

FINANCIAL FLEXIBILITY AS ONE OF THE KEY FACTORS THAT INFLUENCE FIRM INVESTMENT ABILITY

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Abstract

Author sets out financial flexibility as one among the key factors that have a certain impact on firm investment ability. He exposes and studies financial flexibility in the context of his conceptual model where investment ability is the subject of his further research. Thus in this paper he focuses exclusively on financial flexibility. Although there are a lot of different definitions and meanings behind this term, the author resumes its definition as a firm ability to exploit the opportunities without jeopardizing its rating. By rating is meant an assessment of all kinds of risk to which a firm (commodity producer) is exposed. It can be internal and external. The first one should be understood as ability to adapt, and the second one as ability of a firm to reduce the vulnerability while influencing the environment. If a stability is taken into account, it can be found out that the notion of stability, i.e. risk management, is embedded in flexibility. Financial flexibility is a firm's capacity to mobilize its financial resources in response to uncertain future contingencies. On account of this leverage and cash holdings are exposed to define financial flexibility. In line with this view financial flexibility can be a result of the firm's strategic decisions regarding its capital structure, liquidity and investment. Further in this paper various aspects of financial flexibility are considered. The author pays attention to some of them, like risk, resources of financial flexibility, financial structure, financial flexibility through different configuration, growth, and market conditions. Measuring and assessment of the financial flexibility is another issue the author takes into consideration. A logic basic starting point for measuring the financial flexibility is a capital structure of a firm. In the last section the author connects financial flexibility as an ability of a firm to generate a sufficient cash flow for funding the exploitation of the business opportunities without jeopardizing its financial stability to investment ability, to his conceptual model, which can be demonstrated as an ability to fund the growth, i.e. ability to provide additional net working capital, and to fund new fixed assets, what can be also understood and defined as investment ability.

Keywords: financial flexibility, investment ability, financial leverage, capital structure

1 INTRODUCTION

The problem I have been dealing with (studying) derives from the real economic sector, from the firms as the investors. Quite a few of them invested in the last decade a lot of capex (capital expenditures) in new projects, like equipment, technology, research and development, in other words in their growth. But also quite a few of them did not succeed. On the contrary, they failed. I am wondering about the reasons of their failures. I simply state, they do not have an appropriate investment ability. My research tackles with this particular issue. The following questions draw my attention to investigate: What is the investment ability of a firm, what parameters or variables do define it, how does investment ability influence the firm's performance, etc.

So far I have set up a conceptual model, and in this paper I am presenting one of the three constructs (factors) that influence firm investment ability, i.e. financial flexibility.

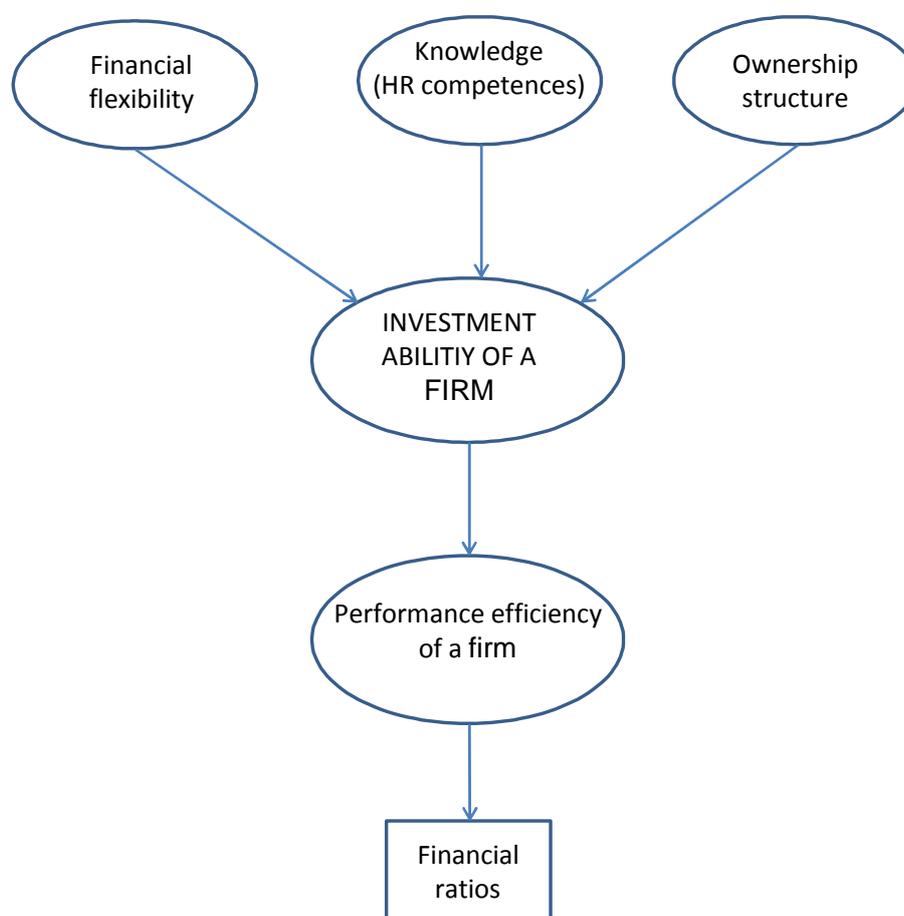
At the very beginning I am explaining shortly the conceptual model of the firm investment ability, so a reader can follow my further work dealing with defining the construct »financial flexibility«, and see how it is linked into the model. I also say couple of words about methodology I am going to apply.

The main part of this paper is dedicated to »financial flexibility«, to one of the most important constructs in my model. I intend to show how it is understood and explained by various authors who have dealt with it through many years.

2 CONCEPTUAL MODEL AND A SHORT DESCRIPTION OF THE METHODOLOGY TO BE USED

The main thesis of my dissertation is the following: financial flexibility, knowledge (HR competences) and ownership structure define the investment ability of a firm, what makes business performance efficient and successful. The figure 1 below illustrates a conceptual model of the investment ability of a firm and its impact on firm performance.

Figure 1: A conceptual model of the firm's investment ability



I am focusing on the selection of those factors (constructs) by which the firm investment ability can be defined. The firm investment ability is an important interface between the firm's resources considered through prism of financial flexibility, knowledge and ownership structure and the firm performance efficiency. The latter will be measured by some properly selected financial ratios, like ROE, EBITDA, ... The goal of my scientific research is to look at how the firms integrate their capabilities (resources), I have chosen in my model, and how they link them to the performance measurement to achieve efficient investment and firm performance. Further, the goal of my research is also to define investment ability of a firm. The research will explore the »possibility« of developing or adapting a performance measurement framework that can be applied in the context of the firm's investment ability.

To make an assessment of the theoretical model, a structural equation model (SEM) will be used. Connections between the sources for defining and assessment of the firm investment ability, i.e. financial flexibility, knowledge (human resources competences) and ownership structure, and the firm investment ability present the resources model structure and the firm investment ability together with its impact on business performance.

3 FINANCIAL FLEXIBILITY - DEFINITION AND ITS MEANING TO INVESTMENT ABILITY

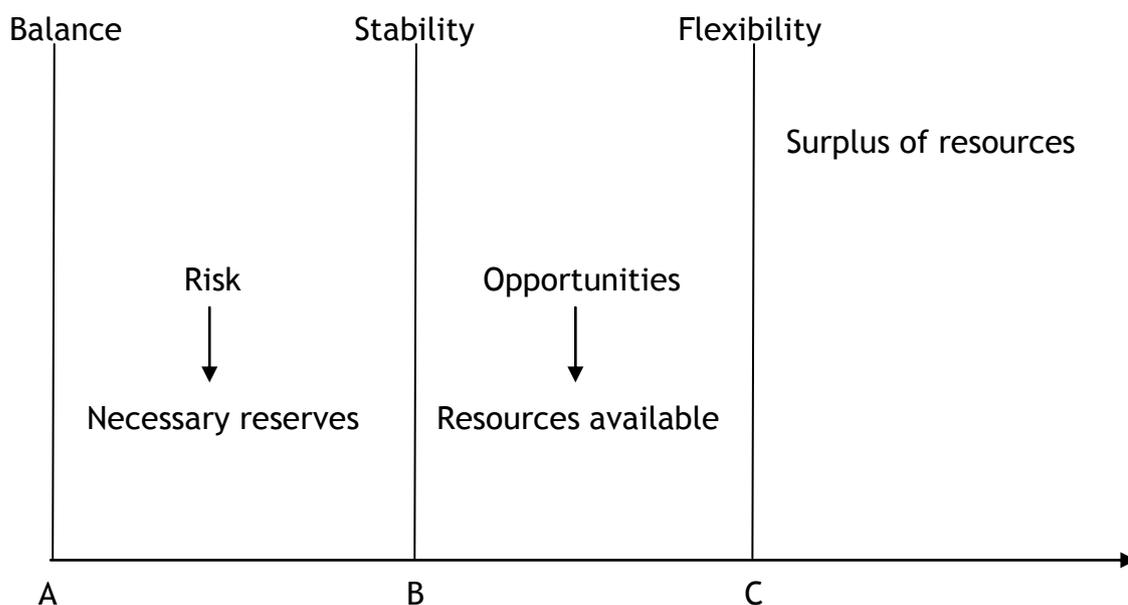
Let me proceed with presenting the first construct in my model, i.e. financial flexibility of a firm. At the beginning I try to clarify some terms about flexibility which they appear in the literature. Further, based on literature review I define financial flexibility of a firm, looking for various variables / indicators which are accounting for this term. I explicate various aspects of the financial flexibility. In my paper I also expose a problem related to measuring and assessing financial flexibility of a firm. Finally, I link financial flexibility as the construct in my conceptual model to the firm investment ability.

3.1 Definition of the financial flexibility and its clarification

In dictionary (Chambers, 1988) flexibility is explained by movability (mobility). English professional literature understands flexibility of a business system in a broader sense: strategic flexibility, organizational flexibility, operating flexibility (Harrigan, 1985, Pasmore, 1994; Trigeorgis, 1993), production flexibility (Reinartz, Schmid, 2014). Some authors study also managerial flexibility (Farlex, 2012). Volberda (1998) distinguishes between internal and external flexibility. The first one should be understood as ability to adapt, and the second one as ability of a system to reduce the vulnerability while influencing the environment. If we take into consideration stability, we find out with Volberda that the notion of stability, i.e. risk management, is embedded in flexibility.

On this basis we can find out, the stability (risk management) is *conditio sine qua non* for a business system to build up its flexibility, i.e. exploiting the opportunities in the environment. According to Bergant (2015) we can define flexibility of a business system as its ability to exploit the opportunities without jeopardizing its rating. By rating we mean an assessment of all kinds of risk to which a business system is exposed. In other words, exploiting the opportunities may not endanger stability of a business system. This can be illustrated by figure 2 below:

Figure 2: Relationship between balance, stability and flexibility (Bergant, 2015)



A business system at point A is in balance, but it does not have any reserves to manage the risk. Such a situation can last longer, but this means unstable balance, for any moment any risk can occur.

At point B a business system is stable, for it has necessary reserves to manage risk, but it does not have additional resources to exploit business opportunities.

At point C a business system is flexible, for it has appropriate resources and capabilities to exploit business opportunities. Using the resources for exploiting the business opportunities does not diminish the reserves for managing the risk, and consequently it does not aggravate the stability of a business system.

Right from the point C a business system has too many resources, what increases operating costs, and thus reduces its efficiency and profitability.

From the figure 2 it ensues that the need for the surplus of resources depends exclusively on the assessment of the opportunities. If the latter are missing, the surplus capacities must be reduced, otherwise the costs related to them are unreasonable.

We can look at the financial flexibility from some other perspective, for instance in the context of the customer behaviors. The focus on behavior is at the core of the financial capability concept. If financial literacy is what we know, financial capability is what we do. We can set a definition of financial capability. It is a set of customer behaviors that lead to tangible improvements in the financial health of a firm (Center for Financial Services Innovation, 2013).

FASB-Financial Accounting Standards Board (1984) defines financial flexibility as ability of a business system how to manage cash flow at the unexpected needs and

opportunities (Acton, 2009). In this definition two aspects are joined: aspect of a risk (unexpected needs for cash flow), i.e. financial stability, and aspect of exploiting the opportunities, i.e. financial flexibility.

This definition has been supported by the majority of the authors (Kornhof, 1988; Kuti, 2011; Aghei, Shah, 2014). They all agree that financial flexibility is an important starting point for the policy of capital structure of the companies (Graham, Harvey, 2001; Osobov, 2010).

Similar understanding of financial flexibility can be found by some internet professional editions, like in Encyclopedia of Business, 2015, which states that financial flexibility is ability of a company to adapt to the problems and opportunities.

Such a definition can be followed by rating institutions, like Moody's (Credit opinion, 2009), and Standard & Poor's (RatingsDirect, 2014), whose assessment of financial flexibility is founded by two ratios (financial leverage and interest coverage), what implies strong simplification and low indicative value of such a rating.

Some authors understand financial flexibility in narrower sense. Brigham says a firm is financially flexible, if it is indebted less than in »normal« circumstances. For this reason it can borrow money if it is necessary (Brigham et al., 1999). Agha (2014), Denis and Mc Keon (2011) consider financial flexibility as a reserve capacity for hiring credits and loans.

Very close to the concept illustrated by figure 2 are Summer et al. (1988). They understand financial flexibility as an assessment of the needs of a firm for funding, business plans, and alternatives and achievement of the goals without aggravation of the creditworthiness.

Referring to figure 2 Bergant (2015) defines financial flexibility as an ability (capacity and speed) of a business system to finance the exploitation of the business opportunities without jeopardizing its financial stability. By this is meant only exploitation of the economic and financial reasonable opportunities.

Consequently point B in the figure 2 is moved a little bit to the right, what simultaneously decreases free funds.

The majority of senior corporate managers around the world consider financial flexibility as one of the most important determinants of their capital structure decisions (Graham and Harvey, 2001; Bancel and Mittoo, 2004: and Brounen, De Jong and Koedijk, 2006). According to DeAngelo and DeAngelo (2007), Gamba and Triantis (2008) and Byoun (2008a) the motives to attain financial flexibility are related to the future ability and need of firms to raise external funds and restructure their financing at low cost. It is argued that firms with financial flexibility enjoy easier access to external capital markets to meet funding needs arising from unanticipated earnings shortfalls - and/or growth opportunities - and

hence, avoid situations that lead to suboptimal investment and poor performance (Arslan, Florackis and Ozkan (2014).

Economic and financial crises clearly represent exogenous shocks to firms' viability, profitability and cash flows, and generally reduce the expected return on investment opportunities (Arslan, Florackis and Ozkan, 2014). Due to lower asset prices, crises create opportunities for firms with the ability to invest (Mitton, 2002). To the extent that flexible firms are better equipped to cope with the adverse consequences of exogenous shocks, a crisis period would allow us to provide stronger tests on the impact of financial flexibility on corporate performance and investment policy during the crisis (Arslan, Florackis and Ozkan, 2014). The authors investigated the main hypothesis, *ceteris paribus* the greater a firm's financial flexibility at the onset of the crisis, the less severe the decline in its investment expenditures and performance during the crisis. The authors above constructed simple indicators of financial flexibility. Existing studies mainly focus on leverage and cash holdings decisions as ways of preserving flexibility, though these policies are generally considered separately.

Only recently have studies adopted the view that firms can attain financial flexibility through both their debt financing and cash holdings policies. For example, DeAngelo and DeAngelo (2007) explicitly consider leverage and cash holdings to define financial flexibility and argue that low leverage combined with moderate cash holdings and high dividend payouts constitute an optimal policy regarding flexibility. In line with this view, Gamba and Triantis (2008) show that financial flexibility can be a result of the firm's strategic decisions regarding its capital structure, liquidity and investment. Moreover, in the light of increased risk in the economic environment, Bates, Kahle and Stulz (2008) argue that high cash holdings are related to low levels of debt and hence the simultaneous practice of these policies enable firms to forestall distress and default. Finally, Byoun (2008a) reports that small developing firms are more likely to seek financial flexibility and do so through lower leverage and larger cash holding policies.

To address the relationship between financial flexibility and investment the authors above estimate cash flow sensitivities using the investment equation framework commonly used in the literature (Fazzari, Hubbard and Petersen, 1988; Hubbard, Kashyap and Whited, 1995; Cleary, 2006; and Carpenter and Guariglia, 2008). The authors have examined whether the performance of firms with greater flexibility differs from that of less flexible firms.

Financial flexibility can play a potential role for corporate valuation during the crisis. Drawing on recent findings showing strong inter-relations across several indicators of financial constraints and financial health (Cleary, 2006; Carpenter and Guariglia, 2008) the study of the authors also examines how traditional measures of financial constraints, such as dividend, firm size, firm age and business group affiliation, interact with the flexibility indicators. The authors evaluated the relative importance of traditional measures of financing constraints and simple leverage-based and cash-based flexibility indicators in explaining corporate investment and performance.

The empirical analysis of the authors Arslan, Florackis and Ozkan (2014) provide several important findings, like the following: financial flexibility not only leads to higher investment expenditures and lower investment cash flow sensitivity but also to better performance during the crisis. Additional findings of the authors Arslan, Florackis and Ozkan can be cited (2014). The leverage is the most important component of flexibility. Specifically, while a low leverage policy at the onset of the crisis appears to be particularly useful in financing investment expenditures during the crisis, it seems that most of the firms in their sample do not spend cash reserves to fund future growth but, rather, use it as a form of insurance against financial distress. Further, financially flexible firms invest more than less flexible firms during the crisis. The sensitivity of the investment expenditures of flexible firms to the availability of internal funds is lower than that of the less flexible firms. Their analysis also suggests that traditional measures of financial constraints (business group affiliation, size, age, and dividend payouts) are less useful predictors of corporate investment behaviour than the simple flexibility proxies utilized in their study. They also present strong evidence that less flexible firms are more vulnerable to sudden drops in their cash flows.

While the leverage policy and to a lesser extent the cash holding policy of firms are decisive determinants of financial flexibility, business group affiliations of firms play a modest role in maintaining corporate investment at a satisfactory level during the crisis period. These findings reduce the ambiguity in the use of the term financial flexibility in the literature, as mentioned in a survey by Byoun (2008b). In particular, if financial flexibility is defined as the ability of a firm to access and restructure its financing to cope with uncertain future contingencies, the group of firms with the highest ability to do so is that of relatively low leverage and high cash. Their analysis builds on existing studies that analyze the factors that affect corporate performance. It presents overwhelming evidence that in addition to several corporate governance characteristics, financial flexibility constitutes an important driver of performance during economic downturns.

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). When expectations are not met or when events occur that have not been anticipated, a firm may require financial flexibility ex post. Financially flexible positions are desirable not because they provide safe stores of value, but because they preserve valuable options to deal with future contingencies. Indeed, corporate managers contend that they are most concerned about financial flexibility in their capital structure decisions (Byoun, 2011). Also, managers not only react to financing frictions when they occur, but they also adjust their firms' financial policies in order to minimize the future impact of these frictions (Almeida, Campello, and Weisbach, 2006).

Byoun (2011) proposes and tests the financial flexibility hypothesis that there is an inverted-U relation between leverage and financial flexibility demand: developing firms maintain low leverage as they are building up financial flexibility, growth firms increase leverage as they utilize reserved financial flexibility, and mature firms that are in the phase of recharging financial flexibility reduce leverage. Small

developing firms are in the most need of financial flexibility and hence issue more equity and maintain lower leverage; growth firms issue debt and hence have high leverage; and large mature firms rely on internal equity and maintain moderate leverage.

3.2 View of the financial flexibility from various angles

There are various aspects of financial flexibility to be considered, like value of a firm, dividend policy, risk, resources of financial flexibility, financial structure, financial flexibility through different configuration, leadership style, growth, size of a firm and market conditions. Let us look at some of them.

Risk management is considered as a key component of the financial flexibility (Bonaimé et al., 2013). Risk consists of two parts: risk to be managed in order to assure the financial stability at the existing operation, and risk to be additionally taken by a firm at the exploitation of the business opportunities.

Resources of the financial flexibility are that part of the reserves for managing the risk, that are bigger than need for financial stability (Bergant, 2015). As a special kind of non balance flexibility can be accounted for quotation on the stock exchange. It is empirically tested and proven, that a stock company being listed can easily acquire funds (Schouben, Van Hulle, 2011). Some authors define ability of a firm to borrow additional money as the most important resource of the financial flexibility (Naveen et al., 2013). Their researches are mainly focused on how to assure a financial stability in the crisis.

Closely related to the resources of financial flexibility is a structure of a firm's funding. Studies show that firms have lower rate of indebtedness, as we would have expected according to the trade off model (Sayyad, Ulvenäs, 2012). In practice a need for financial flexibility is underlined, but it depends directly on the structure of a company's funding. The researches have shown some deficiency of the theory about a structure of a firm's funding, for they do not pay attention to the need for financial flexibility (De Angelo, De Angelo, 2007). This means when we talk about financial flexibility, not only tax shield and cost of financial distress but also an appropriate cash reserve to be able to exploit business opportunities have to be considered

Financial structure and financial resources influence also the configuration of assets in the balance sheet. They can be either shown in balance sheet or they can be off-balance sheet items. Among the first ones we have cash and cash equivalents (short term securities), short term loans and deposits and long term securities which can be fastly transformed into cash.

Among the off-balance items as the configuration of financial flexibility there are renewals of the short term credits and loans, consented but not used credits, commercial papers and other short term financial instruments, long term financial and hybrid instruments, hidden reserves (hidden profits and possibility of sale of assets, a firm does not use).

Exploiting the business opportunities is closely related to the growth and development of a firm. The last one has a cyclical trend, what also implies cyclicity of the financial flexibility and a need for its maintaining.

When a firm grows, its financial flexibility diminishes due to the investment into development, and on the contrary, when a firm's growth is slow, its reserves increase. For this reason it is crucial to maintain an appropriate financial flexibility during the period of growth. Similarly, it is important to maintain financial flexibility of a firm also in the period of stagnation or crisis, for there are the opportunities for new growth to be exploited as well. Thus financial flexibility should be considered from dynamic and not static point of view (Bergant, 2015).

Sayyad and Ulvenäs (2012) expose a special meaning of the financial flexibility in the crisis. In this context market conditions influence the access to the new financial resources. This access changes and goes along with the market expectations, and it has a strong impact on a firm as far as maintaining an appropriate financial flexibility. When there are restrictions in the market a firm having higher financial flexibility will much easier exploit the opportunities, but the funding costs will be higher as well, or as Power and Tsyplakov (2008) point out, this will imply a higher required return of the additionally issued bonds or loss of tax shield at lower financial leverage.

Why is it so important to study financial flexibility from the various points of view? Bergant (2015) quotes the following statements: it is a starting point for structural understanding and managing risk, it gives a definition of different kinds and structures of measures, which have to be taken, it discloses a need for different information regarding various aspects of the financial flexibility.

3.3 Measuring and assessing financial flexibility

The next question is how to measure financial flexibility. Several aspects of the financial flexibility just explained above demonstrate its complexity and its relevance as well, for it is related with the basic areas of decision making in each firm (its growth and sustainable development). According to Bergant (2015) this implies a strong need for gathering the relevant information about financial flexibility.

However, in compliance with the figure 2 measuring the financial flexibility cannot be found in professional literature. On the other hand, there are many trials to measure or better saying to assess financial flexibility, for as already written above the authors as a rule do not distinguish financial flexibility from financial stability. Let us shortly sum up the basic findings of their research works.

A logic basic starting point for measuring the financial flexibility is a capital structure of a firm. Bergant (2015) advocates such a thesis because of the strong connection between financial flexibility and the structure of financial resources (financial structure).

According to Rapp et al. (2012) financial flexibility cannot be directly observed. In theory and practice there are several approaches. Following their contents we can make three groups of models: measuring the financial flexibility with individual indicators (1), measuring the financial flexibility with only one indicator, derived from various groups of indicators (2), and measuring the financial flexibility with a regression model (3).

Financial capability can be measured in several ways, like how a firm can cover its expenses, how a firm can track its spending, how a firm plans ahead and saves for the future, how a firm effectively selects and manages financial products and services and how a firm can gain and exercise financial knowledge. Financially capable firms are adopting these behavioristical patterns as part of their regular business in ways that yield positive financial outcomes, such as improved credit rating scores or greater savings (Center for Financial Services Innovation, 2013). Some firms (Money-zine.com, 2015) measure financial flexibility simply with financial leverage (all debts to all equity and liabilities). They recommend to benchmark this indicator with the competitors and industry.

A step further is an assessment of the financial flexibility as an ability to borrow, i.e. a debt buffer or a debt capacity. Hess and Immenkötter (2012) say, it is a difference between a target leverage (an estimated debt capacity) and a real leverage.

Cleverley (1985) combines seven (Saidin.com, 2015) or even ten indicators into financial flexibility index, which is important for forecasting of the financial distress of a firm.

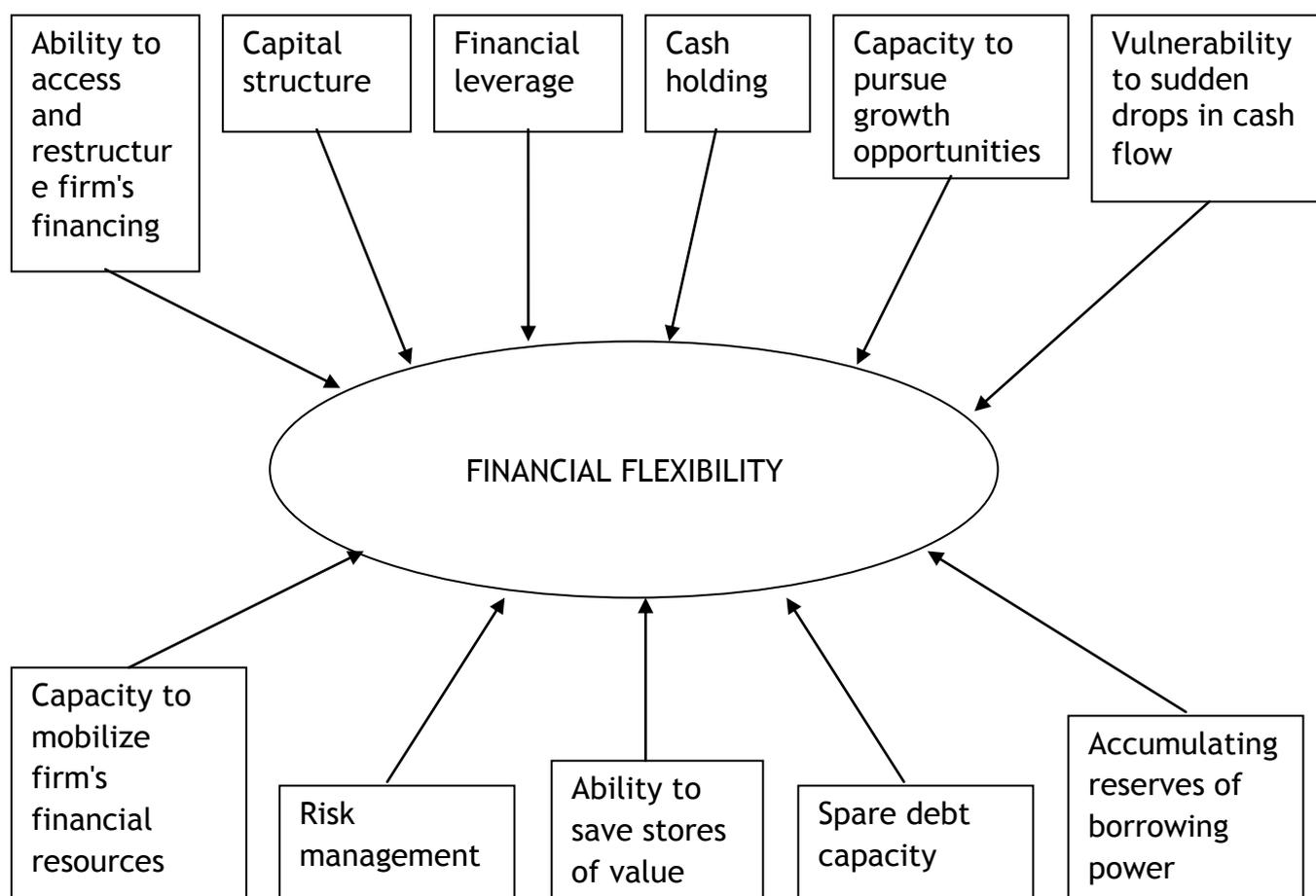
Rapp et al. (2012) have defined an indicator »value of financial flexibility«. It combines an estimation of firm's opportunities for growth, its profitability, costs of free funds, costs of external funding and ability of a firm to transform its long term investments. Rapp takes into account the factors already defined by Gamba and Triantis (2007). These factors have been assessed empirically by a statistical significance of a joint indicator. Similar approach has been used by Aghaei and Shah (2014), who have set up a model for assessment of the financial flexibility.

The approaches explained in the first group are too shallow for being a basis to gather the relevant information on financial flexibility. Bergant (2015) considers them as insufficient for reasonable decision making about financial structure of a firm.

Common positive features of the other two groups of models are the following: linkage between financial flexibility and basic strategic goals of a firm is statistically confirmed, they explain the past performance of a firm, especially related to the financial leverage, the relevance of the individual factors enables a structural reasoning (consideration) how to define appropriate measures in different areas of a firm, and they provoke new research.

After having reviewed the literature on financial flexibility I can now extract from it all the potential variables or indicators which define, each on its own way, financial flexibility. Some of them also influence directly investment ability of a firm. In my conceptual model I will consider them, some as exogenous and some as endogenous variables influencing financial flexibility. These relationships are presented in figure 3 below.

Figure 3: Variables (indicators) which define and influence financial flexibility of a firm



3.4 Financial flexibility as an explaining factor of the investment ability

Financial flexibility has been defined as an ability of a firm to generate a sufficient cash flow for funding the exploitation of the business opportunities without jeopardizing its financial stability. According to Bergant (2012; 2014; 2015) in principal this ability can be demonstrated as an ability to fund the growth (revenue sales), i.e. ability to provide additional net working capital, and to fund new fixed assets, what can be also defined as investment ability in a narrow sense.

Investment ability defined above manifests in an ability to fund new long term financial investments (issue of shares and bonds), and to fund new fixed assets

(including intangible assets), i.e. capacity investments. Investment ability from the financial point of view is a narrower term than financial flexibility. Now after having defined financial flexibility, we can define investment ability of a firm as its ability to fund long term investments without aggravating its financial stability. This definition is also supported by empirical findings. A firm is too much indebted, when the financial flexibility for its future investments is decreased by risk (Hess, Immenkötter, 2012).

Investment ability of a firm is conditioned by its financial flexibility. Increase of the financial flexibility also directly increases the investment ability. This link has also been empirically proven (Marchica and Mura, 2010), especially in the crisis (Sayyad, Ulvenäs, 2012).

Marchica and Mura (2010) have studied the interaction between financial flexibility and investment ability. Their argument, based on the ideas of Modigliani and Miller (1963) and Myers (1984), maintains that in the presence of financial constraints, firms that anticipate valuable growth options in the future respond by accumulating reserves of borrowing power.

Through a conservative leverage policy, firms maintain a degree of financial flexibility that allows them to have better access to the external market when faced with positive shocks to their investment opportunity set (Marchica and Mura, 2010). Recent survey studies regarding the determinants of capital structure give strong support to this view in that financial flexibility is systematically reported as the most important factor on which CFOs base their leverage decisions.

After a period of leverage conservatism, financially flexible firms significantly increase their capital expenditures with respect to previous years. Most notably, the authors identify a sharp increase in their abnormal investments. Their results indicate that firms finance this investment with positive net debt issues.

The authors report strong evidence of significant links between financing and investment decisions. Their findings indicate that after a period of spare debt capacity, financially flexible firms are able to invest significantly more. They demonstrate that the impact of the flexibility factor is sizable in economic terms. An average firm is able to increase its investment by approximately 37 % (Marchica and Mura, 2010). This is an important result, and it provides a rationale for many firms' apparent conservative leverage behavior (Graham, 2000; Minton and Wruck, 2001; Almeida, Campello, and Weisbach, 2009).

Marchica and Mura (2010) consistently find that firms classified as financially flexible tend to outperform the market and experience an increase in operating performance in subsequent years.

Denis and McKeon (2011) report similar results to the results of Marchica and Mura. They report evidence that firms use spare debt capacity to meet large positive shocks to their investment opportunity sets. Their set of US firms (slowly) rebalance their leverage toward the long-term target.

The results of Marchica and Mura offer strong empirical support for the survey evidence and indicate that financial flexibility, in the form of untapped reserves of borrowing power, is a crucial missing link in capital structure theory. In particular, their evidence is broadly consistent with DeAngelo, DeAngelo, and Whited (2011). In their model, firms use spare debt capacity to respond to »funding needs associated with imperfectly anticipated investment shocks, while allowing them to economize on the costs of issuing equity and of maintaining cash balances«. This is consistent with a »modified« trade-off model in which the optimal debt level for a firm incorporates the ex ante opportunity cost of borrowing (i.e. future underinvestment). The firm's ex ante optimum debt level reflects the value of the option of using debt capacity to borrow ex post and to move away, deliberately but temporarily, from target leverage to meet imperfectly anticipated funding needs (Marchica and Mura, 2010).

In investment decision making (capital budgeting) the firm financial flexibility is crucial. As already mentioned there are many variables to be considered, like investment liquidity, financial sources (equity or debt financing), etc. Investment decisions of all firms are found to be very sensitive to firm liquidity, which supports the existence of a financing hierarchy. In particular, firms that are more creditworthy, exhibit greater investment liquidity sensitivity than those which are classified as less creditworthy (Sean, 1998). Further, it is found that debt instruments which are more risky, such as convertible debt, are more strongly related to declines in operating performance than other debt instruments, such as long term debt (Cassar, 2005). These findings support arguments that both the magnitude and type of financing influence operating performance. The same author has found, that the persistence of both cash flows and abnormal accruals is significantly lower when firms are involved in net financing activities. His findings are in contrast to Richardson and Sloan (2003), who investigated external financing and stock returns. They have found, that equity and debt financing are both similarly negatively related to future returns. The empirical findings demonstrate strong linkages between the operating performance of a firm and the use of external financing. This issue will be studied more in detail through the impact of the investment ability to firm's performance (see the conceptual model).

4 CONCLUSION

After having reviewed the literature on financial flexibility it can be stated that there is some confusion about this term. The majority of academicians agree upon definition that financial flexibility means ability to exploit the business opportunities of a firm without jeopardizing its rating. By this is meant financial stability which is *conditio sine qua non* for a firm to build up its financial flexibility. It is ability of a firm to adapt (internally), and ability of a firm to reduce the vulnerability while influencing the environment. Some researchers offer strong empirical support for the survey evidence and indicate that financial flexibility is a crucial missing link in capital structure theory. As it is explained more in detail in this paper, firms use spare debt capacity to respond to funding needs associated with imperfectly anticipated investment shocks. This allows them to economize on the costs of issuing equity and of maintaining cash balances.

However, the majority of senior corporate managers around the world consider financial flexibility as one of the most important determinants of their capital structure decisions. The motives to attain financial flexibility are related to the future ability and need of firms to raise external funds and restructure their financing at low cost. The meaning of the financial flexibility is especially exposed in the crisis. In this context market conditions influence the access to the new financial resources. This access changes and goes along with the market expectations, and it has a strong impact on a firm as far as maintaining an appropriate financial flexibility.

We have also emphasized the meaning of various aspects of financial flexibility, among them risk, resources of financial flexibility, financial structure as crucial for studying financial flexibility.

As far as measuring the financial flexibility is concerned, there were some trials to define some appropriate indicators, like combining them into financial flexibility index, based on empirical data and confirming statistical significance of a joint indicator. Even a model has been set up for assessment of the financial flexibility.

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