THE CORPORATE GOVERNANCE AND THE OPTIONS BETWEEN EQUITY AND DEBT CAPITAL. CONSIDERATIONS ON ACCESS TO CREDIT IN ITALIAN REALITY (PART I)

Rangone Adalberto
University of Oradea and University "G.D 'Annunzio" of Chieti-Pescara

Abstract:
To conduct a business today one needs intuitive skills and, therefore, an ability to respond to the new and numerous challenges that the market requires.
These challenges are economic, but not only. A continuous and steady development involves actually the need to go beyond the limits, not only in the case of traditional companies, but also of those in the start up phase.
To be in a multilateral and global economic system - as the present one – supposes a continuous upgrading of production technologies within companies, sometimes by undergoing serious reengineering processes.
The updating of the company, however, cannot and should not be perceived as a simple and sudden initiative that is applied superficially just to conform to a market trend. It involves a certain difficulty, and especially the demand for new and ongoing investment in the sector of competence, therefore, it requires a careful process of analysis to relate multiple aspects of the company, including the availability of equity or the need to resort to foreign capital, such as to the bond market, to national or European facilitating tools or to foreign intervention of banking nature, on short or medium-long term, calibrating these interventions based on business needs.
It is this delicate "step" in the life of a company - which requires a coherent, appropriate and stable organization of the governance of the company – that we want to tackle within this paper, as well as its interaction with the banking system, which in our specific case is the Italian one, all these by a brief empirical analysis of the relationship that links corporate governance to the access to finances, in the current banking context.

Keywords: Corporate Governance, Banking System, Reengineering, Start up, Management

1. Start up, *Reengineering of the business and the resort to credit*

The corporate governance aims at the company's well-functioning or the fulfilment of its object of activity. This goal requires, besides fully technical management skills, several purely financial capacities as well. The latter can already be held by the enterprise from start, or need to be sought on the market, through external sources.

It is a well known fact, the principle by which foreign capitals generate a flow that should provide a *turnover* sufficient to recover the initial investment completely. To succeed in this task, the governance must perform a series of analyses of the company that shall allowing the company to adopt the most appropriate strategy. This is achieved by monitoring the state of the company before the investment, calculating its rate of return, thus evaluating the usefulness and opportunity of resorting to foreign capital. Normally, companies not so well equipped technologically do not experience too big difficulties in accessing foreign capital, while companies with a *high-tech* predominant in the productive organization do. With the latter we can notice a tendency to use less debt - at least in the *start-up* phase – favouring the venture capital. However, if this is not possible, they will also have to proceed to a careful management in order to make better use of the capitals obtained.

Depending on the financial goal to achieve, governance shall take into account the various possibilities to access capital.

There might be various types:

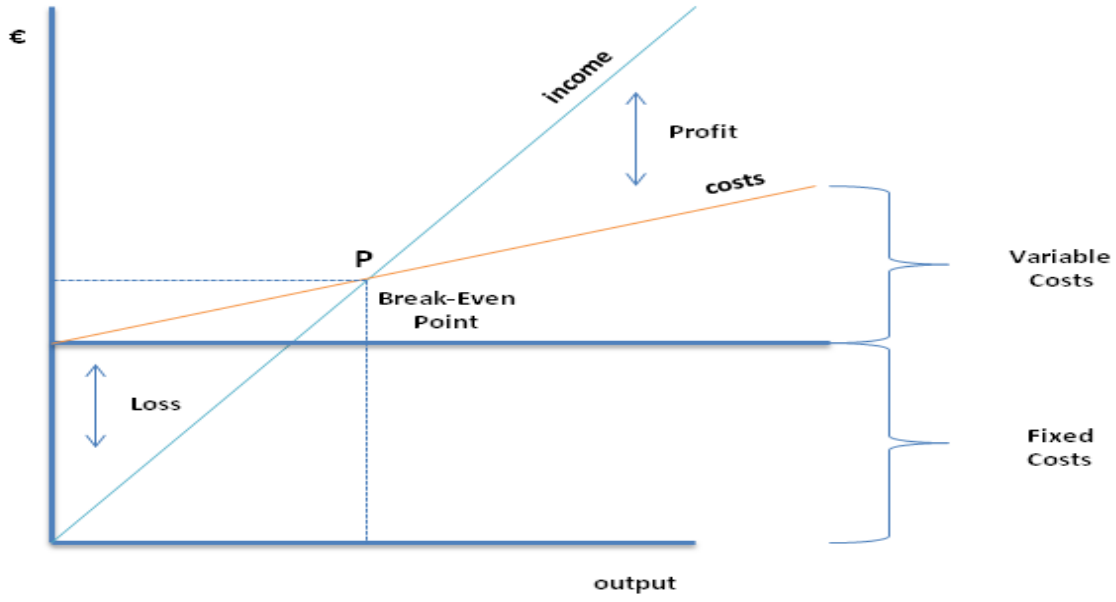
1.Venture Capital [Increase of equity by issuing new shares and / or self financing, resort to Venture Capital, investment funds interventions and / or Private Equity, Seed Capital]

2.Debt Capital [issue of debenture bonds, use of loans or medium-long term grants, national, regional or European financial facilities, operations of Operational Leasing, Finance Leasing, Shareholder Leasing]
3.Disinvestments of existing heritage items or Lease Back
4.Self-financing generated by revenue management

The choice would be based in this situation on the identification of appropriate financial solutions for the process of *reengineering* (1) being implemented or in case of *start up*.
As a first check, the governance will have to calculate what benefits can be achieved by the company and what time is needed to obtain them, in order to better determine the most appropriate financial coverage. Before proceeding to a brief review of the techniques commonly used in books on business economics, both to identify past performance and to calculate the best future investments, it must be said that these estimates should be seen as pure analyses *ex post* or as mere forecasts. This last observation arises from the fact that business management and market economy itself, par excellence, do not represent absolute certainties, but on the contrary, they are subject to different variables and conditions that reveal everything but the certainty of the context in question. A confirmation of this fact is: entrepreneurial risk as such, capital market and its own volatility, recurrent crises reminding of Schumpeter's theory, turbulences in the labour market, socio-political instability, diverging public policies arising from the need to address crises that, in our opinion, are no longer just economic or financial but gain the features of a true systemic crisis.

1.1 Break-Even Analysis

By *Break-Even* analysis we can make an estimate of the levels of *output* to be achieved in order to balance initial costs when an investment is planned. (2)
This analysis is called the cost-volume-outcome. Therefore, during programming it can be used in order to simulate the behavioural *trend.* of the firm. *Break-Even* analysis is usually considered among the preventive studies of typically economic nature.



The *break-even* point indicates the covering of the costs incurred at the beginning of the investment and, consequently, the initial point from which the investment begins to generate profit.
The cost-volume-outcome analysis aims to identify the effects of the variations in sales volume on economic performance, to assess the initiative of investment. In other words, we can say that

it emphasizes how much it needs to be produced and sold so as to begin to gain. *Break-Even Point* highlights the balance point where the gains from sales equal the cost of the products sold.

Assuming that:

CF = fixed cost
Q = volume of sales
p = unit price
cv = variable costs per unit

It is therefore expressed by the equality:

$$\mathbf{C = R}$$

where: $C = CF + cv \cdot Q$
$R = p \cdot Q$

However, this analytical principle - even if now it is a consolidated procedure together with *payback period* analysis - is considered by most researchers as insufficient for a comprehensive consideration on whether or not an investment is risky, regardless of the variability of the market prices and being applicable on short periods only.
In this respect it is customarily to corroborate it with indicators or indices.

1.2 Profitability indices and the Financial Plan

The analyses with indices are a resource observable from several points of view. By applying them, investors can assess the profitability of a firm, thus providing the quality of their investment, the financers can estimate the capacity of beneficiaries to cover the capital provided, or, simply, a company can carry out so-called "past" analyses - or on the previous management of the company - as well as "future" ones, on the administration of capital for specific investments. By this measure it would be possible to quantify the potential return on an investment.
Therefore, the areas of application of the above analyses are numerous:
-Patrimonial - when identification of the *stability* of the company's assets is desired
-Economic - when calculating of the firm's *profitability* is at stake
-Financial – when the identification of the firm's *liquidity* capacity is wanted
The patrimonial motivations tend to represent the characteristics of the patrimony or the latter's stability compared with the requirements of company management.
Considering the case of a company with an indisputable patrimonial stability, it may be outlined by the following equation:

$$\frac{\mathbf{PN}}{\mathbf{C_{mi}}} \leq \mathbf{1}$$

where:

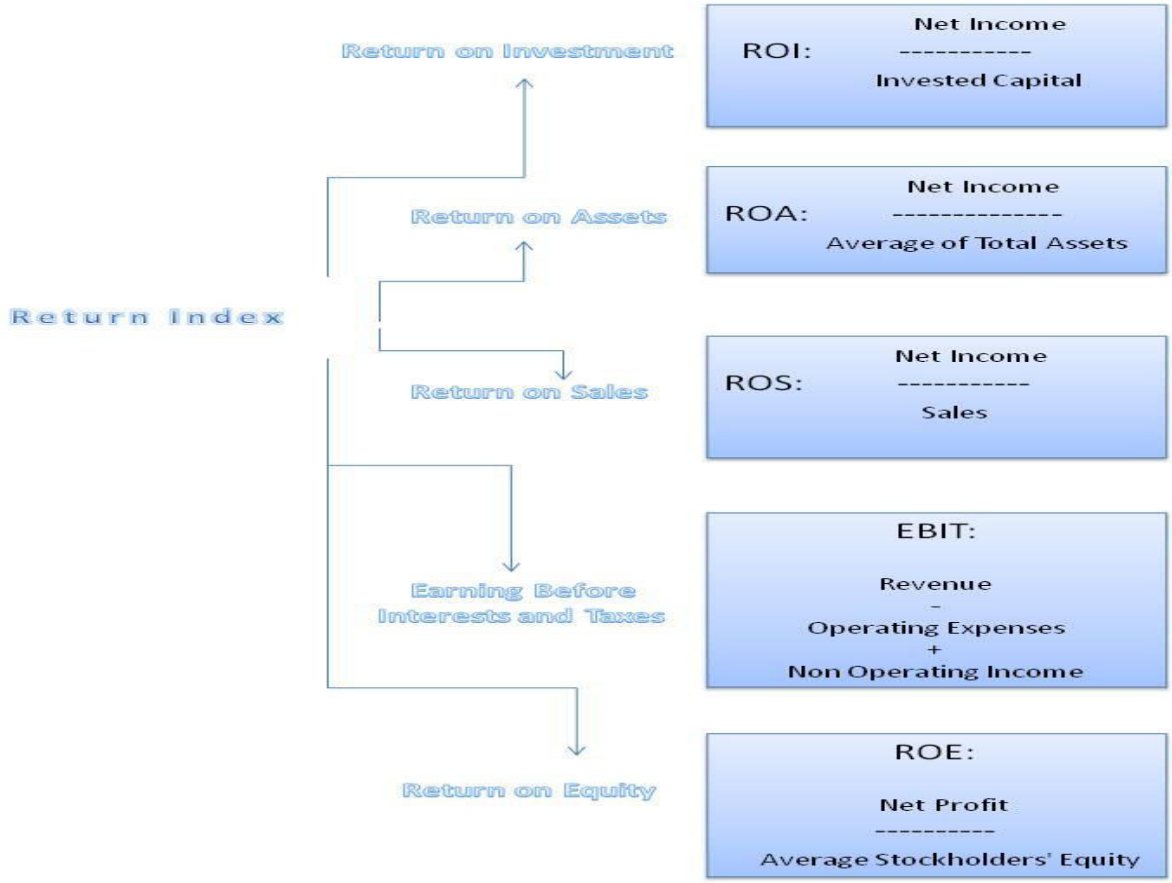
PN = net patrimony (contributed capital + reserves + retained earnings)
C_{mi} = average capital invested along the period considered, represented by the sum A_c + A_i or the sum of circulating assets and fixed assets.

The equation underlines how and to what extent the net patrimony has financed the investments of the company. Also, the patrimonial solidity represents the financial independence of the company. The more the ratio tends to equal 1, the more capable is the company to act without the

conditionalities arising from the banking system or from the resort to the capital market of third parties on the medium and long term.
Because of the size limits imposed to this paper, we shall now move to profitability indicators.

There are several indicators of profitability.
If we consider the relations:

R_o = operating income
C_{mi} = average capital invested along the period considered
P_a = atypical earnings
P_f = financial earnings



We can summarize the indicators represented schematically in the table above:
Return On Investment. It is perhaps the most widely used way to calculate best the ability of a company to produce capital fully exploiting its potential. ROI is the indicator of the firm's capacity to recover the invested capital. It is expressed by the relation between the operating income and the average capital invested along the period considered.
Return On Assets. It is adopted when the financial profits or the atypical ones become "real"; with this indicator we can measure gross profit from the total investments. The company's operating income indicates the gross return of all investments, be they operational, atypical, extraordinary or financial. Therefore, it includes equity and debt capital. It is often identified in order to then apply ROI.

Return On Sales. The indicators mentioned above are then added a variation by calculating the ration between the total sales in the period considered and the operating income. This indicator is the return on sales and it derives from the relation between operating income and net volume of business resulting from the administration of the given operations. If the value is "> **0**", it means that there is a further area of gains available after covering the total costs that arise from the company's administration proper, further gains thus usable to cover other costs of administration and to reward equity. If the report is "= **0**", the gains from the sale are barely enough to cover the operational costs. If the coefficient is "< **0**" we are dealing with a company administration insufficient to cover operating costs.

Return on Equity. ROE - understood as the ratio between net income and net patrimony – indicates a firm's profitability in relation to its risk capital. Although this indicator is very often subject to manipulation so that the company appears solid and promising to third parties, it remains a valid and effective tool for business management analysis. (3).

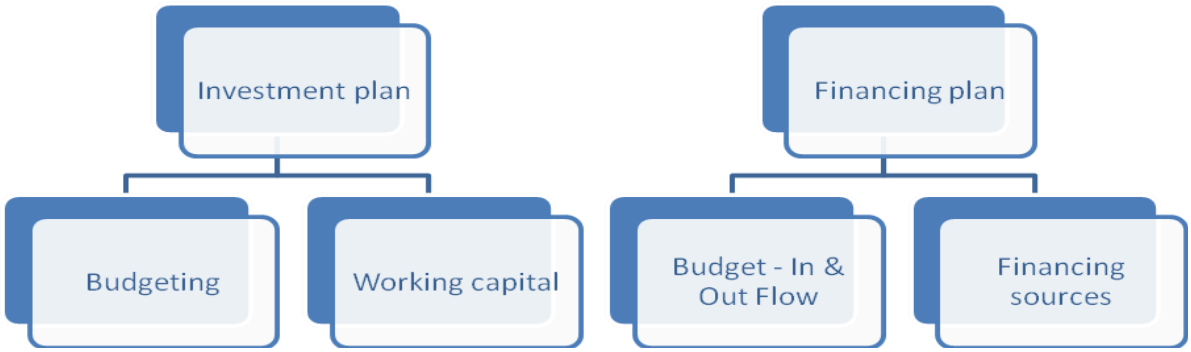
Earning Before Interest Taxes Depreciation and Amortization. Another indicator is the one referring to the gross operating margin. This indicator gives only a statement of business administration without consideration of the costs arising from depreciation, from other devaluations of the year and from fees.

We feel right again to confirm that these analytical methods constitute a source of research very important for defining a future investment plan. It is the very analysis on its own patrimonial stability and on its own profitability that guides the governance of an enterprise in its decision whether it is appropriate to make investments.

After the quick look at the key indicators of profitability, we will now consider the components more closely linked to the financial aspect of an enterprise.

When examining precisely its own financial situation, the corporate governance must take into account, above all, its own financial resources, to then calculate the structure that will shape due to the investments. The financial plan is certainly a viable help. This planning is developed through two different instruments:

Investment Plan and Financing Plan.



Through the investment plan the firm manages to develop a scheme that identifies all investments to be made both in durable goods or fixed assets (Capital Budgeting) and in goods of the circulating assets (working capital).

It will then be possible to undertake a range of analytical techniques – applicable in conditions of "safety", i.e. in the absence of inflation or of extraordinary financial constraints (4) - such as:

a) average rate of return
b) payback period
c) net present value
d) internal rate of return
e) current rate of return

As explanatory only, we considered it necessary to present a simple list, although we are aware of the importance of these techniques, they require indeed a deeper study that would fail to be integrated in the current paper.

Once drawn up an investment plan that can maximize production capacity able to satisfy the sales estimate provided by the business plan, the review of the financing plan will follow. By this, the governance identifies the sources and their use, this resulting in a fair allocation and distribution on the various units. Therefore, the estimates of *inflow*, i.e. input flows, and of *outflow,* i.e. the output flows, are identified. (5)

Next, we shall identify the techniques of the financial analysis of investments in progress, and the indicators useful for future estimations.

1.3 Financial research instruments

Concentrating in a short exposition the analyses that aim at verifying the financial needs of the company, we want to emphasize that the *ex post* analysis of a company's balance sheet, or the review of a business plan of a *start-up* must have the following objectives:

a) the study on the firm's capacity to meet at any time the payments necessary for its economic management;

b) As a consequence, this analysis implies returning a judgement on the relationship existing between funding and the uses of funds available or sought by the company;

c) the examination of the constraints that exist between the company's liquidity and the economic aspect of its administration.

We shall briefly see a series of financial indicators or ratios.

Relating the following elements:

$L_{i/b}$ = immediate and short-term liquidity

D_b = short term debt and other liabilities

we have:

$$\frac{L_{i/b}}{D_b} <=> 1$$

This relationship is called ***"quick ratio"*** because it highlights the ability of the liquidity to meet short term debts quickly.

The degree of liquidity that marks the average capital invested is expressed in symbols by the following equation:

$$\frac{L_{i/b}}{C_{mi}} \leq 1$$

The rigidity of funding sources can be expressed by the ratio of average invested capital and short term debt, in symbols:

$$\frac{C_{mi}}{D_b}$$

The liquidity index or cash coefficient, as called by some authors (6), has a function proportional to the degree of liquidity invested and a function inversely proportional to the degree of

exigibility of the correspondent total capital acquired, regardless of the form and / or nature of the acquisition of capital.
We can highlight a further financial and patrimonial coefficient, called "***Net worth to fixed ratio***" which represents the ratio of self-coverage of the fixed, or immobilised, capital.
This index results from the relation of net patrimony and fixed assets.
Thus, we have:

$$\frac{PN}{A_i} <=> 1$$

Assuming, instead:
V = sales made in a certain period
We have:

$$\frac{V}{C_{mi}}$$

that will be the average income per unit of operational investment.
This indicator may also capture some aspects of the financial dynamics and tends to measure the movement of the capital invested in the company analyzed.
Desiring in the second part of our analysis to make some considerations on the possibility of access to debt capital, mainly acquired from the banking system, we will consider one more very important indicator for the choices made by the firms that resort to external capital.
This is ROD, or *Return On Debts.*
This indicator is an important resource for companies that want to access external funding and, as long as the financial obligations that the company has to acknowledge to creditors usually have a massive influence on the remuneration of risk capital, they are values that should not be underestimated. (7)
The rate of return on third parties' financial means will be obtained taking into account the values:

I_p = passive interests
I_{fm} = average financial debt in a certain period

from which we obtain the ROD formula:

$$\frac{I_p}{I_{fm}}$$

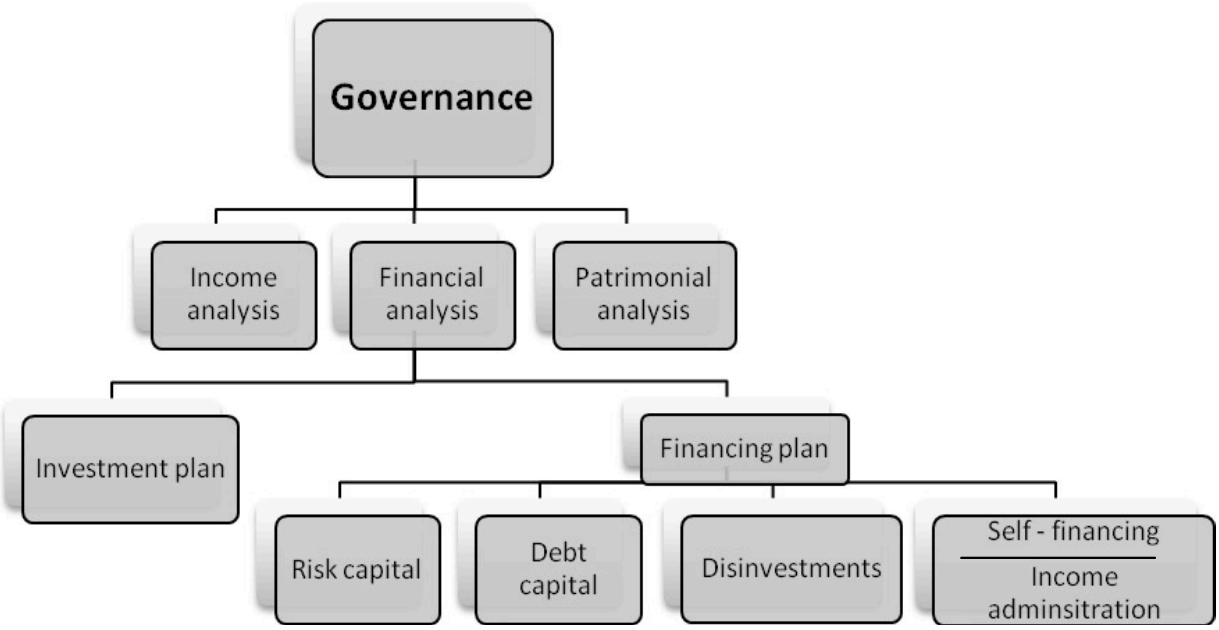
Obviously, if you want to evaluate ROD value on a medium-long term, we will have to apply the long-term interest to the numerator and the debt values on a medium-long term to the denominator.
Also, if we want to obtain the value of ROD on short-term, we will need to apply the short-term interest to the numerator and the short-term debt values to the denominator.
When taking into account not only financial indebtedness, but the total debt - which highlights debts to suppliers and controlled companies - we get the RODT indicator.
It is calculated using the following formula:

$$\frac{O_f}{I_{cm}}$$

with:

O_f = financial obligations
I_{cm} = average overall debt in a period

By use of these analytical principles the company will be in a position to be able to choose from the many forms of financing the one that best suits the project, either for *start up* or for *reengineering.*
We want to emphasize once again that the role of company management supposes a painstaking analytical process that extends from monitoring the historical evolution of the company, through the analysis of present management, to the forecast for the future, not forgetting perhaps the most incisive factor or the changing conditions imposed by the market.
Just explanatory, we shall summarise in the diagram below the decisions making process that is the attribution of the enterprise governance:



The diversity of the analytical techniques allows a support, not infallible, certainly, but at least effective, against the possible *default* (omissions) that a careless or unconscious management can encounter during its own investment. Obviously, we would like to illustrate the techniques without claims of completeness. Given these processes, typical to management, in the second part of our brief research we shall analyze the sources of companies' financing - mainly in Italy.
We will examine the countless possibilities of access to credit and through the data provided by Banca d'Italia it will be possible to outline a current view on the relationship between credit institutions and companies.

Notes – Part I

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