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Internal Finance as a Source of Investment: Managerial/Principal Agent or Asymmetric Information Approach?

2.1 Introduction

Although there is evidence of a strong relationship between investment and internal finance, the reasons behind this relationship remain subject to controversy. So far, the literature has identified at least two approaches to the underlying cash flow theory of investment which influence this relationship: specifically, the managerial/principal agent framework and the asymmetric information approach. A dominant theory in corporate financing patterns for many years has been a firm’s preference for internal over external finance to fund investments. Baumol clearly articulated this idea which would be called a ‘financing hierarchy’ by later researchers, stating:

[i]t would appear that the bulk of business enterprise should finance its investment insofar as possible entirely out of retained earnings because that is, characteristically, the cheapest way to raise additional funds. Only when it becomes impossible to provide enough money from internal sources should the firm turn to the stock market or to borrowing for resources. (Baumol, 1965)

Although many researchers agree that the information asymmetries which are the root cause of the preference for internal finance have an important impact on investment, there is substantially less agreement about their cause. Thus, there still remains the question of whether information asymmetries between borrowers and lenders lead to firms that face ‘financing constraints’, where profitable investment projects are not exploited, or whether agency costs lead managers to waste the firm’s resources.
Before both the neoclassical theory of investment and the Modigliani–Miller theorems, the dominant explanations of investment decisions of firms were the liquidity theory of investment preceded by the accelerator theory. Significant aspects of the neoclassical theory of investment are based on the Modigliani–Miller theorems. The neoclassical theory assumes that a firm can always obtain necessary funds to undertake investments as long as it provides a return above the cost of capital. Consequently, internal and external finance are viewed as substitutes; firms use external finance to smooth investment when internal finance is scarce. The neoclassical view also implies a complete separation of real and financial decisions faced by the firm. On the contrary, cash flow theories of investment emphasise financing hierarchies faced by the firm and therefore the crucial role of cash flow in determining the capital expenditures. For instance, the asymmetric information approach to investment explicitly considers capital market imperfections which raise the cost of external finance, whereas the managerial/principal agent approach allows managers to use their discretion when considering similar decisions. 2 Thus, cash flow seems irrelevant for all other models of investment including the accelerator, modified neoclassical, and Q models of investment as they say nothing about the source of finance. Based on these differences, it is useful from the outset to distinguish between the managerial/principal agent (MPAA) and asymmetric information approaches (AIA).

2.2 Asymmetric information approach to investment

Asymmetric information intensifies financing constraints. In asymmetric information models, firm managers or insiders are assumed to possess private information about the characteristics of the firm’s investment opportunities. According to Myers and Majluf, the theoretical underpinning of this empirical regularity is underinvestment. Financing constraints due to asymmetric information problems in the issuance of equity cause the cash flow investment dependence (Myers and Majluf, 1984). They also showed that, if outside suppliers of capital are less well informed than insiders about the value of the firm’s assets, equity may be mispriced by the market. In particular, the market may associate new equity issues with low-quality firms. Due to the information asymmetry in comparison with insiders, providers of capital expect insiders to raise capital when this new capital is overvalued. The implication of this adverse selection is that managers and firms face a premium on external financing. Therefore, firms will initially fund