Considerations on the financial structure of the company

Nitu, Cornelia

8 June 2012

CONSIDERATIONS ON THE FINANCIAL STRUCTURE OF THE COMPANY

Cornelia Nitu

Abstract

The basic objective of the financial function of the company is the continuous increase of the company's value, so that there can be achieved a maximization of its value in comparison with the assets structure they form.

The financial structure of the company is one of the most important problems of the financial management. It represents the support of the company's development strategy. Many specialists in financial management have tried to define the concept differently, but the essence is the same; the financial structure represents the proportions in which a company resorts to the activity financing through equity capitals or loaned capitals.

Key words: financial structure, financial policy, capital, financing, company

Classification JEL: G32, M21

Introduction

The term of structure is borrowed from the Latin „struere" and mean building, the manner in which a building is built or a thing is organized and arranged. Generally, the notion of structure represents the reports that join the components of a whole.

In social sciences, the structure is a setting of the parts of an abstract phenomena whole.

In political economy, the structure of an economic entity represents an assembly of proportions and relations characterizing the entity in particular conditions at a certain moment.

Within a company, the structure can be defined as an assembly of mechanisms through which a company or more generally, an organization, distributes, organizes and control the activities and tries to orient the behavior of its members.

Theoretical approaches on the structure of capital

The company, regardless its form of using its capital, of the type of capital, deploys the activity in accordance with an assembly of rules that shall be complied with, in some monetary and financial flows.

From a financial point of view, the structure represent the in which a company resorts to the activity financing through equity capitals or loaned capitals. At the level of a company, ***the financial structure*** reflects the composition of capitals, and this is why it is better known as the *structure of capitals.*

According to some authors (Toma &Alexandru, 2003) the financial structure of a trading company represents the existing report between the short-term and long-term financings, while others (Stancu, 2002) consider that it can be defined as the sum of participating percentages of different financing resources to the establishment of the capitals invested in the concerned company. In fact, this can be identified to that part of the balance sheet that highlights the resources of a trading company, represented by the structure of the balance sheet liabilities.

In the context of the economic mechanism, the structure presents the following characteristics: *total of funds*, represent the assembly of funds of the company, *the changes* registered by the financing costs, *the risk* bared by of the company and *the self-adjustment,* namely the possibility of changing the structure of funds.

The financial structure is a variable which does not depend only on the company, its objectives, economic development or on the estimated risks. The financial structure is often influenced and determined by stakeholders (shareholders, banks, state, etc.), as well as by the financial and economic circumstances: situation of the financial markets, variation of the interest rate, monetary depreciation, financial crisis, etc.

In the analysis of the structure of capital other factors must be taken into consideration, such as (Hoanță, 2003):

- *Costs of bankruptcy,* which include legal costs, other direct and indirect costs caused by the bankruptcy or by the company reorganization that form the bankruptcy financial costs. These cost affects not only the costs of debts, but also the costs of equity capitals.
- *Costs corresponding to agreements or conventions* established through a contract which protects the rights of shareholders, owners of bonds and managers, and this costs are increased when the interests of these parts are in conflict.
- *Asymmetric information.* The choice of as structure of capital by the managers (insiders) can transmit the information related by the company to investors and can lead to a change of the company's value.

Choice of the financial structure – a financial policy decision

The choice of a particular financial structure represents an important financial policy decision. Although the criterion of profitability is very important, the decision related to the financial structure inevitably takes into account other elements, such as the total amount of the financing needs, as well as the type of different necessities (Toma &Alexandru, 2003).

One of the accounting objectives with direct implications on the efficiency and control of the company is the establishment of an optimal financing structure, of a suitable proportion between equity and loaned capitals. (Giurcă Vasilescu, 2009).

The decision concerning the financing structure must be an optimal decision, in that of the establishment of a report between financing through credits and financing through equity capital which would lead to minimal costs (Hada, 1999). This depends on a multitude of factors, as for example: the objectives of increasing the company, the level of the expected profitability, the level of fiscal system, the general economic circumstances etc.

Furthermore, it should be taken into account the fact that both equity capital and loaned capital suppose costs. The fundamental difference between the cost of the equity capital and of the loaned capital consists in the fact that the personal funds are remunerated only if the company registers benefits, while the loaned capital must be remunerated regardless the company's profitability. (Toma &Alexandru, 2003).

The basic objective of the company's financial function, the basic preoccupation of mangers must be the continuous increase of the company's value, so that ma maximization of its value is achieved in comparison with the assets structure they compose.
The financial structure of the company is one of the important problems of the financial management. It represents the support of the development strategy of the company. The obtainment of the company's capital supposes costs: dividend, taxes and/or duties and interests. The collected capital must be engaged in a production and exchange process that generate a surplus (profit) from which different taxes, duties are subtracted in accordance with the legal provisions.
The main objective of the modern company is *the maximization of its value*.
The delimitation of the relation between the financial structure and the company's objective is based on the premise that a structure can favors or encumber the fulfillment of the company's objectives. In this context, the establishment of the optimal financial structure is compulsory, which minimizes the cost of capital procurement and the market value of the company (Tudose, 2007).
In conclusion, the modern financial theory is a theory of the financial structure. The maximization theory of the company's profit was the subject of this capital use. In time, through assimilation, the "maximization of profit" has become synonym with the "maximization of capital"; in other words the "maximization of the shareholders' wealth".
On the base of this postulation, the theory "invite" the company to establish the its financial structure which provide the lowest rate of updating the capital cost in conditions of risk and uncertainty, aiming to obtain the maximal value of the company.
The analysis of the liabilities structure shows that most of the companies have different financing sources: common shares, preferential shares, loans (long-term debts), medium-term and short-term debts, bonds etc. In addition, there are very few companies wholly funded with equity capital. No company can deploy the activity basing 100% indebtedness.
There is a problem which consists in knowing if the use of a particular financing method has effects on the capital cost of the company.
While the aforementioned works, related to the financial analysis, gave most importance to the study of the financial markets, F. Modigliani and M. Miller bring a contribution regarding the company's financing through the study of the relation between the market value of the company and its composition of the financing structure.
Supposing that they are on a perfect financial market and referring to a model of balance partially based on the notion of classes of risk, Modigliani and Miller have demonstrated that the financing structure, that is the report equity capital-financial debts, evaluated at the market value, has no influence on the value of a company and, consequently on the capital costs.

Besides the results, the fundamental contribution of their demonstration is that they do not rely too much on the proposed approach, which comprises three essential aspects:

- it changes the evaluation problems of the company and the investments choice problems on the financial market;
- it clearly highlights the connection between the value of the company and the composition of the assets structure;
- finally, the arbitration process used by the investors, which supposes the law of the flat price for the same assets and constitutes the base of many financial and economic theories, has become an essential component of financial thinking.

In the specialized writings, the notion of structure has the following forms: financing structure, capital structure and financial structure. If in the terms of the financial analysis, we can talk about a financing structure, in the terms of the long-term financing decision we can approach only the idea of a strategic structure of financings. In consequence, the financing structure comprises all the elements regardless their type and term for which they have been withdrawn, and the financing structure comprises the long-term and medium-term financing sources. Thus, the financial structure is a part of the financing structure. At the level of the company, the financial structure reflects the composition of capitals and, because of these grounds, is also known in the specialized writings as *structure of capital.*

The sum of the financial debts that must to be taken into consideration in the study of the financial structure cannot be easily defined. In the balance sheet something without a great importance is entered. It is recommended to be used the annual average, even if it cannot rigorously expressed the conditions to use the short-term indebtedness. Consequently, when establishing the financial structure of the company, the specialists in management and financial analyses have different opinions. Thus, regarding the loaned capitals, some author include only the long-term and medium-term debts, others take into consideration the total financial debts regardless the due date. On the contrary, others integrate the commercial and treasury credits.

The study of the financial structure of a company refers to the analyze, at a certain moment, of the composition of its patrimony, taking into account the fact that this patrimony ca be changed in very short period of time by its activities.

This supposes to confront the degree of used capitals liability with the degree of “available assets” liquidity, the degree of liquidity being the measure in which an asset can be quickly transformed into available funds through the company’s functioning.

The financial structure corresponds to the division of financial resources of the company between equity capitals and indebtedness. It is often mistaken for the report indebtedness/equity capitals called “financial leverage”.

Other authors claim that the financial structure of the company represents the sum of the equity capital and financial debts. The financial structure of the company means the composition of the procured capital, both on sources and on intervals of use. Furthermore, in the specialized writings it is claimed that the financial structure can be characterized through rates in what the liabilities composition is concerned.

Although many specialists in this financial management have tried to define the concept differently, the essence is the same. Thus, the financial structure is expressed as the report of equity capitals/total financial debts. The financial structure of the company may also be its financing method.

Conclusion

Identifying the financing sources of the activity, as well as their combination in order to obtain the best profitability-risks report is a permanent provocation for the managers of a company. The different proportions in which a company uses financing through equity capitals or through loaned capitals define the *financial structure* of the company.

The preoccupation of optimizing the financial structure of the company is one of the basic objectives of the financial management. The analysis of the assets and liabilities conditions the normal functioning and development of the company.

The importance of the financial comes from the role of the indebtedness on the financial profitability that is of the equity capital profitability, as well as on the financial risk.

A good accounting of the company's capital implies the concrete solving of the two problems: attraction of capitals and allocation of the monetary resources on different destinations.

In order to achieve the objectives, the company needs resources, generically called capital. The development of the financial markets, diversification of financing resources and increasing of competition imposed the financial manager to orient in order to find new possibilities of attracting the capital and to a better use.

References

Depallens, G., Jobard, J.P., (1990), *Gestion financiere de l'entreprise*, Ed. Dalloz Sirey, Paris

Ginglinger, E., (1997), *Gestion financiere de l'entreprise*, Ed. Dalloz Sirey, Paris

Giurcă Vasilescu, L. (2009), *Finanțele firmei. Prelegeri şi studii de caz.* Ed. Universitaria, Craiova

Goagara Daniel, Giurca Vasilescu L. (2011), *The Liquidation – Based on Evaluation and Accounting Information,* Munich Personal RePEc Archive, MPRA Paper no. 29585, 12 March

Hada, T., (1999), *Finanțele agenților economici din România,* Ed. Intelcredo, Deva

Hoanță, N., (2003), *Finanțele firmei,* Ed. Economică, Bucureşti

Modigliani, F., Miller, M, (1958), *The. Cost of Capital, Corporation Finance, and the Theory of Investment,* American Economic Review, June

Sichigea, N., Giurcă Vasilescu, L., (2008), *Gestiunea financiară a întreprinderii*, Ed. Universitaria, Craiova

Stancu,, I., (2002), *Finanțe,* Ed. Economică, Bucureşti

Toma, M., Alexandru, F., (2003), *Finanțe şi gestiune financiară de întreprindere,* Ed. Economică, Bucureşti

Tudose, M. B., (2007), *Gestiunea capitalurilor întreprinderii. Optimizarea structurii financiare,* Ed. Economică. Bucureşti

Vasile, I., (2008), *Gestiunea financiară a întreprinderii,* Ed. Meteor Press, Bucureşti