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## The determinants of financial structure: How to explain the “paradox of insolvency and debt” among SMEs in Cameroon?



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### ABSTRACT

The paradox of insolvent enterprises regularly contracting new debts is the motivation behind this research. Statistical tests carried out on a sample of 62 manufacturing firms show that the financial behaviour of these enterprises is mainly explained by two factors: the rate of asset immobilization and the manager’s social capital. The impact of the first factor is due to the asset capacity to serve guarantees, and the impact of the second is inherent to the possibility that enables relational networks to get around norms or to reach informal circuits and alternative sources of financing. The latter aspect is the beginning of the answer to the insolvency and indebtedness paradox. This result denotes the coexistence of two parallel dimensions in the Cameroon business environment. Besides the formal sphere, where the lack of confidence and readability between the actors pushes financial backers to excesses of prudence, subsists an informal universe where confidence, loyalty and solidarity seem to cement business relationships. However, the economic rationality of actors in these networks remains problematic.

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### Contents

1. Introduction .....	74
2. The determinants of financial structure in Cameroon .....	74
2.1. Determinants of context .....	75
2.2. Economic and financial determinants .....	75
2.3. Determinants related to ownership structure .....	76
3. Research methodology .....	77
3.1. Sample selection and data collection .....	77
3.2. Measurement of variables .....	77
3.3. Characteristics of sample firms .....	77
4. Results and implications .....	79
4.1. The impact of economic factors—The financial structure of SMEs .....	79
4.2. The impact of ownership structure on financial structure .....	79
4.3. The impact of contextual variables on the financial structure of SMEs .....	80
4.3.1. Variables of maturity and scope .....	80
4.3.2. Relational network manager and financial structure of manufacturing SMEs .....	80

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5. Conclusion .....	81
Appendix A .....	82
A.1. Multiple regression linked to economic factors—Financial .....	82
A.2. Multiple regression variables related to context .....	82
References .....	83

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## 1. Introduction

In Cameroon, as elsewhere in Africa, where large public companies do not play a strategic role in economic growth, private sector small and medium industries (SMIs) in general and small and medium enterprises (SMEs) in particular are the foundation of value creation. These companies are slowly recovering from the throes of the economic crisis of the decade from 1980 to 1990 and now represent an undisputed sub-regional force. They operate in an environment of excess liquidity of banks and credit rationing for SMEs. In principle, these insolvent companies should experience great difficulty in acquiring new debt. Paradoxically, they succeed, and on a regular basis. What kind of companies are they? What are the factors explaining the financial performance of these companies? These questions suggest, following the pioneering work of [Modigliani and Miller \(1958\)](#) and recent developments in the financial structure of companies, the issue of the determinants of the financial structure of firms in the context of special characteristics.

The existing literature on the subject is essentially Anglo-Saxon and Western. It focuses almost exclusively on big business, even on listed companies, thus making unlisted SMEs a field of research which has been explored very little. However, since the beginning of the 21st century, a growing interest in the financial structure of firms has been felt. These studies have focused specifically on SMEs for some ([Fathi and Gailly, 2003](#); [Gellatly et al., 2003](#); [Chen et al., 2006](#); [Colot and Croquet, 2007a](#); [Janssen, 2007](#); [Mateev et al., 2013](#)), on family and family businesses for others ([Poulain-Rehm, 2005](#); [Colot and Croquet, 2007b](#)), or finally, and most particularly, on industrial enterprises ([Achy and Rigard, 2005](#); [An, 2012](#); [Collins et al., 2013](#); [Pattitoni et al., 2013](#); [Shahid et al., 2014](#)).

The exploratory phase of this research has identified a large number of indebted companies or disastrous financial structures. In addition, the financial behaviour of entrepreneurs in this sector does not seem part of a growth strategy, much less a goal of value creation. More striking, but especially paradoxical, financial behaviours observed seem to depart from the standards of financial orthodoxy. Such companies, as well as many others with indicators of solvency and profitability, adversely, in fact, contract new debts. This paradox of “insolvency and debt” leads us to wonder about the factors that determine the capital structure of these companies.

## 2. The determinants of financial structure in Cameroon

Financial structure refers to the composition of the financial resources of a company, the weight and the balance between its own resources, and its debt. Despite the heterogeneity of approaches, contexts and diversity of factors taken into account, financial structure distinguishes between equity and debt. Equity is internal to a company's financial resources, while debt and similar resources are funds obtained from external providers. By the standards of financial orthodoxy, the company must, depending on the cost of capital, return on investment and its preferred level of autonomy, distributing its sustainable resources between debt and equity.

Regarding the determination of the optimal level of debt, the dynamics of financial theory have now almost arrived at a standstill. Indeed, according to [Modigliani and Miller \(1958\)](#) and [Myers and Majluf \(1984\)](#), no solution has been given to the problem of optimal financial structure. In the conclusion of the fourth edition of their book, [Brealey and Myers \(1991, p. 922\)](#) point out the problem of the optimal financial structure of capital as being among the 10 unsolved problems in finance. [Rifki and Sadq \(2001\)](#) propose classifying firms in the market according to the critical debt level determined by investors. Companies of higher quality will have a superior debt capacity than the threshold set by investors, while companies of lower quality will have a debt capacity below the threshold set by investors. The financial structure of firms is thus a function of the “rational factors” or “rational objectives” approved by investors.

Many theories (classical financial theory, the theory of property rights, agency theory, the theory of contingency, etc.) have highlighted the determinants of the financial behaviour of companies. For example, changes in the financial structure caused by increasing debt load have the effect of increasing the perceived value of a firm ([Ross, 1977](#)). This means that the more a firm is distinguished by high debt, the higher the value assigned by the market. This is justified, *inter alia*, by the fact that a bank, before granting assistance to a business, carries out an analysis of the activities and cash flow generated by the latter. In connection with this banking expertise, debt indicates the quality of a firm ([Ross, 1977](#)).

Among the determinants of the most recurrent financial structure in the literature, the following can be addressed: size and age, which are, respectively, indicators of the size and maturity of a company, the rate of fixed assets, profitability, the rate or growth opportunities, economic risk, etc. In the African context, also to be taken into account are the moderating effects of the specificities of the business and its environment.

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