How to strengthen the financial autonomy to boost investment in the company?

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Abstract

Boost investment is the ultimate goal of every company. There are many strategies to achieving this goal. Indeed, each company imposes a duty to promote efficient investment. In this perspective, many contractors see that the financial autonomy is the solely or principally option for enhancing investment.

This paper will focus on the factors that lead to the promotion of investment in the business, but it will insist on the preference of finance autonomy, which would represent a significant issue, allowing for a more coherent framework for promoting investment.

Company needs to focus efforts in improving this option that provides direct sources of growth in term of investment, now and in the future because the movements towards financial autonomy started under the conditions of severe budgetary problems and fiscal constraints.

Currently, financial autonomy is a recurrent notion in the economy, but some questions related to the processes of investment cannot be answered without a thorough analysis of the contents of local financial autonomy. Financial autonomy is not in itself desirable, but serves as a means to certain end. This paper explores this notion, its relationship with the dynamic of investment as well as its impact in the company's perspectives.

In our contemporary era, financial autonomy is seldom treated as a separate subject and never been investigated systematically. In order to be consistent with the objectives set by the current economic climate and the globalization, financial analysis should bypass this lack in favor of a new approach. For this purpose, this paper tries to give some possible reflections that help us to develop the analytical tool that may help us to improving the way towards the amplification of the analysis paradigm.

Keywords: financial autonomy, investment, operating cash flow, debt, financial risk, financial management.

Introduction

Control over the finances of the company aims to promote optimal allocation of mobilized resources and ensuring the regularity of their use. It is therefore both a control of effectiveness, efficiency and regularity. The intention of this control is the search for efficiency[1] that will stimulate investment.

In this perspective, the financial autonomy appears as an important issue.

A. Factors that lead to promote investment in the company

Performance of the company is to increase sales and to develop the market share of the profit. It also manifests through social work and the satisfaction given to staff. As we can see, it is a multifaceted phenomenon and it is only through the plurality of interventions that give an image nearby to the real world. Therefore, there are no scientific contributions is not emotionally involved the definition of performance.

Factors that contribute to business performance are numerous. In fact, the performance requires a number of privileges such as: the qualities of innovation, the ability to mobilize financial resources, the wise arbitration of combination of factors, the successful trade integration and the sustainability of the production unit in the competition. We will focus our analysis on the mobilization of financial capacity.

Moreover, the reason of the integration of this approach into an economic perspective is due to the fact that when a company is losing ground in the battle of competition, its market share will immediately picked up by others, and it is possible that this process will lead to a misallocation of resources.

Thus, the research of company's foundation performance requires essentially the study of factors which increases its investments.

We will discuss the relationship between finance and the business performance in terms of investments.

B. How to finance investments?

[1] Efficiency means cost minimization, effectiveness means producing outputs in quantities and qualities according to the underlying goals. In an economic interpretation these goals reflects the users' preferences (see Cowan, J., effectiveness and efficiency in higher education 14 (1985), p237).

Before examining the methods of financing investments, we will study its determinants. National accounts investment studies based on the concept of *Gross Fixed Capital Formation* (GFCF)[2]. In addition, the material investment is generally consisting on investment capacity[3]; replacement investment[4] and alternative capital for labor investment[5].

Economic theory generally insists on four determinants of investment (Kergueris, 2003): anticipated demand by companies, the cost of factors of production, the profitability of investment projects of companies and financial constraints. In our analysis, we will focus on the latter factor.

To study constraints access to financing, we note that for investment, a company has to prioritize its own resources. If these are insufficient, the company should borrow. It may also, if its size allows it, raise equity capital. Thus, financing conditions for productive investment depend on the specific characteristics of each company's financial situation. The latter one can be understood by indicators such as financial autonomy, debt capacity and cash flow.
When a company is already heavily in debt and a have a low cash flow, it may not to invest, even if interest rates were low and the marginal efficiency of capital rose[6].

Reflections on the financing of investment have long been conducted within a theoretical framework defined by Modigliani-Miller (1958). According to this theorem, it is irrelevant for a company to finance its investments through debt, issuance of shares, or retention of profits. However, this theorem is dependent on highly restrictive conditions which are not verified in practice.

Companies have an interest in borrowing for several reasons. In fact, they can take advantage of leverage effect and the tax benefit related to the debt. But the extension of debt leads to a greater risk of default. The company must arbitrate between the benefits of debt and the cost of default risk.

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[2]The GFCF is a flow value. It is measured by the total value of a producer's acquisitions, less disposals of fixed assets during the accounting period plus certain additions to the value of non-produced assets realised by the productive activity of institutional units.
[3] It is expected to boost the production capacity of the company; i.e its machinery.
[4] Also known as amortization, it is designed to replace worn and obsolete equipment to maintain production capacity in state.
[5] In case where the labor factor would be more expensive than the factor capital, the entrepreneur will tend to incorporate more capital factor and save labor to produce; it is a productivity investment designed to improve, modernize and streamline production.
[6] On the other hand, the existence of strong cash flow margins and a very low debt may allow companies to invest even when market interest rates are high and the marginal efficiency of capital is low.

We note in this context the importance of opting for financial autonomy, also called financial independence. Our choice is justified by a lack of literature finding concerning this point. Thus, we try to improve the analysis.

C. The financial autonomy

1. Definition

Financial autonomy refers to the degree of solvency of the company by comparing equity capital and total of liabilities. Higher the level of financial autonomy, the higher will be the level of solvency and the better the ability of the company to meet its financial commitments in the long term.

Also, the financial autonomy means the more or less dependence of the company to foreign capital providers (banks and suppliers), and how it finances its fixed assets. It then examines the importance of equity and how assets are financed.

2. Importance and measurement of financial autonomy

It is widely recognized that the importance of equity capital is a guarantee of the solvency of the company. If this seems insufficient, creditors require special guarantees, such as a mortgage or pledge related to certain goods.

The high amount of equity provides some independence towards creditors and allows borrowing at better conditions. Of course, beyond a certain absolute amount, it is mainly the ratio between equity (or net position) and liabilities, or a part of the liabilities, which is significant. Under the term debt-equity ratio, usually calculated the proportion of equity in total liabilities.

- Equity capital and degree of solvency

In general, we say that a company has financial autonomy when more than half of the resources available to it, comes from its own capital. This financial independence can be characterized by the following ratio:

$$\textit{Financial Autonomy} = \textit{Equity Capital} \,/\, \textit{Total Liabilities}$$

When this ratio increases, the financing business is generally less dependent on borrowed capital. The explanation of this autonomy can be found in the capital increase or in relation to the balance of the income generated by the company. That is why it is always advisable to analyze, as is the case for all ratios, its evolution over time.

Very nigh to the previous in a point of view of its title (with a different method of calculation), the ratio of financial independence brings near equity capital to permanent capital, the latter consisting of equity and long and medium term loan.

Financial Independence = Equity Capital / Permanent Capital

This indicator is more sensitive than the previous one, while prevailing in the same way. It indicates how much of the permanent capital isn't form of borrowing.

This ratio measures the weight of own resources in the foreign sources. The more financial independence ratio increase, the higher the company is healthy. On the other side, if the company is heavily indebted, the financial risk is high and the cash flow weakens.

Furthermore, analysis of financial independence cannot be done without taking into account the analysis of leverage. Indeed, the use of foreign capital depends on the internal rate of return (IRR). If the rate of return on funds invested is higher than the cost at which the company may borrow, so in this case, it is preferable to increase foreign capital since the return on investment of these capital covers the cost of the loan.

- Debt ratio

The debt ratio is given by the formula:

Creditors Protection = Net Worth / Current Liabilities

When this ratio is greater than 1, it means that the company has no financial autonomy and therefore the creditor's protection decreases due to the growth in debt levels. Such an interpretation is static because it considers the protection of creditors in the event that they would be taken to put an extreme way to recover their debts.

In contrast, the level of debt can be seen as an indicator of the financial risk of the company. This is the risk that the company getting when it is engaged to finance in part from net worth whose remuneration and repayments are considered fixed while the results as well as the liquidity of the company are variable.

3. The characteristics of financial autonomy

There are two essential characteristics which can be identified when we try to examining the financial autonomy:

- The movements toward financial autonomy started under the conditions of severe budgetary problems:

Low budgetary problems affect the investment spending of firms. These firms have sufficiently attractive investment opportunities. In addition, for a firm whose profitable investment opportunities are low relative to its cash flow, it can finance all its desired investment from retained profits and still pay out relatively high dividends.

- The movements toward financial autonomy started under the conditions of tax constraint:

The impact of company taxes on investment will be more complicated than is often assumed. In particular, the average tax rate will influence the level of investment spending, in addition to the impact of taxes on the cost of capital, and any increase in the total revenue raised from corporation tax could have a directly adverse impact on business investment. Therefore, financial autonomy will be a savior to boost investment.

D. Through which channels financial autonomy does boost investment?

1. Planning medium and long term financing investment

A number of financial ratios are used to make an initial judgment on how the company was able to finance its investments, in particular the share of equity capital in the resources used and how durable capital can cover capital assets. The debt of the company is also the subject of special attention with the calculation of the degree of leverage analysis and details of debts according to their exigibility. The weight of debt service compared to some results is also very revealing. It is crucial to avoid the genesis of an excessive accumulated debt.

The more or less adequate relationship between financing and investment is considered indirectly through the characterization of equipment aging but also through the evolution of the costs of labor and machines. In this way, borrowing plays a special role; it must be increased by leverage effect. Many types of loans exist for business, but some loans are subject to debt and income conditions.

Other resources than loans can be searched such as equity capital increasing by setting aside a portion of income or decreasing private levies decreasing, new capital contributions, investment subsidies, renting rather purchasing, etc.

Concerning resources, own resources, particularly tariffs and prices, and the external resources should be carefully controlled through budgetary transfers and monitoring of borrowing and credit.

2. Managing the financial risk

Financial risk is a risk of losing money due to a financial transaction (on financial asset) or an economic transaction which have a financial impact (e.g sales credits or sales in foreign currency).

The main types of financial risks are:

- Counterparty risk: it is the risk that the party with whom a contract has been concluded hasn't met its commitments (delivery, payment, repayment, etc.).
  For a bank, this is the risk that customers are unable to repay their loans, or another bank with which it has operations (correspondent banking) is faulty.
- Interest rate risk: is the risk of lending and borrowing. This is the risk that lending rates move unfavorably. Thus, a borrower with a variable-rate undergoes rate risk when rates increase because he must pay more. Conversely, a lender endures a risk when rates fall for the reason that he loses income.
  For a bank, this is the risk that changes in market interest rates leads to a compensation cost of deposits greater than gains generated by interest on loans;

Financial risk is inherent on economic activity. Every business is facing this risk since it realizes trade, industrial or financial operations. Development of financial markets and the internationalization of business activities have given rise to a new type of risk which is added to the traditional risks. This new risk, called financial risk is the result of unpredictable movements in exchange rates, interest rates and commodity prices.

Companies can manage their risk using two methods often complementary. The first, *operational risk management* consists in the selection and adjustment of strategies and policies of an entity recorded to reduce exposure. The second is the use of *specific financial instruments*. Derivatives are contracts between two designed to exchange at the date the product, called underlying or support, at a predetermined price. The supports can be currencies, commodities, interest rates, stock market index, etc. Options, futures and forwards contracts, currency swaps and interest rate are examples, to mention only the most standard. The increase and the improvement of the cash flow is the main reason why companies manage their exposures to the financial risk. But they have also in risk management a way to enhance their ability to access to debts and their power conditions to bargaining credit.

3. Controlling cash flow

Cash flow from operations (CFO) is the potential of the company to identify, through its activity period, a resource (an enrichment of the funds flow). CFO is the potential cash flows (excluding time lags) generated by all the normal activity of the company. In fact, it does not account receipts and disbursements actually made during the period.

Confusion between CFO and cash flow is recurrent. For cash flow resulting from operating activities, we must subtract the changes in working capital[7] during the period. By subtracting from CAF the amount of dividends paid during the period from CFO, we obtain the flow.

Comparing COF to total of debt, banks measure the repayment capacity of the company. They are attentive to changes in the following ratio:

$$\textit{Repayment Capacity} = \textit{Total Debt} / \textit{CFO}$$

This ratio indicates the company's ability to repay its debts. For example, a ratio equal to three indicates that the company takes three years to repay.

Otherwise, an investment is considered profitable if it shows capacity flow (returns) further than its cost (initial outlay). Investment will be profitable if the net present value (NPV)[8] is greater than 0.

The internal resource can be used in particular to intensify the business' activity, to finance new investments, to repay loans or debts, to pay dividends to the owners of the company and to increase working capital. It shows the enhancement of performance level of the company.

[7] It is a financial metric which represents operating liquidity available to a business, organization or other entity, including governmental entity.
[8] It is defined as the sum of the present values (PVs) of the individual cash flows of the same entity.

Many a profitable business has ended up in bankruptcy because the amount of cash coming in doesn't compare with the amount of cash going out. Firms that don't exercise good cash management may not be able to make the investments needed to compete, or they may have to pay more to borrow money to function.

So as we show, cash flow is one of the most critical components of success for a small or mid-sized business. Without cash, profits are meaningless.

You have to work at it. Companies need to work to achieving a *positive cash flow*[9]. They need to analyze and manage their cash flow to more effectively control the inflow and outflow of cash. Also, they should undertake cash flow analysis to make sure they have enough cash each month to cover their obligations in the coming month. So, this control can helps companies get better and better at creating cash flow projections they can rely on as they make business decisions about expanding their business and taking care of their existing bills.

4. Mastering indebtedness

When launching investment in a company, one of the most important factors needed to consider is how much debt the company is carrying.

A metric that shows a company's overall debt situation by netting the value of a company's liabilities and debts with its cash and other similar liquid assets is calculated as:

$$\textit{Net Debt} = \textit{Short Term Debt} + \textit{Long Term Debt} - \textit{Cash and Cash Equivalents}$$

Otherwise, the debt ratio should not exceed a certain threshold, which can be set to about 50% to give an order of magnitude (as it is discussed according to the sector of activity, legal form and company size), which corresponds to a financial autonomy ratio equal to 1.

In fact, a high debt is often associated with financial difficulties and limits the margin of the contractor in its relations with creditors. But debt levels must be considered in relation to the date of resumption of operations and the mode of tenure. The purchase of land causes significant property loans that increase the rate. Similarly, the modernizations of the operation, construction of farm buildings, equipment investment are often accompanied by a significant increase in debt in the long and medium term. The level of debt is a very stable indicator (it moves slowly enough).

[9] This occurs when the cash funneling into your business from sales, accounts receivable, etc. is more than the amount of the cash leaving your businesses through accounts payable, monthly expenses, salaries, etc.

A degree of debt instead of zero means that all assets were financed by equity capital. A level of debt of 100% indicates that all assets financed by borrowing, which is worrying, but in some cases, such a rate is also due to the lack of mention of certain assets in the balance sheet.
If the level of debt is too high, the ability to raise new resources is also threatened.

The consequence of the genesis of excessive debt is the slowdown in investment and development. These processes are cumulative over several years. So, excessive debt will be a source of business weakening and bankruptcy

One of the major criticisms of Modigliani and Miller model (1963) is that they was not taken into account the costs of bankruptcy. If the debt is, as we have seen, cannot create value, the excess is harmful. Alternatively, precursors as Beaver (1966) and Altman [1968] showed that the lack of operating profitability and debt played a significant role in business failure. Financial difficulty may be associated with the legal concept of bankruptcy, but the authors who are interested in the problem have shown that this definition was too restrictive. Financial difficulty is a process that is manifested by a series of symptoms that we cannot identify a clear causality direction. Thus, the financial difficulty is often associated with the growth of the debt, even if we can not accurately determine if this phenomenon is a cause or a consequence.

Avoid debt and indebtedness debt is the first solution to ensure the stability and continuity of business operations. How to ensure this?

Growing companies often use business credit to finance all of its needs. But the loan, whether personal loan, line of credit or a business credit, can quickly become unmanageable and cause the indebtedness.

To avoid this, it is necessary to understand the financial situation of the company. Here are the criteria to consider not making the right moves:

First, the company should prick when and how to borrow. Before borrowing money, it is necessary to plan the capital needs to calculate the necessary amount. The company has to take loans if they are designed to develop the workforce, to embark on a new market, to acquire necessary materials, to improve cash flow, etc. Establish a funding plan is highly recommended to any company wanting to borrow. Moreover, this is required by the financial institutions in the establishment of credit business, because it is a comprehensive review of the financial results of the company.

Second, company has to detect what type of loan choosing. The type of loan should be setting according to the business needs. Prefer as much as possible short-term borrowings is a good manner to keep away from indebtedness. Compared to long-term loan, this solution offers several advantages. The short-term credit offers a more affordable rate. If sales increase rapidly, this loan is the best solution. If the company’s growth is steady and long-term business credit is more appropriate. Finally, before signing a credit, the company should consider its current state. Take a credit for a period of financial crisis is not recommended.

E. The impact of Finance autonomy in the company prospects

1. Good financial governance

Financial governance of the company is the set of processes and practices used by the company in order to ensure transparency and integrity in the financial sector.

It is widely recognized that good financial governance can enhance the financial autonomy and of course boosting investment. Quality, credibility and transparency of financial information submitted by the company to its shareholders, markets and regulators, including through the annual report are a central element of right financial governance. Then, improving financial governance should be at the first plan because whatever the socio-economic utility of a project, success depends primarily on the financial environment and financial institutions involved.

2. Ethics and financial responsibility

Meet the requirements of many internal and external counterparties (employees, suppliers, State, lenders, shareholders, etc.), the company and its relationships with its counterparties should be set in a way to operating stable and as much as possibly satisfactory to reduce risks. In this respect, financial management occupies a special place because of its responsibility to deal with the shareholders and creditors of the company, but also to represent within the financial commitment.

There are four issues that should be understood as the management of liquidity risk: the optimal ratio of equity relative to debt, the duration of financing issue, the nature of guarantees granted, and the level of confirmed credit lines.

F. Outlook for financial autonomy

Financial autonomy does not treated as a separate subject purpose but, it should be treated as an integrated approach. In fact, the study of the financial system of the company must be considered in its complexity. In this perspective, to attempt to understand the financial autonomy in its environment, its functions, its mechanisms, a comprehensive approach is crucial.

Objectives inherent in this global approach are essentially:

- Acquire more specific knowledge on the concept of financial autonomy to appear at a clearer understanding of these fundamental concepts and practice consciously and effectively;
- Expand professional practices in identifying and analyzing the modes of action that structure their course of action;
- The financial aspects of projects (e.g. financial reports and other necessary procedures) are executed in a controlled conduct;
- Scheduling the financial autonomy involved in developing the budget and the projection of cash flow.

Thus, taking into account financial autonomy is essential to have a comprehensive vision of the financial structure of the company; this may help leaders to decision making

Conclusion

Business performance is closely linked to benefits from their investment operations. To promote investment, it is imperative to enhance the financial autonomy. To achieve this goal, several tools are available. Operational risk management and use of specific financial instruments play key roles in financial risk management. Similarly, to master the debt, and thus to promote the financial independence of the company, we must know when and how to borrow and what type of loan to choose.

For these reasons and others, financial autonomy should not be treated as a separate subject. The reinterpretation of finance autonomy in a new integrated approach becomes a necessity to manage efficiently, transparently and accountably the financial resources.

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