

## FINANCIAL FLEXIBILITY AND FINANCIAL POLICY

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### ABSTRACT

*This paper surveys research on financial flexibility, with special attention to its influences on capital structure and payout policy. This paper includes five sections: first, explains why financial flexibility matters; second, explains how to get financial flexibility for a corporation; third, details how to measure financial flexibility; fourth, summarizes relationship between financial flexibility and payout policy; finally, draws conclusions and elaborates future research prospects.*

**Keywords:** Financial flexibility, Financial Policy, Payout Policy, Leverage Policy

### INTRODUCTION

From a global perspective, today's firms are facing internal and external environmental uncertainties, including uncertain investment opportunities, as well as uncertain future market price of debt and equity securities. Obviously, if firms maintain a certain capability which makes firms react quickly to the uncertainty under unpredictable environment, the errors or failures which are due to the uncertainty can be avoided. In these cases, a financial flexibility theory will be created. In 1963, Modigliani and Miller in the study of the relationship between taxation and optimal capital structure, discovered the phenomenon that firms do not use debt as much as expected considering the income tax shield, because firms save their debt capacity in order to keep flexibility to respond to future capital requirements, which has opened a flexible theory in the field of financial management---financial flexibility.

Over the last two decades, especially the decade of the 1990's, considerable academic interest has focused on the financial flexibility. Financial flexibility is generally defined as the ability of a firm to access and restructure its financing at a low cost (Gamba and Triantis, 2005; Byoun, 2005) and the motives to attain flexibility which is related to the ability and the need of firms to raise external funds. There is ample evidence in the literature showing that financial executives see financial flexibility as one of the most important determinants of capital structure decisions (Graham and Harvey, 2001; Mittoo and Bancel, 2009; Brounen et al., 2005). Now, some 20 years later it seems appropriate to take stock of where this research stands and where it is going. Our goal in this survey is to synthesize the recent literature.

The plan of the paper is as follows. In section one we discuss the importance of financial flexibility, in section two we discuss the two main access to financial flexibility, in section three we summarize the methods of measuring financial flexibility, in section four we discuss how the financial flexibility affects dividend policy, at last, in section five we discuss the conclusions and future research prospects.

#### Why does Financial Flexibility Matter?

According to Byoun's definition, financial flexibility is a firm's capacity to mobilize its financial resources in response to uncertain future contingencies. If capital markets are perfect, then there is no need for financial flexibility (Byoun, 2011).

Graham and Harvey (2001) argue that the most important factor affecting corporate debt decisions is managers' desire to maintain financial flexibility. This opinion is agreed with Stulz (1990) who believes that the level of debt depends on the balance between two needs: financial flexibility and restriction of cash flow wastes. Killi et al. (2011) research debt conservatism and discover that European listed companies employ lower debt level when they have higher marginal value of financial flexibility in the capital structure. Byoun (2005) empirically tests the effects of financial flexibility decisions on capital structure. By employing life-cycle theory to classify companies, Byoun discovers that developing companies who use more equity financing and maintain a lower leverage ratio have the highest financial flexibility; growth companies issue bonds and thus maintain a high leverage ratio; mature companies rely on internal equity and therefore have modest leverage ratio. He also finds that the relationship between leverage and the company financing life cycle is a U-shaped relationship. Ignoring endogenous factors, Clark (2010) finds a negative correlation between the leverage and the marginal value of cash (to be considered an alternative to the marginal value of financial flexibility), which is based on Faulkender and Wang (2004) concept of marginal cash. By investigating the deliberate increase on the leverage, Denis and McKeon (2010) find that the main purpose of issuing debt is to provide funds for investment and increase working capital. In addition, after increasing leverage, the company will slowly but not actively issue shares to reduce the debt ratio. Mura and Marchica (2010) find that the company's investments are substantially increased after improving financial flexibility. Arslan et al. (2010) consider that the financial flexibility can be obtained by means of conservative financial policies, as well as excess cash holdings. Flexible study finds that financial index based on debt levels and cash flow levels can better explain the company's investment capacity and performance levels than that which is based on a single index (such as company size, dividend policy, business alliances, etc.) .

As we stated, CEOs regard financial flexibility as first order important determinants of capital structure decisions. But why does financial flexibility matter? Financial flexibility represents the ability of a firm to access and restructure its financing at a low cost. It is well known that financing is a critical financial decision for a firm, and the financing process is very complicated because the decision makers must weigh both internal financial conditions and external financing constraints. Under above scenario, financial flexibility can (1) explain the firms liquidity policy puzzle: why should simultaneously borrow and lend under financing frictions? Financial flexibility can also (2) explain the firms' payout policy: stock repurchases or dividends, and (3) some capital structure puzzle.

### **How to get Financial Flexibility?**

As concerns the study on how firms get financial flexibility, on one hand some literature argues the importance of obtaining financial flexibility through low leverage policy (Billett et al., 2007 ; Byoun ,2011;Goldstein et al.,2001;Poitevin,1989), and emphasizes that the firms adopting low leverage policy can reserve the capacity of future borrowing by raising their leverage ratio. On the other hand, some literature considers firms can obtain financial flexibility through excess cash (Almeida et al.,2003; Faulkender and Wang,2004; Harford et al., 2005; opler et al., 1999; Riddiek and Whited, 2009), and argues that when firms cannot finance externally or the cost of financing is very high, those who possess ample cash will get more financial flexibility in the face of growth opportunity and adverse impact. Recently research focuses on the combination of the two above policies. For example, Bates et al.(2009) proves that with the increase of the economic environment risk, the firms should be in high level cash holdings at the same time be in low level debt. Further, the paper finds that use the two financial policies at the same time can preclude firms from falling into financial

distress or the possibility of default. Byuon (2011) finds that small size firms relatively have more tendencies to obtain financial flexibility, and such firms will keep low debt and high cash holdings at the same time. In reality, some firms maintain low debt level in order to obtain debt financing flexibility, some other firms hold high cash level in order to obtain cash flexibility, and meanwhile some firms maintain both high level cash flexibility and high level debt financing flexibility.

### **How to Measure Financial Flexibility?**

So far, the mainstream literature adopts the following three ways to measure firm flexible financial : (1) Single index method. This method is only based on single firms financial index (such as financial leverage or cash holdings) to judge the level of financial flexibility. In the existing literature, Mura and Marchica (2010), and Arslan et al. (2012) have been using single index method to research financial flexibility. (2) Multi-index combination method. According to DeAngelo and DeAngelo(2007), we could combine a number of financial indexes (such as financial leverage and cash holdings) to determine the level of financial flexibility. (3) Multi-index synthetic method. This method considers a number of financial indexes which reflect the status of firm financial flexibility, and then gives each index a weight respectively to calculate a composite score which judges the level of firm financial flexibility. Doidge. et al. (2009), Arslan et al. (2012) and Ma (2010), have been using multi-index synthetic method to measure firm financial flexibility.

### **Financial Flexibility and Payout Policy**

Effects of the financial flexibility to the dividend policy can be broadly divided into two categories.

First, firms employ dividend payments in order to maintain financial flexibility. DeAngelo and DeAngelo(2007) argue that firms behavior such as high cash holdings , low leverage, distribution of dividends are all the necessity for reserving financial flexibility. When confronting a sharp decline in future investment opportunities or operational performance, the firms keep lower financial leverage and adhere to cash dividend policy, which will be an easier access to external capital markets. However, the excess cash holdings will induce managers' agent behavior to achieve individual maximum benefits by cash abusing, thereby increasing the cost of financial flexibility reserves. Accordingly, firms will not hold excess cash to reserve financial flexibility, instead, distribute dividends or repay debt to payout the excess cash. Oded (2008) suggests that financial flexibility is one of the most important factors that drive corporate dividend payout policy; the core of the dividend payment policy is how to get free money without weakening financial flexibility. That is, dividend payout policy is a tradeoff between maintaining financial flexibility and utilization dividend to eliminate agency costs. Lie (2010) finds that the firms who increase dividend payment are usually in sufficient cash holdings, low debt leverage, facing a good business environment and low business risk. In addition, these firms who have adequate financial flexibility will not externally fund in high cost or give up investment opportunities due to allocating cash dividends. Therefore, the change in dividend distribution can release information of business risks and earnings condition to investors. DeAngelo and DeAngelo (2007) consider that the internal monetary fund is not a zero-cost form of financial flexibility because cash balance will produce agency cost and generate flexible revenue. Mature firms limit internal funds by largely paying dividends, because on the one hand, low leverage can provide idle debt capacity and reduce investment deviation; on the other hand, dividend payment will increase the company's reputation, which would make firms sell stocks closely at the intrinsic value in future. Only by reducing the amount of cash and utilizing debt capacity could the firms get

corporate tax incentives. Under special institutional background in China capital market, Wang and Zhang (2012) consider company's dividend policy presents a kind of catering behavior for the semi-mandatory dividend policy.

Second, in order to maintain financial flexibility, firms do not support the dividend payment. Jagannathan et al. (2000) find that the more volatility of company's cash flow has, the stronger and the more requirements of temporary additional cash flow is, and then the firm is more likely to take share repurchase rather than the distribution of dividends. That is because share repurchases are more conducive to maintaining firm financial flexibility than dividend distributions. Mura and Marchica (2007) find that corporate dividends suspending is a means of improving financial flexibility, by which firms can seize valuable investment opportunities. Studying on the correlation between dividend distributions and flexible financial, Bulan (2007) discovers that firms who suspend dividends are usually poor and risky in performance, facing low financial flexibility level and increased investment burden. A quarter of firms who suspend dividends have been improved business performance in a relatively short period of time, and subsequently the firms resume distribution of dividends within three years of suspended dividends. In brief, these firms have lower leverage and greater growth opportunities. Previous short impact on fall of cash flow makes firms suspend dividends, therefore, dividends suspending improves their financial flexibility, which enable firms to seize more investment opportunities to improve their performance.

## **CONCLUSIONS AND FUTURE RESEARCH PROSPECTS**

Financial flexibility is a key factor for corporate management. Meanwhile, academics have proved that the demand of maintaining flexibility is a crucial determinant of corporate financial policies. The literature to date reveals that firms obtain financial flexibility through low leverage policies and through cash holding policies. This paper provides a guide to our understanding of how firms manage their financial policies in the face of costly external finance and uncertainty environment.

Despite this research evolve, several problems remain unresolved and are, therefore, meaningful topics for future research. First, there are still controversy surrounds the degree of flexibility considerations in corporate financial policies decisions. For example, DeAngelo et al. (2010) and Strebulaev (2007) offer dynamic capital structure models which show contrasting views on this question. DeAngelo et al. (2010) argues that dynamic leverage structures are shaped primarily by flexibility considerations and that debt capacity is the main source of financial flexibility. Instead, Strebulaev (2007) argues that dynamic leverage structures are shaped primarily by adjustment costs and uncertainty of investment opportunities.

Second, there is still a gap existing in the relationship among alternative sources of financial flexibility. As we know, firms can change flexibility through cash policies, payout and leverage policies, but what drive these choices? Especially, when firms face lack of internal financing or unexpected investment opportunities, when they need to employ their financial flexibility, from where do firms get the necessary funds?

Third, there are still no satisfying explanations about the puzzling managerial actions of corporate payout in consider of financial flexibility. The literature to date provides convincing evidence that payouts are proper for firms subjected to excess cash flows and poor future investment opportunities. What is less clear is what explains the motivation of payouts among firms who seem to require financial flexibility. Theoretically, the firms with requirements of flexibility could avoid costly external financing by adopting a low payout policy, yet practically choose not do so. Meanwhile, the literature has long confirmed that

financial managers are unwilling to cut dividends. Furthermore, Brav et al. (2005) and Daniel et al. (2011) find managers would rather cut investment than cut dividends. In brief, these managerial actions reveal an astounding reality that payouts are more important than financial flexibility, yet it is still cannot be explained reasonably.

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