6 A COMPARISON AND EVALUATION OF BOTH SOURCES

6.1 Comparison and evaluation

Looking back on the discussion in the previous three chapters, the first impression that is likely to arise is that the determinants of financial structure presented in the theory of finance are rather different from the ones suggested in the practical literature. Indeed, at first glance the plethora of different subjects and methodologies incorporated in the practical literature seems to bear little resemblance to the neatly arranged theory based determinants. However, on closer investigation certain common elements become clear. In some cases, such as the effect of collateral security on the financing decision, the theoretical and practical literature obviously describe the same determinants of capital structure. In other cases, the practical literature refers to phenomena that are usually assumed not to exist in financial theory, e.g. transaction costs and limited access to capital markets. In still other cases, such as the entrepreneur's age, the relation between the two is less obvious but can still be argued to exist (viz. by the nondiversification argument which may lead to "age related" financial policies). Additionally, the growing attention in the theory of finance for empirical aspects of the firm's capital structure has induced theorists to draw upon the empirical data previously dominated by pragmatists. If anything, both approaches share the same empirical basis.

Since these common elements mainly refer to the phenomena being studied, a first conclusion can be that both approaches differ more in method than in content. There are marked differences in the methods applied. As could be expected, the theoretical approach rests on the application of strict rules to derive conclusions from the assumptions, whereas the practical literature arrives at conclusions using many different methods, including reasoning, empirical facts and research outcomes such as simple correlations. As a consequence, the nature of the conclusions differs rather strongly between both approaches. In the theoretical approach, simple and straightforward conclusions are derived on the basis of a large set of complex assumptions. By contrast, in the practical literature complex and often entangled conclusions are formulated on the basis of simple, if any,
explicit assumptions.\footnote{The assumptions made implicitly in the formulation of conclusions can, of course, be quite complex.}

In view of the variety of methods and the nature of the conclusions in the practical literature, it is perhaps not surprising to detect a number of flaws in the various argumentations. In the previous chapter's summary, there are several cases in which determinants of financial structure, once reviewed within a "cause and effect" framework, appear to be motivated in a somewhat questionable manner. First, causes are put forward without a corresponding effect, e.g. small firms are reported to face high flotation costs and to lack a specialized staff, but the effects on the firm's leverage remain unclear. Second, causes are presented that fail to capture the purport of the argument in practice. For instance, legal form is argued to determine the possibility of outside participations. Although legally this is a correct argument, it is much more likely that in practice legal form is chosen to accommodate the available sources of finance (i.e. cause and effect are reversed). Similarly, corporate bodies may indeed pass the dividends in a bad year, but this only provides increased latitude if the owner-manager has the disposal of other sources of income. If the owner-manager depends on the firm for his livelihood, he must use some of the earnings for his cost of living, regardless the legal form. Third, in the practical literature simple correlations are encountered without an accompanying cause and effect motivation. For instance, younger and better informed entrepreneurs are reported to use more debt solely on the basis of statistical correlation. Fourth, and last, we find in the practical literature examples of two or more causes mixed together. For instance, small firms allegedly use little debt because of insufficient collateral and low profitability. In this argument, the effects of size, collateral and profitability are mixed. The above discussion of various flawed argumentations is not intended to disparage the practical literature, but rather to accentuate the need of a critical evaluation of its conclusions.

One aspect of the practical literature that is often overlooked, is that the concepts and techniques used in these studies are usually quite old, some even date back to the beginning of the century. For instance, the classical example of a ratio pyramid, the DuPont system of financial analysis or DuPont chart, which is still widely used today, was developed in 1919 by the American company of the same name. Early studies of "credit barometrics" and of financial differences between successful and unsuccessful firms date