Evolution of corporate finance methods

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Abstract

The paper has more introductory character, aiming in general terms to introduce the concept of corporate financing by briefly addressing the genes of this process. The historical part refers to the development that this institute has had in Europe and beyond. In the focus of this topic are the legal aspects of corporate finance modes, leaving out any financial analysis of this element. Consequently, the entirety of legal acts governing corporate finance will be addressed. For reasons that mainly relate to the integration processes of our country, European legislation has been selected, as a comparative base reference. Consequently, the analysis of Albanian legislation in this respect will be made with reference to European legislation that is abundant and widely dealt with in European academic circles.

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JEL Classification: K22, K23

1. Introduction

Societies and their capital needs commercial companies are created to achieve a common economic objective which is and should be at the same time the goal of all its administrative staff. The purpose of creating a business organization is to maximize the profits and wealth of its shareholders.

Shareholders maximize their profits by increasing the profits of the company that will then be distributed proportionally to the share they own each, as well as through raising the value of the shares in the market. Society is a legal entity that, in the exercise of its activity, in addition to the interests of shareholders, affects the interests of a much wider group of stakeholders. For this reason, alternative objectives of other groups of interest may challenge the primary objective of the company's shareholders. Other stakeholders, such as employees, clients, creditors, and the local community where the company operates, may have different expectations and different visions for the company that may conflict with shareholders' expectations. In this context, society is obliged to take into consideration, in the exercise of its activity, the interests of other actors which in any case, will serve the primary objective of society. To achieve the goal for which it is created, it is necessary for the company to have an initial capital.

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The capital that serves the main economic objective of the society is accumulated at the moment of establishment through the payment of contributions according to the provisions of its statute.[2] The totality of these contributions, which constitute the capital of the company, has two main functions: first, to exercise its economic activity by avoiding the primary objective of the shareholders, secondly, to serve as a minimum guarantee for the creditors of the company (this assertion applies to capital companies whose shareholder liability is limited to the value unspecified of the signed contribution).

However, only the existence of the initial capital with which the company starts its activity is insufficient to maximize profit and at the same time protect the interests of interest groups associated with the society. For this reason, especially immediately after the founding moment of the company, but also during the exercise of its activity, the company may need additional capital for various purposes, either to finance its projects or investments in order to generate profits, or to have liquidity at specific moments (such as pay for employee bonuses). Under these conditions, society may need long-term financing or short-term financing. If the issue of such a decision is made before the company, then it should carefully assess what is the best and least costly way to finance capital needs.

Once society sets itself in front of the capital requirement, it will choose the most efficient way to finance its operations, aiming to accumulate the necessary capital at the required time and with as little cost as possible. It is clear that there is a link between the decision on funding received by the company's administrators and the shareholders' assets.[3] However, before the company makes a decision on its funding, it must have full knowledge of internal resources financial, as this may exclude certain funding modes. Sources of funding are classified into external and internal financial sources. Domestic financial resources are all assets, reserves or retained earnings of the company. However, these resources can be used depending on the company's financial standing and its previous financial performance. Thus, if the company has accumulated reserves and has not distributed profits made over the previous financial years, it can make use of internal resources to finance its needs. External Resources of financing are more varied and classified as equity issuance financing, which shows equity capital and debt financing. This funding may be required for short, medium and long term. Short-term financing is financing through short-term debt securities (with a maturity of less than one year), mid-term financing through debt or debt securities with a maturity up to 5 years and long-term financing , which is realized by obtaining long-term borrowings and issuing long-term securities (with a maturity of more than 5 years).[4]

External resources may be provided depending on the conditions and other circumstances in which it is located society. For example, a listed company is

[2] Article 3, Law "On Traders and Business Companies", no. 9901, dated 14.04.2008

[3] Watson, Denzil; Head, Antony, *Corporate Finance Principles and Practice*, Prentice Hall Financial Times, 2007, fifth edition, p. 31.

[4] Berk, J., De Marzo, P., Harrford, J., *Fundamentals of Corporate Finance*, second edition, Prentice Hall, 2012, p. 14.

easier to generate capital by issuing shares or other financial instruments. On the other hand, a company that has bad financial records, resulting in large liabilities, can not be successful in issuing debt securities.[5] In terms of capital need, the company may utilize several options from which can generate capital. In our country, a stock company found before the need for capital, can potentially use three ways of financing: a) the use of internal resources; b) Issue of Participation (Ownership) / Shares; c) borrowing. In banks or other financial institutions (this is also called indirect financing, as the bank stands between fund providers (who are bank depositors) and the company that seeks financing.

2. The evolution of corporate financing methods

The need for capital of society is not a modern phenomenon, because the company is directed directly to investors who guarantee the respective funds it was born from the time of the establishment of the companies after the traders had established the existence of a proportional link between the capital invested in the company and the generated profit. Under these conditions, investors repeatedly sought to supply their capital needs by addressing markets for These developments date back to the Middle Ages, when the first forms of business organization were born.[6] Since ancient times, the civilizations established in Mesopotamia had found primitive ways that performed the function of meeting the needs for exercising trade. Then, in the Greco-Roman cultures, several other methods were introduced for the expansion of trade activity.[7]

The growth of trade transactions between some European countries, mainly between the countries of North and South Europe, encouraged the facilitation and expansion of the financial sector. As a center for these developments, the Italian city-states were transformed into the basic practices that today serve the foundations of international trade and financing, such as financing specialized projects, diversifying portfolios, accepting deposits, exchanging currencies and others. These methods were also helped by the improvement and drafting of relevant legislation.

In this way, Italian traders created new methods to limit their personal responsibility and risk diversification[8]In these city-states, mainly Florence and Venice, the first forms of corporations were created. Creating these forms has given rise to new financing practices and organizational character. During the Middle Ages, new forms of business or financial organizations stimulated medieval economic life.

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[5] Mishkin, Frederik S., Eakins, Stanley G., *Financial Markets and Institutions*, Pearson Addison Wesley 2006, p. 246.

[6] Baskin, Jonathan B.; Miranti, Paul J., *A History of Corporate Finance*, 1999, Cambridge University Press, p. 29.

[7] Paragraph 2.1.3, TSE Regulation.

[8] Bachner, Thomas, *Creditor Protection in Private Companies: Anglo-German Perspectives for a European Legal Discourse*, Cambridge University Press, 2009, p. 22.

Three types of banks were developed:

(1) institutions providing foreign exchange services, accepting deposits and lending to local businesses;

(2) large commercial banks combining international trade and exchange bills as necessary financing instruments for international trade; and

(3) banks with guarantees that provide loans secured by hostages on personal assets.[9] Trade expands in the course of major geographical discoveries, which increase the needs for capital of traders.

The rise and development of joint stock companies during this period (16th and 17th century) is characterized by the assessment of managerial practices to reduce the risk and increase efficiency and find ways of financing that best meet the needs of investors and 'owners of society'. One of the case studies widely dealt with by foreign literature is the East India Company, which serves as an example of a successful society for the time.[10] This society widely used close relations with the state to provide guarantees to potential investors about the risks that companies might face in the 17th century. So, the founders of this society use the power of state power to overcome investor suspicions and attract them to financing their capital needs. This state support appeared in the form of exclusive rights or monopoly given by the state for the exercise of certain activities. However, although state support was a guarantee, it was noticed in the long run that the company's internal administration was of the utmost importance.[11]

The use of the state figure as a guarantor served to initially attract investors who were doubtful regarding the activity of the society, while the internal well-being of the society became essential for the preservation and expansion of advantages in international trade, after the initial phase of formation.[12] Investors met the needs for capital of the company in question, due to the good structure of domestic governance and the exclusive rights guaranteed by the state. Also, during this period, the company used borrowing to increase its capital due to the low interest rates it offered. The large-scale development of companies that trade across national borders positively affected state economies. Strengthening state economies fueled the emergence of anonymous financial markets[13].

Although prototypes of the first modern public debt instruments appeared in Italy in the cities of Genoa and Venice, and in the low places in Antwerp and Bruges, markets for these bonds achieved great efficiency in England between 1688 and 1815.[14] The first financial markets were not perfect but carried a series of

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[9] Baskin, Jonathan B.; Miranti, Paul J., *op. cit.*, p. 32.

[10] For more about the history of this period, see: Baskin, Jonathan B .; Miranti, Paul J., *op. cit.*, pp. 55-59.

[11] Hull, John C., *Futures, Options and Other Derivatives*, 5th edition, Prentice Hall, Financial Series, p. 2.

[12] Idem, p. 2.

[13] Mantysaari, Petri, *The Law of Corporate Finance: General Principles and EU Law*, Springer, 2010, p. 132.

[14] Ferran, Eillis, *Principles of Corporate Finance Law*, Oxford University Press, p. 147.

problems that stemmed, among other things, from the lack of information and the still unconvented economies of the states.

These factors had a great influence on determining the first instruments that began to be traded in these markets, which were state bonds. These were titles that were characterized by the guarantee as the state had a more stable performance compared to businesses. Moreover, state bonds were characterized by fixed payments during the maturity period, against shares for which there was no specific provision regarding the income they provided. At the beginning of the twentieth century, academic theorists widely accepted the idea of "trading the equity parts [with this term referring to stock]". At the heart of this idea is the implicit recognition of the problem of asymmetric information and the effects it has on determining the relative share of debt and equity in the area of corporate finance.[15]

During this period, major infrastructure works such as railways and road infrastructure. These investments were made by the societies of that time by using external financing, but under state control, as objects built at this time were in the function of the public interest. Before the society in need of capital, two alternatives are set in order to maximize profit if they are unable to finance this need or because they are suspicious of carrying the entire risk alone. Under these conditions, the company may decide to divide part of its profits with other investors, who receive the share of profit in return for the risk they face.

On the other hand, the company may seek to maintain the monopoly for gaining profit and to issue other securities that carry less risk, which are debt securities. Funding of these projects had the main objective to ensure a sustainable environment that was conducive to expanding the opportunities of joint stock companies. As a focal point of these efforts was the need for a long time to learn the most efficient way to utilize technology and management potentials. However, corporate practice in the United States and Britain during the 19th century showed that it had a preference on issuing debt securities even in the absence of any fiscal advantage[16]. The strands of financial markets we found earlier in this historical look, however, the 20th century was the period when these markets developed broadly.

Prior to the 20th century, the opportunity to increase the company's equity by issuing ordinary shares was limited. This barrier reflected the inadequacy of information for investors so that they assessed their investment risk and the ability to calculate the profit that would be realized. Moreover, there were a number of other barriers stemming from lack of honesty or incompetence of agents for the execution of transactions. On the other hand, investors rarely managed to overcome physical barriers to space and time or some of them were passive and failed to estimate the investments they would make. These factors influenced the selection by investors of those financial instruments that offer more collateral and fixed income.

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[15] Baskin, Jonathan B.; Miranti, Paul J., *op. cit.*, p. 89.

[16] Ibidem.

During the 1920s due to the spread of knowledge about the stock concept, investment in this type of instrument grew. Another reason that triggered the issuance of shares was the possibility that the existing shareholders of the company would maintain control over it, as the number of shares issued did not change this structure. Given these developments, during the 1930s, the state's concern to regulate the markets increases and at this point we see the rise of state regulatory structures. These structures were at the very beginning of their development and could not guarantee price security and the basic function of these markets, which is the guarantee of liquidity.

Today, in developed countries, not only have the relevant regulatory structures of the financial instruments markets been established but there is a full regulatory framework with obligations mainly for joint stock companies that have to publish information about their activity or related risk with the instruments offered by them in order for investors to make an informed decision. Also, the ways of financing are much more varied than in the early 20th century.

3. Conclusions

The theme was generally motivated by the lack of juridical treatise in this area, aiming in this regard the enrichment of the doctrine with works and contemporary debates on a not so familiar concept for the Albanian legal environment. Another boosting motive that gave its contribution in selecting this thesis was to offer the Albanian business environment the legal aspects of corporate financing with a special focus on investor protection. The thesis is focused on the elaboration of the potential methods of corporate financing.

However, major attention it is shown to protection of investors through highlighting their protection mechanisms. In this thesis the term investors includes especially minority shareholders (as buyers of small amounts of shares issued by corporations) and bondholders. These aspects are elaborated through the analytic model, but not only, because to properly understand the new provisions introduced in the Albanian legal environment it was necessary to follow a comparative perspective as well. Because of the integration process in the European structures the selected legislation was mainly the European one.

In conclusion of these studies, it results that the Albanian legal environment is lately enriched with laws governing the methods of corporate financing that offer alternative financing options besides bank and the financial institutions borrowing. It is also noteworthy that these financing options are not used by the Albanian companies because of the lack of active financial markets. The introduced legislation has aimed the approximation with the European legislation. This aim is partly fulfilled as in the conditions of our country the full harmonization was not possible. However, the approximated legislation leaves room for future upgrades and improvements.

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