THE FINANCIAL STRUCTURE AND ITS ROLE IN THE FINANCING OF THE ENTITY

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Abstract. In the paper the authors show the importance of capital structure and the financial structure in the company financing taking into account the owner's capital and the borrowing capital.

Key words: capital structure, debts, leverage

1. Content of the financial structure of the entity

The financial structure of the enterprise is determined by the structure of the entire liability of the balance sheet and we believe it shows the role of capital in financing the company. Comparing to the structure of the capital, the financial structure additionally includes the capital borrowed on short term basis.

We also believe that the financial structure include the capital structure of the company. In this sense, by financial structure we understand the report existing between the short term financing and the long and intermediary term financing of the company.

$$\textit{The financial structure of the company} = \frac{\textit{Short term financing}}{\textit{Long term and Intermediary term financing}} = \frac{\textit{Treasury resources}}{\textit{Permanent capital}}$$

The financing requirements emerge both in the line of operating, respectively production activity, as well as on the line of certain operations non-specific to operating.

The treasury resources are formed by short term banking credits, as well as by commercial credits and cover a part of the circulating assets.

Permanent capital is formed by the own funds of the company and intermediary and long term loans and covers the non current assets, as well as a part of the circulating assets seen as the working fund.

Indicator	**2 002**	**2 003**	**2 004**	**2 005**
Non current assets	130 191 372	146 704 676	180 674 661	179 735 454
Circulating Assets	53 557 906	66 459 041	109 256 641	124 800 912
Advance Payments	13 730	5 647	12 806	1 241 452
Current Assets	53 571 636	66 464 688	109 269 447	126 042 364
Total Assets	183 763 008	213 169 364	289 944 108	305 777 818
Due (intermediary and long) term debts	29 730 177	28 603 328	33 712 286	29 594 985
Owners'Capital	86 545 935	123 204 887	150 607 746	146 207 167
Permanent Capital	116 276 112	151 808 215	184 320 032	175 802 152
ShortTerm BankCcredits	34 595 754	32 228 592	63 909 060	71 822 097

Commercial Credits	32 891 142	29 132 557	41 715 016	58 153 569
Treasury Resources	67 486 896	61 361 149	105 624 076	129 975 666
Total Liabilities	183 763 008	213 169 364	289 944 108	305 777 818
Long Term Financing	63.28	71.21	63.57	57.49
Short Term Financing	36.72	28.79	36.43	42.51

Table 1 - The evolution of resources and allocations at SC ELBA SA

From the table above there results that during the entire analyzed period of time, over 60% of the resources have been allocated for the investment activity and a bare 40% of the resources have been allocated for the operational activity.

The leverage of the company may occur by using banks and other specialized financial institutions or bond financing.

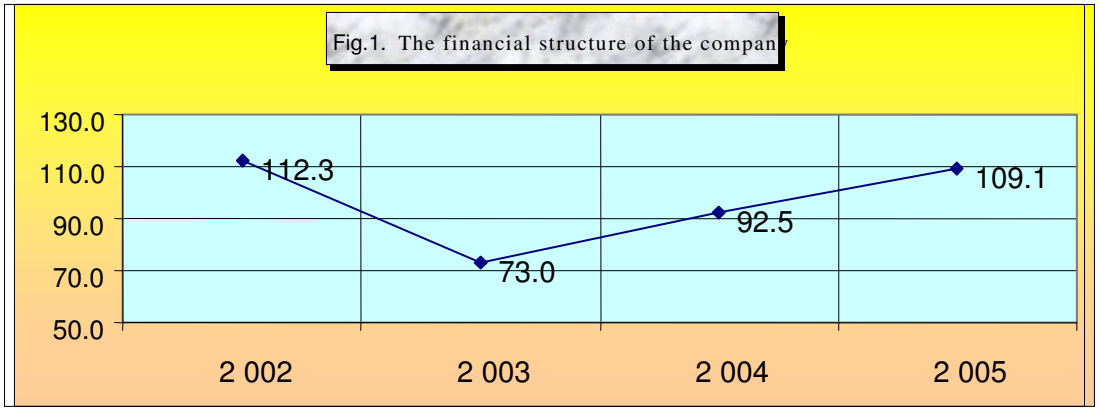
In a simplified way, *the financial structure of the company* can be appreciated according to the report:

$$\frac{\textit{Total debt}}{\textit{Shareholders' equity}}$$

Reflecting the amount of financing based on borrowed resources, as compared to own resources.

Indicator	2 002	2 003	2 004	2 005
Total debt	97 217 073	89 964 477	139 336 362	159 570 651
Shareholders equity	86 545 935	123 204 887	150 607 746	146 207 167
Financial structure of the company	112.3	73.0	92.5	109.1

Table 2 -The Evolution of the Financial Structure at SC ELBA SA



From this graphic representation, we may notice that foreign financing resources are larger then the own resources in 2002 and 2005 with 12.3%, respectively 9.1%. This is important since it influences negatively the financial autonomy and independence of SC ELBA SA.

The choice of a certain financial structure represents an important *financial policy decision*. If the financial covering through short term obligations provides a certain flexibility for the entreprizer, in the sense that he/she may develop or reduce operatively the volum of the activity, the financing through permanent capital is less expensive, therefore more profitable. Even if the profitability criterion is a very important one, the decision regarding the financial structure also takes into account other elements, such as the total volume of the needs to be financed, as well as the nature of the various capital uses.

The financial structure is a variable that does not depend solely on the company, its economic growth objectives, foreseen profitability or the risks it agrees to assume. The financial structure is influenced, and often determined, by shareholders, bank or other financers, by the state, as well as by the economic-

financial context: the situation of the financial market, the oscillations of the interest rate, monetary devaluations etc.

Last but not least, the adoption of a financial structure is also determined by the creditors taking into account the risk to which they are exposed when crediting the respective client. Creditor's risk may be a risk of capital loss when the debtor can no longer reimburse the contracted loan; it can be an interest risk when the debtor can no longer reimburse the due interest, but it can also be an non current risk, which can emerge even when the debtor pays his/hers due time obligations. This means that the creditor blocks his/her capital in different assets (inventories, receivables) thus being forced to re-finance himself/herself under crcumstances of interest and time that may be unfavorable.

In order to prevent these risks, the creditor (the bank) acts by creating insuring collaterals and, at the same time, imposes the participation of the debtor with own capital to the respective financing. If the profitability is low, the debtor has to provide a larger participation with own funds in order to protect the creditor, and vice-versa. In the case of an unsatisfying profitability, the financing through leverage stresses the insolvability and lack of liquidity risk.

2. Criteria in choosing a financial structure

In order to choose a certain financial structure, managers have to take into account several criteria, presented below:

- The criterion of profitability in choosing a financial structure

Both shareholders equity and the borrwed capital imply risks. The fundamental difference between the cost of shareholders equity and borrowed capital is represented by the fact that shareholders equity is not remunerates unless the company makes profit, while borrowed capital has to be remunerated irrespective of the company's profitability.

An enterprise with highly levered (over 50%) will permanently have high financial expenses (principal plus interest), a fact that diminishes its possibilities to finance itself. Therefore, the respective company will have to use new credits in order to cover its financing needs, credits which will increase financial expenses. This is possible when the profitability rate is higher then the interest rate, this making possible and desirable the use of credits, as compared to the alternative of waiting the gradual formation of own funds for financing a project.

The leverage effect is obtained by comparing the economic profitability of the company with the cost of the borrowed capital. This:

- if economic profitability is higher then interest rate, there results a positive or favorable leverage effect;
- If economic profitability is lower then interest rate, there results a negative or unfavorable leverage effect.

Supposing, for example, that the economic profitability (R_e) is of 16%, and the interest rate (D) is 12%, the company is interested to *finance through leverage*, since it makes a profit with 4% higher then the borrowed capital ratio. The profitability ratio of the shareholders equity is as high as the report borrowed capital/shareholders equity is higher.

- The criterion of sources destination in choosing a financial structure

The non-current assets, which represent permanent needs, may be covered with permanent capital, while circulating assets (the expenses of the operating cycle) mainly formed by goods inventories and other material values, by receivables over clients and short term financial investments, may be covered, if possible, with the own working fund – which represents a part of permanent capital – but also with short term debts formed by treasury credits and obligations towards suppliers.

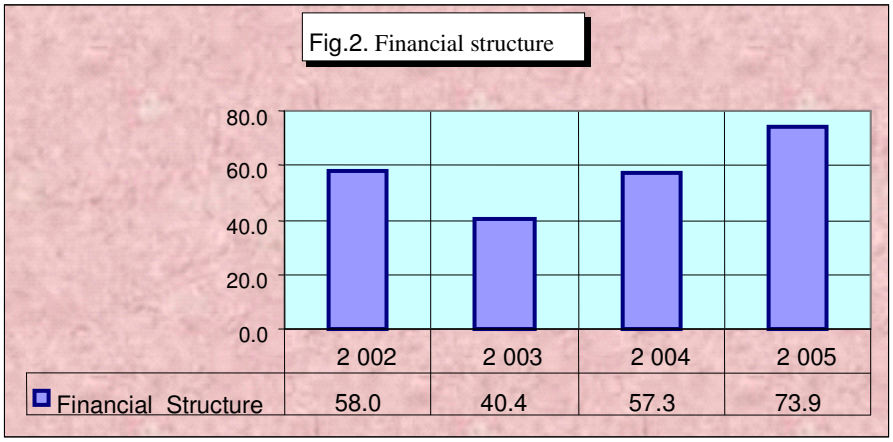
For every company it it important to adapt its financing decision according to the permanent or temporary character of the financing needs.

As previously presented , there results that *the financial structure of a company* is expressed not only as report between *leverage and shareholders' equity*, but also as a report between *short term financing and long term financing*.

Financial structure = Short term financing/Long term financing = Treasury resources/Permanent capital

Indicator	2 002	2 003	2 004	2 005
Treasury Resources	67 486 896	61 361 149	105 624 076	129 975 666
Permanent Capital	116 276 112	151 808 215	184 320 032	175 802 152
Financial Structure	58.0	40.4	57.3	73.9

Table 3 - The Financial Structure at SC ELBA SA

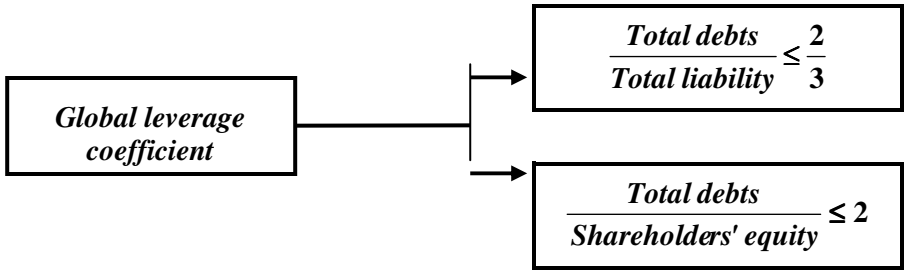


From the graphic representation above there can be noticed that treasury resources, as compared to permanent resources has the following values: 58% in 2002, 40. 4% in 2003, 57%3% in 2004 and 73.9% in 2005.

- Leverage capacityis is another criterion

Taking into account the importance of the financial structure for any company both for evaluating its own situation and for expressing it in the relation with the bank, it is useful to determine, in the case of *financial analysis*, certain *indicators* that would show *the usage degree of shareholders' equity*, as compared to long and intermediary term loans or with total loans.

If we state that **the asset** of a company is formed by non current assets, goods investories and other material values, clients discount and other liquidities, and **the liability** is formed by permanent capital (shareholders' equity, long and intermediary term debts) and by short term debts (suppliers, treasury credits), we may use as *analysis instruments of the financial structure* the following indicators:



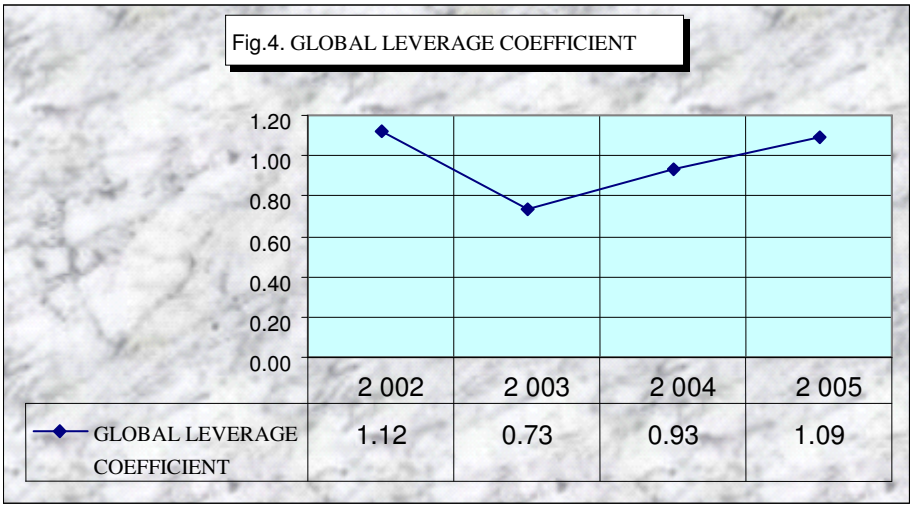
Indicator	2 002	2 003	2 004	2 005
Total debt	97 217 073	89 964 477	139 336 362	159 570 651
Total liability	183 763 008	213 169 364	289 944 108	305 777 818
Global leverage coefficient	0.53	0.42	0.48	0.52

Table 3 - The Evolution of the Global Leverage Coefficient at SC ELBA SA

From the graphic representation above we can notice that SC ELBA SA is situated in a gry area, with a leverage ratio between 30% and 50%. This is a negative aspect from the point of view of the suppliers and creditors, who, in the case of insolvency, would record bigger losses then the company's owners.

Indicator	2 002	2 003	2 004	2 005
Total debt	97 217 073	89 964 477	139 336 362	159 570 651
Shareholders' equity	86 545 935	123 204 887	150 607 746	146 207 167
Global leverage coefficient	1.12	0.73	0.93	1.09

Table 5 - Evolution of the Leverage Ratio at SC ELBA SA



The evolution of this indicator was: 1.12 in 2002, 0.73 in 2003, 0.93 in 2004 and 1.09 in 2005.

In our opinion a leverage ratio over the unit endangers on short term basis the financial autonomy of the company, and, on a long term basis, th capacity of reimbursing the loan.

The indicator „global leverage" is expressed above in two ways, but we believe that it sufficies the approach of an unique model when referring to the analysis of the financial structure or the solvability of the company. Analysis favor *the second calculation method of the indicator* since it refers to the usual banking norms, according to which total debts *can not be twice as shareholders' equity*. These limits may be reconsidered by the banks. In the situation in which these leverage limits are reached, the leverage capacity is seen as *saturated* and the company can no longer obtain long or intermediary term financing sources through leverage.

3. Conclusions

The indicators presented above express essential elements that characterize the financial standing of the company, but, in order to maintain normal relations with the banks, they are concerned with their clients' situation also in the sense of their capacity of reimbursing the contracted credits. Banks are interested to know beforehand whether the reimbursement of the loan and the payment of the corresponding interest can be fulfilled by the clients in normal circumstances, without creating major financial difficulties. For this purpose, there can be used come indicators presented above, expressing the possibilities, which may be accepted by the banks, for fulfilling the obligations of the debtor clients towards the credit institution.

From a fiscal point of view, it is believed that a leverage ratio smaller then 1 provides the possibility that the company completely deducts the expenses with interests and net loss related to the foreign currency exchange. If the leverage degree equals 1 or is higher then 1, the amount of expenses with interests and net loss related to the foreign currency exchange is deductible only in the limits of the following sums: the income from interests plus 10% of the other taxable incomes, less: income from interest, income from

foreign exchange, income recorded in 711, 721 and 722 accounts, as well as the other incomes resulting from operations having as aim the increase of this limit[34].

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[34] *Code of Fiscal Procedure, approved by Governmental Order 92 from 24 december 2003, published in M.Of no 941 from 29.12.2003, art. 69*