital to expand, get a higher return and assure the continuity of their operations. For this, they employ both equity and debt as sources of financing. An inappropriate financing decision can bring disastrous consequences for the company, resulting in a low return for its shareholders and, consequently, decreasing its value, or, in the most extreme cases, bringing financial difficulties which can lead the organization to insolvency.

Due to the complexity of the business context, accountants and managers are more and more required to make effective financial decisions to increase the value of the firm in the market and to attract potential investors interested in its performance and in the possibility of return on their investments. For making successful decisions, accountants and managers must have a broad knowledge of finance so that they will be able to recognize and use the most valuable information, understand the implications of choosing a given investment and realize the best form of financing that investment in order to affect positively the value of the firm.

One of the key points in financial decisions is the value of the firm in the market, which directs the actions and defines the behavior of shareholders and company's owners. However, the effects of financing decisions – the capital structure arrangement – on the value of the firm still generate controversy among the financial theoreticians, and many questions remain open.

Based on the above, the following questions arise: does the financing decision influence the value of the firm? If so, which is the contribution of accounting in the financing decision process? Based on the problems posed above, this paper aims at [a] verifying the influence of the financing decision based on the capital structure on the organizations and [b] discussing the role of accounting information in the financing decision.

The methodology used to achieve the goals of this research can be presented under two views: regarding the ends and regarding the means. Regarding the means, this study falls into the category of bibliographic research, since literature review is used to develop a research protocol, with the use of deductive method to indicate the importance of the capital structure in the market value of the firms. Regarding the ends, this study can be classified as an exploratory research, which provides familiarity with the problem in order to make it explicit and enable the construction of hypotheses (GIL, 2006).

CAPITAL STRUCTURE

According to Damodaran (2002), there are only two forms by which a company can obtain resources: debt or

equity. The resources for investment are thus provided to companies by shareholders and bondholders. To the creditors, the companies assign part of their cash flows as a payment of interests, and to the shareholders, the residual profits, to be paid in the future or in the form of dividends. The arrangement chosen between long-term debt and equity is called capital structure.

Capital structure has a cost of raising funds called cost of capital. Gitman (1997) defines the cost of capital as the rate required by the capital suppliers to put their funds at the disposal of the company. When owners and investors apply resources in a given organization, they require a minimum return as earnings of their capital. This return to the investor is called cost of capital for the company, which can be characterized as explicit – as, for instance, debt interests expressed in contract –, or implicit – as the earnings expected by the companies' shareholders.

The cost of capital constitutes one of the main factors to determine the value of the firm. When the company defines its financing *mix*, if the goal is to maximize its value, this can be obtained by minimizing its cost of capital. When the overall cost of capital declines, the value of the firm increases; when the overall cost of capital increases, the value of the firm declines (DAMODARAN, 2002).

Perobelli and Famá (2006) consider that, if the financing generates costs, the return adjusted to risk of the projects in which this investment is employed must be such that: 1) it pays the creditors the interests and the principal amount; 2) it pays the shareholders the cost of equity; and 3) it generates an increment for the wealth of these shareholders.

Under this perspective, no investment decision can be made without considering the financing costs – measured from the combination between debt and equity. According to Brealey and Myers (1992), a policy which maximizes the firm's market value is also the best policy for its shareholders; nevertheless, the problem is to find the particular combination that maximizes the company's market value. The question that remains among theoreticians is: will there be an optimal combination of debt and equity that minimizes the financing costs of the company and, thus, maximizes its value?

In addition to the two theses which polarize the theoretical discussion on the relevance of capital structure in determining the value of the firms – Durand's thesis (1952), which emphasizes the existence of an optimal capital structure, and MM's thesis (1958), which argues that how the companies are financed, under certain conditions, is irrelevant –, there is a third one, defended by Myers in 1984, according to which the level of debt is not motivated by the search for an optimal point, but by the need of financing not covered by internal funds.

THE IRRELEVANCE OF CAPITAL STRUCTURE

In 1958, Modigliani and Miller (henceforth MM) provided the basis for the study of the effect of financial structure on the value of the firm, which represented the cornerstone for the studies on the corporate capital structure. In this study, MM argue that the value of a firm is independent of how it is financed, since its value is determined by its real assets (investments) and not by the stocks it issues (financing). In other words, no matter what the composition of capital structure is, it has no influence on the value of the company.

MM allow complete separation of investment and financing decisions. The MM theorem (1958), also known as “the capital structure irrelevance hypothesis”, states that, under certain conditions, the value of the firm is invariant with respect to its capital structure, since it is determined by its assets. The debt-equity ratio used by a company is irrelevant to determine its market value. This theory is called MM Proposition I without taxes and its assumptions are: absence of taxes, symmetry of information and equality of costs of debt for individuals and corporations.

In addition to the Proposition I without taxes, MM formulated the Proposition II, which states that any increasing of financial leverage through higher debt results in a higher financial risk for the company's shareholders and, for this reason, the rate of return expected from their shares increases as the firm's debt increases (BREALEY; MYERS, 1992). This way, if the risk of the firm increases at the same proportion of its debt, the shareholders are compensated by an additional premium for this risk. In other words, the premium increases as the debt increases.

In a later review of Proposition I, MM (1963) recognized that the result of shareholders does not depend on the capital structure, except for the influence of the tax benefits generated by debt, due to the deductibility of interests from the calculation of the taxable profit. This decreases the amount of income tax payable, resulting in a higher free cash flow for this company (KAYO; FAMÁ; NAKAMURA, 2004). In theory, such tax benefits would recommend a capital structure fully formed by debt, since this policy would provide the highest level of tax savings and, consequently, maximize the value of the firm. The idea was that the higher the debt, the higher the tax earnings. However, it can be observed that, empirically, no firm is financed 100% by debt as Proposition I with taxes suggests, since this could lead companies to insolvency.

After the violation of the hypothesis of perfect market due to the existence of some market imperfections, such as the presence of bankruptcy and agency costs, the irrelevance of capital structure hypothesis began to be challenged. However, despite the several researches carried out in this field, this issue is still not totally defined.

THE THEORY OF OPTIMAL CAPITAL STRUCTURE

Unlike the MM propositions, the Traditionalist School, represented by Durand, in 1952 (PEROBELLI; FAMÁ, 2006), defends that, in practice, it is possible to define an optimal capital structure which allows to maximize the value of the firm and, therefore, the wealth of shareholders. According to this school, the higher the debt, the higher the risk and, consequently, the higher the cost of capital, the lower the value of the firm.

The optimal capital structure is determined by the *trade-off* (compensation) between costs and benefits of the loan. The value of the firm increases due to the tax benefits of financial debts up to the point in which the high level of debt starts to cast doubts on the company's financial health and, as a result, to increase the costs of a possible financial difficulty. In this perspective, the firm replaces debt by equity, and *vice versa*, until its value is maximized (KAYO; FAMÁ; MAZZON, 2002).

Damodaran (2002) claims that the maximization of the firm's value would occur through the minimization, on equal terms, of its overall cost of capital employed to finance its activities. In this case, the debt index in which the cost of capital is minimized is the optimal debt index, and this will be the one that maximizes the value of the firm. In this respect, the traditionalists suggest that the maximization of the firm's value occur by means of the minimization of the overall cost of capital employed to finance the firm's activities. Therefore, the firm should get into debt up to the point in which the weighted average cost of capital (WACC) is as little as possible.

According to the theory of “optimal capital structure”, the level of debt of companies would be reached by the combination of two factors that act as contrary forces: on the one hand, the tax savings would encourage the use of debts, and on the other, the expected costs of bankruptcy would indicate the company's trend to become seriously default due to situations of high debt. This way, the optimal structure would be reached when the cost of capital is minimized with the benefits of debt, but before the action of financing costs. The maximization of the firm's value would occur by the minimization of its overall cost of capital employed to finance its activities.

As indicated by this theory, the companies would aim at an optimal capital structure after considering the advantages and disadvantages of debt. Among the advantages are the tax deductibility of the financial expenses and the minimization of problems of free cash flow. The disadvantages are the increasing agency costs and the risk of bankruptcy.

Although the Trade-off Theory has a widely accepted financial rationale, it is not practical in the sense that it does not allow the firms to determine their optimal debt level (NAKAMURA; MARTIN; KAYO, 2004).

THE PECKING ORDER THEORY

The Pecking Order Theory was developed by Myers (1984), and Majluf and Myers (1984) on the assumption that the firms follow a hierarchy of choices when defining how they will finance their projects, firstly recurring to internal funds, followed by debt issues and, finally, by equity issues (MYERS, 2001).

According to this approach, debt level is not motivated by the search of an optimal point, but by the need of financing not covered by internal funds. Companies prefer internal financing when available, and they would only issue new shares as a last option, on account of the adverse effects caused by the existence of asymmetric information in the market.

Brealey and Myers (1992) point out that the hierarchy of choices is a consequence of asymmetrical information, since the managers know more about their respective companies than external investors, and so privileged information is used to finance the firm with risky assets when the firm is overpriced. Investors may interpret new equity as bad news and when new shares are issued, the market value of old shares decreases.

Under these aspects, debt is better than capital since asymmetry of information can reduce the value of the company. Optimist managers will prefer debt to underpriced shares, and pessimist managers will be pressed to follow them. According to the hierarchy of choices theory, shares will only be issued when the capacity of debt ends and the financial difficulties become a threat (BREALEY; MYERS, 1992).

According to this theory, companies do not aim at a target structure in order to maximize the value of the company through cost of capital; instead, they aim at obtaining external funds in an order that they do not underprice the company due to asymmetrical information.

THE ACCOUNTING INFORMATION

In the constitution of a firm, investors or shareholders define the type of society, the volume of capital to be invested, the activities to be carried out, normally based on plans, aiming at investing in resources that can maximize the value of the company and, thus, increase the wealth of owners and shareholders. All these activities are expressed in monetary values and constitute facts that generate accounting entries, that is, entries of data in the accounting information system (SILVA, 2006).

These facts recorded in the accounting information system involve calculations, classifications and records, forming a rich database. This database generates a set of information to help the decisions of managers and investors when they have to choose between different investments, subsidizing the evaluation of the projects and their possible

sources of financing and the evaluation of the use of equity by issuing new shares or searching for investor's money. The projects approval will be conditioned to an expected return rate that exceeds the cost of the capital employed in the project financing. In this perspective, the manager's goal is to obtain as much efficiency and profitability as possible on the asset and keep the lowest cost of capital in the sources of financing.

In this context, accounting plays a key role as an information tool, since the capital structure is formed by the long-term liabilities and equity from the balance sheet of the companies. Capital costs, both from debt (through interest payments) and from shareholders and owners (through the payment of the required returns), also constitute information made available by the accounting, by means of analytical information. Therefore, accounting, as a social science, has the purpose of producing reliable information on the firms' assets for its internal and external users. In order to be useful to the decision-making, accounting information should be true, clear and timely.

Iudícibus (1981) defines accounting as the method of identifying, measuring and communicating economic information, enabling suitable decisions and judgment by its users. The author also highlights that this process of communication implies the recognition of the types of information required for each major category and the assessment of the ability of users to interpret the information properly.

According to Iudícibus (2000), the main goal of accounting (and of their reports) is to provide relevant economic information so that each user can make its judgment and decisions safely. In this sense, the purpose of accounting is to provide its users with information on the company's assets through the appropriate measurement of administrative events that influence the company's assets.

Atkinson *et al* (2000) address the accounting information explaining that management accounting is a process of producing operational and financial information directed by the informational needs and oriented to decision-making, both operational and of investment.

In this context, accounting not only generates information but also allows to explain the equity phenomena, carries out analyses, controls, predicts and designs the following accounting years, enabling to determine, through accounting reports, the most useful way to present the results of the company's businesses to the stakeholders. The provision of timely information, which shows the future capacity of the organization, can cause to decision-makers, shareholders and future investors either positive or negative reactions regarding that information, and this shows the influence of the accounting information on the price of shares in the market.

THEORETICAL ANALYSIS

Capital structure is generally addressed under two views, which diverge on the relevance of capital structure for the firm's value: Durand's traditional proposal (1952), which defends an optimal level of financing that minimizes the cost of capital of the company, increasing its value and, consequently, the wealth of shareholders; and MM's proposal (1958), which opposes the traditionalist position by stating that how the firm is financed is irrelevant to its market value, since its value is determined by its real assets (investments) and not by the bonds it issues (financing). Then, in 1984, Myers presents the Pecking Order Theory, which proposes a hierarchization in the preference for sources of financing, and the use of debt would be determined by the need of financing when all the internal resources are used; therefore, there is not an optimal goal for debt.

Although there is no consensus concerning the relevance or not of capital structure in the value of the company, in practice, managers choose the financing source that presents the lowest cost for the company. This decision is taken on the basis of the cost of capital – rate required by the capital suppliers to make their funds available to the company –, which is one of the main factors to determine the value of the firm. Lower rates required by the capital suppliers represent higher cash flows and, consequently, higher returns for the company. This way, the maximization of the firm's value occurs by the minimization of its cost of capital.

The discussion on the decision between debt and stock issue lies in the tax benefits provided by debt, since debt expenses can be reduced from the income tax. This way, the assumption is that the company, by increasing its debt, obtains higher tax benefits and, as a result, reduces the cost of capital. However, the increasing of debt beyond the optimal level tends to increase the cost of capital, due to the higher return required by the lenders considering the risk of bankruptcy. In this sense, the possibility of tax benefit would be relevant up to a certain level of debt, but beyond this point, it would be replaced by the effect of the risk of bankruptcy. The existence of more or less regular levels for the company's debt would cause a situation of equilibrium, determining the limit of debt of the companies.

When choosing between using debt or not, it is necessary to take into consideration that debt can be a positive factor for the company, since the return is higher in relation to equity, due to tax incentives. Due to the possibility of income tax deduction, companies use debt moderately as an additional element to increase profitability. However, if the degree of indebtedness is not well managed by the administration, it can generate unwanted results and may even lead the company to bankruptcy.

The search for the increasing of the firm's market value – which, consequently, will maximize the wealth

of shareholders, attracting potential investors – makes the managers look for a combination of debt and equity that optimizes the financial results. As the goal of companies is to maximize their value, any financing decision that reaches this goal is considered good, while any decision that decreases the value of the firm is considered bad.

The major challenge for managers is to find a *mix* between debt and equity that minimizes the capital costs in order to maximize the firm's value. The manager's goal is to obtain the most efficiency and profitability from the assets and keep the lowest cost of capital in the financing sources. In this context, accounting plays a key role as an information tool, because its records allows to demonstrate the current cost of capital and make simulations concerning the future cost of capital of the several financing alternatives available in the market. The several simulations of financing promoted by the accounting allow managers to take the most suitable decision for the company, minimizing its cost of capital and maximizing its value, and, consequently, the wealth of shareholders.

By identifying and measuring the acts and facts that influence the company's assets, accounting allows real-time and reliable information on the composition of the firm's capital structure, demonstrating the cost of raising each fund, as well as the overall cost of capital formed by the weighted average cost of the several rates required by the investors. This way, through the balance sheet, accounting aims at providing economic information to its users, allowing managers to make rational decisions concerning actions which maximize the firm's value, assuring its continuity in the market.

FINAL REMARKS

This study showed that, despite the inexistence of a consensus among theoreticians concerning the relevance of capital structure in determining the value of the company, in practice, managers opt for financing sources that present the lowest fund-raising cost, that is, the lowest cost of capital. By minimizing the cost of capital, the company's results are maximized and, therefore, its market value increases.

The theories presented in this study showed that a higher debt-equity ratio used by the companies to finance their investments can minimize their cost of capital. In this sense, the cost of raising funds would increase the company's cash flow, resulting in higher returns to the company and, consequently, to the shareholders. The possibility of returns results in lower risks and, therefore, more offer of capital at low cost. Companies that present low return are riskier, and in this case the capital suppliers require higher earnings as a premium to compensate the risk taken.

In this perspective, this study indicates that the financing decision influences the value of the company, because the option for a financing source with low cost of capital results in a higher cash flow and, consequently,

a higher market value for the company. An inappropriate financing decision can bring risky results for the company financial health, resulting in a low return for the shareholder and thus decreasing its market value.

In order to help managers take the best decision to maximize the value of the firm, the accounting must be updated and reliable, and produce clear and accurate information. This helps the managers' decision-making concerning the most attractive form of financing the company. Without this information, decisions can be made on the basis of the agility and facility of the financings available in the market, avoiding complex and significant alterations in the company, as, for instance, the opening of capital and the issuance of shares. Nevertheless, the most agile financings are not always the most attractive ones and the company ends up incurring in high costs of capital, compromising its continuity and its market value.

In this sense, accounting information on the capital structure, obtained from long-term liabilities and equity that figure on the balance sheet, as well as the costs of the several financing sources, is essential to the manager's decision-making regarding the ideal level of debt and the need (or not) for the opening of capital and the issuing of common and preferred stocks. This way, accounting plays a key role as a "manager" of information on the capital structure and its respective cost, helping managers in the decision-making in order to maximize the value of the company and, consequently, assure its continuity.

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