

The Formation and Development of Modern Firm Financial Governance Theory

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Abstract: This paper points out the drawbacks of traditional financial governance. After introducing Chinese and western economists' researches on firm financial governance theory, we put forward modern firm financial governance system, which is based on the core of finance-rights allocation. In our opinion, the theory of finance-rights is the important cornerstone of the theory of financial finance-rights theory. Financial governance structure system is the basic framework of the research of financial governance.

Key words: financial governance; property rights; finance-rights

1. Introduction

Finance refers to the input of money and income activities, which form a specified economic interests relation in the process of the production and operation of the firm. The characteristic of the definition of finance determines that the finance research should be conducted from its dual natures——economic attribute (capital movement) and social attribute (property rights contract relation). Traditional financial management is conducted from the quantitative analysis of the finance economic attribute. It belongs to the category of the theory of value management. The drawbacks lead to the rise of the researches in financial governance theory.

Corporate financial governance is the main part of corporate governance. Financial governance is a contract arrangement of the allocation of finance-rights from the perspective of nature.

There exists a close relationship between the theory of the firm and corporate financial theory. Corporate finance theory is built on the basis of specified firm hypothesis. Different firm definitions and the changes of firm characteristics have a decisive influence on the theory of corporate finance.

In practice, in recent years, the capital of listed companies occupied by large shareholders, listed companies' false statements, and misleading information disclosure which have broken the law and violated the principles, often take place in Chinese capital market. These have hindered the development of capital market and damaged the investors' interests. The main reason is that we are lack of an effective investors' interests protection mechanism, and we lose the control of corporate finance governance. In order to strengthen the finance governance of listed companies, we need to solve this problem eagerly that the allocation of finance-rights can really safeguard the investors' interests.

2. Tracing the Economic Source of Modern Financial Governance Theory

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The research scheme of traditional finance theory belongs to the neoclassic economics research scheme. Neoclassical firm theory regards the firm as a whole, which maximizes profit and minimizes cost, takes institute and structure as given and examines conditions for realizing optimal allocation of resources. Because of the implied serious drawbacks and mistakes of the hypothesis, traditional finance theory which is based on neoclassical firm theory has congenital drawbacks. Firstly, the traditional finance theory based on classical firm theory ignores the research in the characteristics of modern firm property right contract relation. The theory is not accordance with the reality. Secondly, taking the institution as given, it does not put institute in the explanatory framework of financial behavior. Thirdly, it excessively concerns financial economic efficiency and economic regulations, and also despises financial social attribute, thus until now even the shade of social person can not be seen (Xinghe Li, 2002). This is the reason why financial deceitful behaviors are so popular in capital market. Fourthly, it disconnects with the research results of New Institutional Economics.

In order to solve the prior problems of traditional finance, we need to realize the great change of research mode and train of thought of finance theory. This change needs supports from theoretical economics. New Institutional Economics rising in 1960s-1970s develops in the criticism of neoclassical economics. New Institutional Economics focuses on the institution and construction of themselves, and tries to search institutional structure of the allocation of resources.

It emphasizes an institutional important role in economics and brings a brand new systematic analysis framework. The most important restrain variable is not only production cost, but also transaction cost. In Wuchang Zhang's words, it is institutional cost. New Institution Economics tells us that an institutional framework and institutional innovation are vital important for an institutional arrangement which save transaction cost.

The contract attribute of firm capital structure makes it possible that the research of New Institution Economics can be mixed together with the research of finance. The research framework and train of thoughts of modern finance governance theory adopt the latest research results. Incomplete contract theory is its core. Financing structure affects and restricts the firm governance mechanism through financial contract. It connects with the relationship between firm contract attribute (contract's incompleteness) and enterprise's ownership allocation. In this way, the theory of finance and New Institution Economics are perfectly combined with each other.

3. Modern Firm Financial Governance Research in Western Theoretical Circle

3.1 Historical Changes of Western New and Old Financial Thoughts and the Rise of New Institution Economics

Modern western finance developing from old financial thoughts to the new one has a deep logic thought and theoretical background.

From historical references, the old financial thoughts formed in 1950s. They include Portfolio Theory , MM Theorem, Efficient Market Theory, Investment Decision Theory and so on. After 60 years development, two theoretical frameworks have been established which are modern portfolio theories by Tobin, Sharp and Lintner. But these two theoretical frameworks themselves have too many theoretical hypotheses and incomplete empirical supports which are vital drawbacks. It is very difficult for them to explain firm financial problems clearly and fundamentally. Because the drawbacks of the two theoretical frameworks have been realized, a group of scholars who represent new financial thoughts began to look for a new theory, which can explain the problems of the firm

much better from 1970s. New financial thoughts refer to the opinions, views on financial problems researches in western financial circle from the late 1970s. They include Arbitrage Pricing Theory (APT) by Roll and Ross, Agent Cost Theory by Jensen and Meckling, Pecking Order Theory of Financing by Myers, and so on.

From the theoretical background of the historical change of western new and old financial thoughts, 1970s is another revolution period of western economic theory. One of the most important symbols is the rise of New Institution Economics research. After thirty years development in the twentieth century, property rights theory, transaction cost economics theory, contract economics theory, informational asymmetries theory mounted on the stage of the academic circle one by one.

3.2 Western New Financial Thoughts Research on Finance-rights and Corporate Financial Governance

Western new theories of capital structure include agent cost theory of capital structure (It can also be called incentive theory), signaling model of capital structure, and theory of control rights of capital structure.

(1) Agent cost theory of capital structure. The theory thinks capital structure can influence operators' level of hard work and other behavior choices and then influences market value of firm further.

The theory emphasizes that there is a connection between financing structure and operators' behavior. The typical representatives are Jensen and Meckling. In their opinion, agent cost is the decisive factor of the firm. The reason why agent cost exists is that the operator is not the completed owner of the firm. The basic conclusion that they have drawn is that the equilibrium of enterprise ownership structure is determined by a trade-off between the agency costs of stockholder's rights and creditor's rights. Firm's optimal capital structure makes the marginal agent costs of the two financing ways equal and the total agent cost minimum.

(2) Under the condition of asymmetric information, different capital structure transmits different signals about firm's true value to the capital market. In Ross's opinion, investors treat a higher debt level as the symbol of a high quality. That's to say, firm's issuing debt shows that the management expects to have a better achievement. On the whole, the higher the debt level is, the higher firm internal holding ratio is, and the better the firm's quality is.

(3) The theory of control rights of capital structure. The choice of capital structure is the choice of firm's control rights among the different stockholders (Harris and Raviv, 1988; Stulz, 1988). Because the future is indefinite, and the contract is incomplete, the distribution of residual control right becomes more important. When the contract is incomplete, whoever owns the residual control right has an important influence on the firm efficiency.

From the above analysis, it can be seen, asymmetric information theory as the core, western new capital structure theory researches and analyzes on the financial contract governance of capital structure. This kind of non-quantitative research on capital structure does not verify the optimal capital structure in particular. How the capital structure allocates the corporate finance-rights and how the capital structure influences the financial governance structure lay a solid theoretical foundation for the financial governance researches.

4. Domestic Theoretical Circle's Research on Firm Financial Governance Theory

4.1 The Initial Stage of the Researches on Finance-rights and Financial Governance

The research results about firm financial governance scatter in the theory of the firm and the theory of capital structure. The definition of financial governance has not been put forward, and the complete theoretical system has not been formed. In this field, some domestic financial scholars put forward some representative opinions. Doctor Guisheng Liu's view is financial distribution which discusses that the nature of finance is a kind of

distribution activity which is conducted on the financial resource by the owner who has the distribution rights. It reflects different owners' economic interests relation. Doctor Zhihua Xie's view is investors' finance which discusses that investors should build financial incentive and restrain mechanism for operators. This kind of property rights mechanism can really play an important role. Doctor Guliang Tang's view is operators' finance which discusses that firm's property rights mechanism should be brought into theory of firm finance.

4.2 The Developing Period of Research on Financial-rights and Financial Governance

On the basis of the above research, from 1995 to 1998, Doctor Zhongxin Wu's doctoral thesis *The Introduction of Modern Finance Economics——property rights, Information and analysis of social capital* starts from the theory of modern property rights, stating the nature of modern finance in the light of finance-rights, putting forward that finance-rights flow brings the thoughts of property rights economics into finance, and widens the vision of finance research. It studies comprehensively the problems of financial theory and practice in the light of "Value" and "Right" and appears to be more systematic and comprehensive. The theory plays a very important leading role in the development of the theory of financial governance structure.

From 1998 to 2001, on the basis of doctoral thesis, Doctor Zhongxin Wu's thesis *The theory of Modern Firm Financial Governance Structure* puts forward establishing modern finance theory system on the basis of finance rights. It gives out the definition of financial governance structure and its theory system. The thesis discusses that firm financial governance structure is the important content and main part of firm governance structure. The status and roles of the investors, board of the directors, and management in the finance-rights flow are set up. Financial governance structure is a set of system arrangement. It governs the group's relationships——stockholders, creditors, and operators, which play very important roles in the firm financial governance activities and expect to better benefits of firm finance.

4.3 The Prosperous Stage of the Research on Finance Governance

Professor Shu'e Yang considers firm financial governance is a series of dynamic system arrangement which adjusts stakeholders' status in the finance system and increases firm governance efficiency through finance-rights allocation among stakeholders. We need to clarify it from the static and dynamic angles.

Professor Xinhe Li puts forwards the theory of stakeholders finance. It considers that the value of firm finance evolves from stockholders' interests to stakeholders' interests. Financial problems are studied from the perspective of stakeholders, and financial governance entities spread to the outsider stakeholders. With respect to the research on the medium and small-sized stockholders and protection of creditors' interests, it is greatly meaningful.

Using comprehensively modern finance theory, firm governance theory and property rights economics, Doctor Xinlong Yi puts forward a general framework of finance-rights allocation, and builds an elementary financial governance system, and in his opinion financial governance should includes governance structure, governance mechanism, and governance behavior.

Until now, the definitions of property rights, finance-rights allocation and financial governance structure have been put forward, but a theoretical system of finance governance has not been formed.

5. Modern Financial Governance Theory System Based on the Core of Finance-rights Allocation

5.1 The Theory of Finance-rights Is the Important Cornerstone of the Theory of Financial Governance

Regarding finance-rights as the core, the finance-rights theory is an entire set of financial theoretical system. We consider that financial basic theory must be the production of the perfect combination of value and right. The logical start point of the finance research is the finance-rights, that is, financial ability plus corresponding right; Finance-rights flow is the exact expression of the theory of finance nature; Financial entities should have two basic standards: economic attribute and financial independence. Maximized firm's value and stakeholders' interests is the exact expression of the financial objective from different sides. Resources allocation and finance-rights allocation are the basic functions of the modern finance.

5.2 Making Clear the Relations of Some Concepts Such As Financial Governance Is the Presupposition of the Research of Financial Governance

It is necessary to make clear the relations of the concepts such as firm governance and financial governance, firm governance and firm management, financial governance and financial management, financial governance and financial governance structure. In our opinion, financial governance is the core and important part of firm governance. Financial governance structure is the core and the form of expression of financial governance. Firm governance and firm management are the important parts of modern firms. They are two sides of one question. Financial management is the core of firm management; financial governance is the core of firm governance. Financial governance mainly handles financial relations. Handling financial relations are allocating finance-rights flow (right). Financial management mainly handles financial activities. Financial activities handle principal movements (value). As the following chart shows:

Firm governance	Financial governance	Financial relations	Finance-rights flow
Firm management	Financial management	Financial activities	Principal flow

5.3 Financial Governance Structure System Is the Basic Framework of the Research of Financial Governance

In our opinion, corporate financial governance structure is included in the firm governance structure which is about institution arrangement of firm finance-rights allocation. Financial governance structure needs to be brought into the framework of firm governance structure. At the same time, as a systematic theory system, financial governance structure is the way of achievement of financial governance.

5.4 Finance-rights Allocation Is the Core of Financial Governance Structure

Financial governance rights are made up of financial decision right, financial control right and financial supervisory right. Finance-rights allocation is the core of financial governance structure. Financial governance right is the core of the category of finance-rights. Financial decision right is the core of financial governance right, finance-right allocation and financial governance structure.

5.5 Capital Structure Is the Basis of Financial Governance Structure

Finance-rights arrangements of firm financial governance influence firm governance from two sides. On one hand, it forms a specified financial structure (capital structure), which affects firm management. On the other hand, it forms a type of financial incentive and restrain mechanism, and affects firm governance in institution. Capital structure is the basis of financial governance structure, while incentive and restrain mechanism is the core of the financial governance structure. Under the given institutional framework, capital structure is the basis of the firm governance structure. Capital structure embodies and reflects firm financial governance structure. To great extent the efficiency of firm governance is determined by the choice of capital structure. How stockholders and creditors play the role in corporate governance is the key to the research of capital structure in corporate finance governance.

5.6 Establishing Incentive and Restrain Mechanism Is the Core of the Financial Governance Structure

We consider finance-rights allocation is the core of firm finance governance structure, while establishing a set of financial mechanism of combined incentive and restrain influences people's behavior as a direction and brake. Both of them are necessary. After the establishment of financial incentive and restrain mechanism, financial-rights allocation can be protected and corporate financial governance structure can be built and perfected.

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(Edited by Lisa, Ann and Edward)