CAPITAL STRUCTURE AND THE LIFE CYCLE OF FIRM

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ABSTRACT

The capital structure overlooks the fact that businesses have specific capital needs over their life cycle. The study explores, by using the lens of the company life cycle, the funding options for small and medium-sized businesses, i.e. those most vulnerable to knowledge and opportunity issues. In the empirical literature, people described that the controversy regarding determinants of the decisions on the capital structure is based on the inability to consider different levels of the knowledge complexity as well as the characteristics and requirements of companies in particular phases of their life cycles. The results show that, as companies move through the phases of their corporate life in a banking-oriented world, companies continue to follow different financing strategies and another hierarchy of financial decision making. Unlike traditional wisdom, debt is shown to be essential to early business operations, which are the first option. The pecking order theory shows a high level of application at the stage of maturity, by contrast, where companies rebalance their capital structure, gradually replacing debt with internal capital, and companies that consolidate business. This pattern of financial life appears homogeneous and constant over time for different industries.

KEYWORDS: Capital Structure, Financing, Financial Growth Cycle, Leverage, Small & Medium Enterprises

INTRODUCTION

Research in the field of small and medium-sized enterprises (SMEs) is driven primarily by their significant economic position in the region. However, it depends on adequate funding and capitalization of the companies to grow and extend sustainable SMEs. Therefore, it is important to consider the determinants of their funding decisions or of their capital structure decisions in order to understand how businesses fund their operations. The capital structure is a mixture of debt and equity used to fund the company. A decision on the capital structure represents a wide variety of management and market practices. Despite of data accessibility, most of the previous studies were based on larger businesses. The research community also started to pay attention to small and medium-sized enterprises as a study subject. According to Ang (1991) an empirical study of SMEs is important, as the modern theory of enterprise finance was developed in the minds of small enterprises[1].

By maintaining a balance between tax and financial hardship and the expense of bankruptcy of debt, the optimum allocation of capital can be achieved[2]. In order to achieve this balance, businesses will strive for debt rates that offset the tax advantages of increased debt by the expense of future financial distress. The theory of punching order is an alternative to the principle of trade-offs. Researchers assume that investors have an asymmetry of knowledge. Because consumers are typically less educated than insiders, typical inventories are undervalued by the market. In addition, businesses have no target requirements for money.

Lodging businesses are capital-intensive, since both investment and operating phases require huge resources. Because host companies' assets are mainly fixed assets, they naturally increase the proportion of long-
term debt and the equity of their shareholders. Therefore, the lodging companies are particularly vulnerable to structural risks due to the sector’s structure. Accommodation firms also face high operating and financial risks[3]. The composition of the capital structure and the factors influencing leverage decisions is critical in all these features.

Many of the ground-breaking ventures in corporate finance focused on why businesses chose to fund their activities in various proportions in their debt and equity. The arbitration claim from Modigliani and Miller was perhaps the most famous work in this area, triggering a flood of investigation in the field of capital structure[2]. In theory of capital structure there are today five main sub-theories that seek to explain why the capital structure matters and how it relates to the overall value of the business. Nevertheless, no study has been definitive, and the matter is still debated vigorously.

One of the five sub-theories indicate that a company's organizational life may affect its capital structure, as funding needs that change with a changing business situation[4]. Yet in general, the theory of capital structure and of organizational life is discussed in isolation. Research into capital structures has traditionally been conducted by researchers with a knowledge of corporate finances or economics while research into strategic management has grown in organizational life stadiums. While researchers on the outskirts of both fields indicated that the relation between capital structure and the life process had never been specifically tested. The purpose of this work is, therefore, to review theoretic literature in a way that adds value to both and finally to conduct a pilot study that examines the relationship between the life stage of the business and its capital structure.

Their aim is to include a traditional capital structure analysis in the company's strategic dynamics. The high degree of correlation among variables found by empirics to be important in approximating both business matters provides support for this objective. Therefore a detailed analysis of the relevant factors which explain the capital structure of the business in the classical theories, i.e. trade and punch order offers as the main elements size, age, tangible assets, production, profitability, risk, R & D. Precisely the main elements in distinguishing between the life cycle phases of the business are investment / disinvestment, development and rentability, along with an excessive rise in age and scale. The question is therefore whether this mixture of factors explaining each stage of existence is the explanation for non-linear leverage relationships with firm characteristics[5].

The empirical definition for life cycle phases is an excuse to increase this conceptually simple test. Within the previous literature, the number of stages, names and conditions were not accepted. To address this problem, they have followed Dickinson's novel (2011) paper, in which life cycle phases are developed from operational, investment and financial cash flow information, as the Author explores the relationship with the fundamental principles of the life cycle carefully[6].Informational opacity is one of the many aspects which distinguish small and large companies. In the context of costly verification, adverse selection, and moral hazard, this operational uncertainty usually affects small business financial policy, especially with regard to external equity and debt sources. Costly verification and adverse selection problems tend to support debt contracts, while moral hazard problems tend to favour external equity agreements.

In one of the most important studies on the capital structure of small companies, it was asserted that the general theory of finance does not apply for all companies[7]. The nature of its financial needs, the availability of financial resources, and the associated cost of capital rather depend on the particular phase of the life cycle of the business. This approach encourages life-cycle financial behaviours. The rising level of knowledge secrecy facing a company is guiding its financial life cycle, as Kaplan and Stromberg (2003) claim[8].The financial needs of a company change from its inception to maturity, depending on its ability to generate cash, growth opportunities and the risk of making them available. The
changing funding priorities and the complexity of the particular financial decisions made by a business over its life cycle must reflect this. As a result, companies which tend to have higher levels of asymmetric knowledge, higher growth opportunities and smaller size at earlier stages of their life cycles should have special drivers of the capital structure and should enforce certain funding strategies as they advance through the various phases of their life cycles.

In this area of research, the study documented allows us to verify that the life cycle is an essential element of the financing conduct of a business. Empirical research is used to analyse the position of Italian small business over their life cycles and the differences in determinants of the debt-to-equity ratio. In particular, the following questions are addressed: Do Italian companies in the various phases of their life cycles have different financial structures? How do the determinants of the Italian capital structure shift over the life cycle of a company? Within the literature, the idea that businesses grow over a period of financial life is clearly defined. Nevertheless, the concurrent finance options and the debt-to-equity ratio vary. In fact, the lifecycle model is not suitable for all small businesses, as there are variations, not just in the commitment of management but also in the various market affiliations as organizations working in. Researchers find in their analysis of the capital structure literature, that companies in a given sector usually tend to have the same leverage[9].

In particular, the industry is a significant leverage determinant, explaining up to 26 percent of the variance in the domestic leverage. In addition, as reported by Titman et al. for large corporations and Gaud et al., the structural framework has a significant impact on capital structure decisions[10]. The efficiency of the financial system and general structural context defines the financial growth of companies affecting capital structure choices rather than the form of financial system (market-based or bank-based). Therefore, conclusions about the determinants of capital structure should take into account the relationship of the sector and the institutional climate. This is especially the case for companies which are extremely opaque and asymmetrical[11].

**RESEARCH QUESTIONS**

- Question1: What’s Financial Management?
- Question2: What is capital structure planning?

**REVIEW OF LITERATURE**

Modigliani and Miller are the first theories of capital structure, which state that the interest of an organization is not influenced by its funding. The “capital structure of their irrelevancy” concept is based on a new theory of corporate financial management in relation to the valuation of firms operating in ideal markets deriving from abstract entities[2].

The implications of data asymmetries between insiders and outside companies are explained in Myers and Majluf. Theory suggests that businesses follow a preferential order of sources of funding and using internal funds before finding debts[12].

In addition to defining a target capital structure, Groth and Anderson say that an organization needs to control its own capital structure. Failure to control capital structure affects capital markets, taxation and other practical factors[13].

Harris and Raviv argues that the testing of determinants of the capital structure in various contexts is important for empirical study[14]. The study examines the determinants of capital structure in Egypt, which is based on their conclusion. This study is quite different. Furthermore, Bradley et al. found that the debt-to-financial distress cost reversely reflects insolvency costs and the debt agency cost[15].
Voulgaris et al. examine and propose some policy consequences that could boost the financial performance of the industry, which influence the capital structure of Greek manufacturing companies. The study covers the panel data of two random samples, one for SME, and one for major corporations (LSE). This analysis covers two random samples. The results show that the competitiveness of both size classes is a significant determinant of the capital structure. In comparison with the efficiency of current assets, scale, revenue growth and high fixed assets (non-coma here) that affect the reputation of SMEs, efficient asset management and asset growth are considered crucial for LSEs’ debt structure.[16]

METHOD

Many model life-phases built over the last three decades by academic researchers are based on the life-phase evaluation approach used in questionnaires. However, only the Adzes Lifecycle Assessment Method TM was commonly used for practical applications from the evaluation tools examined. Dr.Jak Adzes’s conception in the early 70’s was revised and changed to calculate firm life stages with increasing precision through the Adzes consulting practice. They considered it to be a higher degree of reliability than the more academic models to use the Adzes Lifecycle Evaluation Tool ® in commercial settings.

DESIGN

Although researchers found that no general theory exists in the assessment of the life stage, it appears that the stage of life has been decided by managers of corporate culture, results, prospects, history and strategy through personal study. Sometimes only one director is interviewed and several managers are interviewed. There is no empirical proof to confirm the maximum number of respondents required per company to determine the stage of organizational life.

SAMPLE

‘The definition of capital structure was one of the most controversial topics in the philosophy of finance in the last quarter hundred’ She has already concluded in 2002 that ‘no universal debt-equity option theory and no reason to expect one’ – even Stewart Myers, one of the leading experts in the field, has not. While it may be unanimous as to what determines the decision on the capital structure, no alternate theories are absent. One of these theories is obviously underdeveloped, namely the theory of the capital structure life cycle. The definition of capital structure was one of the most controversial topics in the philosophy of finance in the last quarter hundred. She has already concluded in 2002 that no universal debt-equity option theory and no reason to expect one. Even Stewart Myers, one of the leading experts in the field, has not. While it may be unanimous as to what determines the decision on the capital structure, no alternate theories are absent. One of these theories is obviously underdeveloped, namely the theory of the capital structure life cycle.

Static Trade-Off Theory

In 1958, when Reacher released a popular arbitrage statement to prove the market value of any corporation is independent from its capital structures, discussion began about how and why businesses choose its capital structure. They would not assume that capital structure will differ from business to company or over the life stages of a single company based upon Modigliani and Miller’s principle of value invariance. Nevertheless, this idea was formulated in deliberately artificial terms without information expenses, no personal or company taxes, no contract or transaction expenses and a fixed investment strategy. Unravelling the hypotheses of Modigliani and Miller brings us to the other theories of essential capital structures. The implementation of tax consequences means that businesses will aim to raise debt rates as much as possible in
principle. Many theories added, however, constraints on an acceptable degree of firm debt, arguing that bankruptcy costs are that with the company raising its debt level, putting an upper limit on the amount of debt that can be in the capital structure of a company. This has evolved into a statically theory of trade, which implies that businesses seek to achieve an optimum capital structure that maximizes the profitability of their company by balancing tax advantages and bankruptcy costs with that debt rates.

In order to understand actual company behaviour, some scientists have found problems in static trade-off theory. For instance, Myers argued that the theory of static trade assumes that highly profitable businesses would have large debt ratios to protect their large tax revenues, while; in fact, highly profitable businesses tend to have less debt than less profitable companies. Researchers suggested that the cost of bankruptcy is significantly lower than debt's tax benefits and that the debt levels are much higher than the theory forecasts. Nevertheless, there is also some empirical evidence and theoretical support that businesses are constructing their capital structure in order to take advantage of the net interest tax burden on creditors while avoiding overly high financial distress costs. Researchers find, for example, that, in the long run, businesses appear to shift into the theory-corresponding goal debt ratios. Therefore, the principle of static exchange offers an explanation of how businesses select their capital structure. It also supports the idea of the life stage of capital structures.

**Information Asymmetry Theory**

By removing another assumption that underlie Modigliani and Miller's value invariances theory 'the market has complete information on companies' activities,' Stephen Ross developed a theory of capital structure information asymmetry. Alternatively, if They believe managers have information that they do not have on the market about their potential prospects, managers should signalize that information for the market in terms of the capital structure. He argued that that leverage will signal to the market that managers are optimistic that they will be able to pay interest in the future and thus depend on future income prospects. Therefore, increasing leverage would increase the value of the company by signalling the size and stability of future cash flows to investors. Despite that, on the other hand, more profitable businesses tend to have lower debt rates. Those who argued that the rise in debt is potentially an indication of poor future income and cash flow prospects as internal funding will be decreased available for development funding.

**Agency Cost Theory**

It is also discussed how asymmetries between managers and investors could affect capital structure. Not only do managers have different knowledge than shareholders on the company's prospects, but even managers have different priorities than shareholders. Agency costs are a good reason for companies to raise their capital structure's debt level as debt 'enables management to deliver on their commitments to fund potential cash flows' Due to the cost theory of the organization, businesses in their financial structure use more leverage as creditors want to push management to use funds efficiently.

**INSTRUMENT**

The questionnaire was designed to be autonomous. The ideal approach to measuring capital structure was to gain access to the balance sheets of companies so that it could be consistently defined and measured by various companies. As they didn't obtain balance sheet information, they requested information from respondents on the balance sheet. As a measure of the capital structure, the ratio of total debt / capital was used. Domestic and multinational companies operating in South Africa were the established population. The hope for the collection of a sample representative was that one of South Africa's four
main banking groups could work together as all companies would have required a bank account, irrespective of the structure of their capital or the life phase, and therefore would have had minimum selection bias with a sample from a client base of a bank. While one party was extremely interested and demanded a formal proposal, it felt that at the 11th hour there was business risk to inconvenience consumers by asking them to be included in the study too early after the time limit for the Financial Information Centre (FICA) Act of 2002, which was in effect from October 2004, and withdrew. It has therefore been determined that a convenience sample should be used, considering the time constraints of this study and the possibility of similar answers from other large banking classes.

**DATA COLLECTION**

It was determined, instead, that a convenience sample should be used in view of the study time limits and the probability of similar answers from other major banking groups. The McGregor BFA database was drawn and emailed the questionnaire to a list of 4450 private and public firms in South Africa with published email addresses. The questionnaire was also circulated to 220 businesses in South Africa who were contacted by telephone. Sadly, only 81 functional responses, adequate for a pilot study only, were received. It is hoped that a major bank would provide the necessary access and support in the future to allow for an extended and thorough review.

**DATA ANALYSIS**

The interviewees were spread uniformly across seven industries: customer, political, produce, energy, services, technology and media and 'other.' In Table 1 they show the number of shareholders in the companies that make up this study.

Many of the responses were received from public corporations (41.5%) and private companies (48.8%). No responses were obtained from partnerships or individual ownerships, and only five from closed businesses. Some of the small businesses they addressed thought like they could not cope with the problems.

<table>
<thead>
<tr>
<th>Proportion of Sample</th>
<th>Number of Shareholders</th>
</tr>
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<tbody>
<tr>
<td>38.1%</td>
<td>Less than 6</td>
</tr>
<tr>
<td>11.2%</td>
<td>6 to 21</td>
</tr>
<tr>
<td>3.1%</td>
<td>21-100</td>
</tr>
<tr>
<td>48.2%</td>
<td>More than 100</td>
</tr>
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</table>

Given the concentration of private and public companies in relation to small and medium-sized enterprises and individual property, they do not find a high degree of concentration of companies in prime and stable life in their sample. The responses of smaller companies may have increased the proportion of companies during puberty, retirement and adolescence. Their work is often likely to be under-counted by corporations in the processes of hegemony, recrimination and bureaucracy. Because they expect senior management to be inclined towards a more favourable view of their business, they may have some reactors in life phase evaluations, and senior managers are not happy with this. Since courtship and death was outside the company's active life stages, no companies in such areas were to be treated.

**RESULTS AND DISCUSSION**

This study supports the idea that the period of life and the structure of capital are related. It allows the study of life-stages to be seen as a way to gain insight into the disposition of resources in an enterprise at any time. Finance managers may use the tool to assess their funding strategy, and analysts and investors can use the tool to consider the financial structure of a
organization in the light of its life-stage growth (as long as it is able to determine its life stage). In addition, there is some insight into the body of literature on the existing capital structure used to build the research idea through the relation between the capital structure and the stage of life and, most importantly, the essence of this link.

The static trade-off principle of capital structure is not accepted by us. They argued that the static trade theory predicts that businesses will have less early and late life debt and the highest amount of primary debt when bankruptcy costs are lower and the tax shield is the greatest profit. They consider the other way through. Their assumptions may be that it is incorrect how static trade theory expected changes in the capital structure during the life phases of the business. For example, companies do not feel like they need any more advantages by funding in the highly lucrative stage since they are already in the top of their industries. Future work will test this probability. In general, however, these results seem to not support the static trading hypothesis.

The theory of pecking order suggests that businesses have a preferred funding hierarchy: first, the domestic equity, then debt if the retained income is not enough, then the foreign money, in the worst-case scenario. The theory of pecking order indicates findings that businesses use more leverage than cash-rich companies in prime, in the early and late stage of existence (typically having less internal funding than needed). The work thus supports Myers’ theory of punching order and expands it by demonstrating how the order of punch is influenced by the different life stages in which businesses proceed.

Their findings offer little support to cost theory of enterprises, which implies that businesses will slowly take on more debt as they grow. The Cost Theory of the Agency argues that firms with strong free cash flow (stable) and businesses in the downturn are at higher costs and will thus have higher debt rates. Although They find that late-stage businesses generally have more debt than prime companies, agency theory cannot explain why companies, with managers controlling more of the business, have more debt than companies in prime stage, at the early stages of growth. Early stage firms that have very large external shareholders in the form of risk investors who are taking out high rates of debt who are not able to do the most scattered shareholders of primary companies. This is another road to further inquiry.

Interestingly, their findings do not support the bulk of the current theory that explicitly addresses the connection between the structure of capital and the stage of organizational existence. The majority of claims in this field concentrate on trade between financial risks and business risks and indicate that businesses should be less indebted in their early stages to compensate for higher corporate risk, while businesses should as debt-intensive as possible during prime stages. Their findings contradict the opinion and indicate the corporate risk is not a major factor in the decision on capital structures.

Finally, the fact that They see a connection between the capital structure and life stage indicates that the research for the life stage of the business financial sector has not been explored thoroughly and that business finance experts trying to understand the life process of an organization will consider using Adizes Lifecycle Assessment Tool™ in order to understand its capital structure needs.

CONCLUSIONS

Some researchers have figured out that the most popular theories of capital structure may describe financial policy in SMEs. To provide a deeper understanding of the factors behind the decisions driving capital-structure decisions in the small and medium-sized enterprises market. The financial cycle trend seems to be stable over time and prevalent in various sectors for small and medium-sized businesses in various institutional contexts. This is the same for companies based in
southern Italy, which have a more fragmented financial system and less investor security, compared with companies located in other Italian macro-areas. A similar pattern of life cycles was observed in nine of the 12 industries examined.

Therefore, given a different average leverage among industries and institutions, financial growth trends were similar, despite the fact that small and medium-sized businesses were seen. Furthermore, although the existence of a pattern of financial growth is relevant and robust over time and across industry and institutional contexts, the capital structure determinants systematically differ across the life cycle of the company. A dispute over the determinants of capital structure in existing empirical literature may be based on the lack of explicit consideration of the different degrees of opacity in information and, therefore, of company characteristics and needs at specific stages of their life cycles.

This paper argued the case for a connection between the structure of capital and the stage of the life of a firm. They offer an overview of both theories with a suggested relation between the stage of life and the structure of property. The empirical research provided some interesting findings that influenced the theory of organizational existence and the structure of capital, and practical applications in the field of finance in company. It's a pilot test, however. To achieve a wide and deep sample, it needs the cooperation of a large bank. This will have access to company budgets that would make it easier to determine the capital structure more accurately. The larger sample would allow more detailed conclusions about the importance of individual life stages of advisees to be drawn and maybe the need to group them.

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