Equity Capital –Basic Tool of Company's Financial Management

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Abstract: This paper aims at highlighting the important role of the equity capital, on the one hand in achieving enough financial results, both for the compensation of the owners as expected and for the solid development of the company and, on the other hand, in ensuring a high protection against risks, especially against the risk of bankruptcy and also against the financial risk.
The study which has been conducted highlights the fact that companies that have a high equity capital fulfill more successfully the two objectives of the company's financial management compared to those that excessively resort to loans.

Keywords: company's financial management, equity capital, profitability, financial risk, bankruptcy risk.

1. Introduction

The main goal of any modern financial management of a company consists of increasing its market value.

This goal can be achieved if the company makes, first of all, high profits, which allows it not only to pay the invested capitals, but also to finance scheduled investments.

At the same time, financial managers must also fulfill the second requirement, that is to protect the business operation against any risks; bankruptcy and financial risks should be paid special attention too.

The study which has been carried out on some Romanian companies of national relevance, highlighted the important part played by equity capital in fulfilling the two essential requirements of any financial management, on theoretical and practical grounds.

The study needed a theoretical investigation of some aspects concerning the financial management of a company, but also their empirical investigation.

Achieving high financial performances requires the company's financial management staff to select the most efficient investments. In business, usually a high return is associated with a risk as high, which gives the expected results a profound aleatory nature.

The basic component of any financial management in an enterprise is the decision. Financial decision making in a modern enterprise requires to be taken into account the consequences of all the factors that compose the environment in which it operates.

Risk is a representative component for the present environment. It is defined in a synthetic way as an antonym of profitability (Stancu I., 2007).

Risk acts as a factor with a profound objective character to the will of financial management staff.

The financial decision making process, on a risk based manner, means assessing its consequences on the company results, followed by the establishing protective measures, so as to ensure what financial theory defines as "the viability of the firm" (Filip Gh., 1995).

The ways of "response" for the company, to the possibility of a risk to happen, can be summarized in the following decisions that managers can take (Bucataru D., 2010):

a) if the analysis of the probability of risk to occur predicts insignificant losses compared with the results, then risk consequences will be ignored;
b) if the conclusions of the analysis lead to the hypothesis of an extra effort for the enterprise, to the normal situation, then the financial decisions will have to target also the establishment of some reserve funds, which would finance any additional costs;
c) if the consequences of expected risks show to be too large for the planned financial results, financial managers can then decide to cancel the projects affected by these hazards.

The present study aims to demonstrate that companies that use primarily their own resources are better protected from risks.

In this perspective, equity fulfills a critical role in achieving effective financial management.

2. Equity Capital –Tool in Achieving Higher Financial Performances

Establishing companies' capital is a complex process that begins and continues to develop according to criteria that aim at increasing their financial performances.

Establishing the social capital, as a first component of any company's capital, marks out the legal stage of the company's setting-up.

Financial viewpoints, regarding the filling of the great shortage of resources, makes the capital increase process go on. This process is sustained by profit accumulation which, added to the already established social capital, completes the own resources. This way, the main component of the company's capital is highlighted, namely the equity capital. Its size will continue to be "modeled" so as to produce higher financial profitability, but also to reinforce company's financial stability.

These goals are also pursued in the process of using the capital by investing it in various fixed and current assets.

The capital is one of the production factors in the absence of which a company cannot exist. It is defined as "all the funds and the monetary expression of the assets available to the company, used for manufacturing goods and/or services that, after they are sold and their counter value is perceived, enable the company to obtain profit" (Bucătaru D., 2010).

Therefore, the capital is a value which, during the economic processes in which it is involved, has many functional facets, respectively monetary, various material forms and/or financial product form. The functional forms, also named capital investments, are highlighted in the balance as fixed or current assets, each of them having a different role, equally important in business operation.

The requirements of making business more efficient makes it have fixed and current assets, in a composition appropriate to the economic processes that are about to be developed. Creating an optimal composition of the assets requires, from the very beginning, the enterprise to avoid

purchasing (fixed and/or current) assets that prove to be superfluous, or to the contrary, that fail to create the normal production structure. This way, favorable conditions are created, which allow the enterprise to operate properly, financially speaking, reducing to a minimum the working expenses, being in the same time able to meet entirely and on time the orders and, on this basis, to obtain high revenues. The optimization of assets composition is a difficult operation, absolutely necessary for the company's financial management make reach its best profitability parameters.

In the context of the previous approaches, we can state that the size of the capital a company should detain, for investments, must be equal to the monetary expression of the assets to be established.

Company's resources, those that give content and dimension to the equity capital, form the nucleus of the future capital invested by the company. It gives consistency to the financial autonomy in exercising company's management and along with the establishment of the equity capital, the financial support for achieving future investments is established.

The equity capital is the first resource invested in the company's production apparatus. At the same time, they represent the warranty presented by the company when requesting loans, which aim at completing own resources.

The methods of establishing the equity capital can influence the quality of the production capabilities of a company, as:

a) If it is strictly sized to the demand justified requirement of assets, it blocks unnecessary expenses;

b) The use in time of own resources (the most available to the company), in close correlation with the stages of investments, leads to shortening their execution time and therefore to the minimization of the so-called contingency losses.

But, the essential part played by the equity capital in consolidating company's management results from the extent to which it participates in making up investment financing resources.

The equity capital profitability may increase if the company succeeds in building an optimal financial structure. The optimization of the financial structure means the fulfillment of several conditions. Out of them, an essential part is played by the involving in investments capitals with the lowest costs.

The financial theories on financial structure sustain the idea that, during the investment process, there is an interdependence relation between the capital cost and the risks undertaken by their owners. In this perspective, the cost of the equity capital is theoreticallñy and checked in practice, in countries in which the market economy laws operate, higher than the cost of the loan capital.

Lately, Romanian companies have evolved very much, from the point of view of aligning their business to the requirements of the market economy. Several failures, especially related to their financial performances, determined and still determine atypical behaviors in their operation. The low profitability of the Romanian companies, first, but also other causes determined an abnormal ratio between the size of the equity capital cost and the loan capital cost, in the sense that the bank loan is much more expensive than the own resource. As a matter of fact, most of the times, the only cost that is explicitly formulated and claimed to be paid for imperatively is the loan capital cost.

Between the two big processes that take place at a microeconomic level in relation to the capital, its determination and its use, some interrelationships are established:

a) the size of the weighted average cost of the determined capital becomes the minimal task to achieve with regard to the profitability of the capital use and

b) the forecast profitability in using the capital becomes the maximal limit of the weighted average cost of the capital that the company is about to obtain.

But, when a cost has not been anticipated for the capital's main component, according to the risks undertaken by the shareholders/partners, then the weighted average cost is artificially decreased, determining on its turn the request of a limit level of the profitability from which the risks are about to be covered, a level which is much more decreased compared to the normal one. This way, Romanian companies lacked the stimulating element for directing their activity towards a raised effectiveness.

Managers have not been obliged to organize their activity so that the results of their work conclude with high standards financial results.

As a normal consequence, in the case of Romanian companies, using equity capital becomes the easiest way of minimizing the weighted average cost.

The formulated objective of financial management in a company is increasing its value. The value of an enterprise depends on the value of engaged capitals according to its business processes or, expressing the idea in a different way, on their efficient use (Pinches G., 1990):

Equation 1. Formula for Value of a Firm

The total value of the firm	=	The market value of common shares	+	The market value of debt	[1]

In practice, there are situations where, due to interest deductibility from taxable profits, the company achieves greater financial returns if it uses bank loans instead of equity. This happens only if the return on loans that are superior to their cost. In financial theory and practice, this situation is called financial leverage.

Without denying the theoretical advantages of such a situation, we want to emphasize that, with a loan commitment, there are created the conditions for the financial risk to occur.

In this way a contradiction is created and appears to become dangerous for the enterprise, between the probably and obtainable character of financial result (which will be used to pay the interest) and the imperative and implacable obligation to pay the debt. In this perspective, financial leverage proves to be a potential positive phenomenon, only accidentally, on the financial management of firms.

Some companies, seeking to increase their leverage, turn to a growing volume of bank loans. Larger loans mean higher interest rates and hence increased financial risk.

The empirical study, conducted upon the Romanian companies, showed efficient financial structure formation features, in this period when crisis effects are deeply felt in the economic environment.

3. Equity Capital – Tool in Insuring the Protection against Risks

A rational financial management involves, apart from enough profitability, the pursuance of an increased protection against risks. The main risks faced by the Romanian enterprises, at least in this period, are the financial and the bankruptcy ones.

The financial risk appears together with the expression of the failure to pay to the bank, of the investment profit, the interest related to the loan capital for its financing. As a result, this risk exists only in the case of the indebted companies.

The decrease of the risk is performed either by increasing the profitability of the investments in which the capitals have been involved, either by decreasing the debt related to the interest. A method which is available to the company, of decreasing the debt related to the interest, means using loans as rarely as possible. In this case, the loan must be replaced, naturally, with own resources. So, using mainly equity capital is a method of protection against the financial risk. The bigger its proportion in the total capital, the safer is the company from this risk.

In this period, the positive effect as a consequence of using bank loans, concretized in the financial lever effect, is not seen in the great majority of the Romanian companies. The reason is easy to underline, namely the decreased profitability of the companies, much lower than the interests related to contracted loans.

As a consequence, it is absolutely necessary to perform the financing in the case of Romanian companies, at least in this period, by using especially their own resources. Profit accumulation, when it is possible, represents the safest way of preparing the future financial performances. This implies tempering the consumption of the profits as dividends and their distribution in order to increase equity capital.

Equity capital increase must continue until the own resources are enough so as to finance the permanent needs of the exploitation. This supposes first of all the entire financing of the fixed assets and then of those current assets that express the permanent expenses of the exploitation. The bank loan is about to cover only the company's temporary needs.

Observing this requirement, the company not only protects itself against the financial risk, but also creates a highly solid support against the bankruptcy risk. The bankruptcy risk is seen in the company's chronic failure to cope with the payment responsibilities towards its partners: employees, suppliers, banks and budgets.

Lately, the manifestation of the bankruptcy risk meant for the Romanian economy the disappearance of hundreds of companies, as a consequence of the claim, in an imperative manner by the creditors of the amounts owed by these ones. The positive aspect, invoked by the production of this risk, refers to the fact that the economy is, on this occasion, drained out by the economically non-productive companies, which represent shorting points of the financial flows that concern the activity of the viable enterprises.

The realities of the Romanian economy showed that the bankruptcy of most companies was not a consequence of the fact that they have not justified in an objective manner their place on the market, but a consequence of a cause with a more subjective character, namely a management performed in an non-professional way by the decision factors of those enterprises.

The great number of bankruptcies resonated at macroeconomic level in a consolidated unbalanced budget where, because of the revenues' decrease, the investments have been seriously limited; at the same time many social programs have been abandoned and the loss of their jobs by a part of population lead to the drastic decrease of the level of living.

These are relevant reasons in order to intensify, when performing the company's financial management, the concerns of protection against risks, generally speaking, and especially against the bankruptcy one.

The protection against the bankruptcy risk imposes, as a *sine qua non* condition, the permanent insurance of the company's financial stability. The financial stability must be built early in the stage of establishing the company, by creating the conditions for equalizing the liquidity of its assets to the eligibility of the resources invested for this purpose.

The first assets needed in order to establish a company are usually the most difficult "liquids", namely the fixed assets. They are the company's production device and they are reflected in accounting especially as fixed means. The requirements of ensuring the financial security, generally speaking, or the protection against the bankruptcy risk, in particular, ask that these investments be financed by means of resources presenting a payability degree as low as the liquidity of the assets mentioned above.

In managing an enterprise, the fixed assets are not the only assets that must be financed by resources that are difficult to charge. Thus, an enterprise has a series of current assets as fixed as the fixed means, even if they return to the monetary form at short intervals of time.

The necessity of immediately reinvesting the capital used for purchasing those current assets needed for operation, impresses a permanent character to these expenses, making them as fixed as the capital invested in fixed means. Thus, the fixed asset period of the capital spent for purchasing those current assets is equal with the fixed asset period of the capital invested in the fixed assets, whose good functioning must be ensured by it.

We have to mention that not all the current assets prove to be permanent investment, but only those that express the minimal need for working capital, because they are the ones that are renewed at the same level, at least during a calendar year.

To sum up, the general condition for foreshadowing the company's financial stability, expressed by the equality between the low liquidity of the fixed assets and of the current ones, with an economic behavior similar to that of the fixed assets, on the one hand, and the equally low payability of the resources used in their financing, on the other hand, is fulfilled if the equity capital is involved for this purpose.

In the financial management of several Romanian enterprises, such reasoning is practiced when its financing decision is underlined. This way, the financial balance is built on a solid basis and it will be more easily maintained during the company's activity.

However, the approach of the financial balance, as it has been presented above varies according to the manner in which the demand with permanent character of the current assets is understood.

Thus, some economists think that the permanent demand for current assets is represented by the value of inventories, that the company is about to establish. The reason for this option is that, without inventories, the operation of the company would not be possible, therefore inventories are mandatory and they may be considered permanent.

In the current activity, the company's financial manager faces some problems that concern not only inventories financing, but also the financing of the result from trade credits of clients and suppliers. Granting trade credits to clients is part of the company's strategy concerning the turnover increase, being a permanent concern of its financial manager. Obtaining payment delays from suppliers, as many and as large as possible, represent the daily "care" of any financial manager in order to record financial advantages which can increase the company's results.

As a result, taking into account, when estimating the dimension of the current assets, not only the inventories, but also the loans received or granted by the company, thus of the need for working capital, is fully justified, because it highlights more accurately the company's financial effort, regarding these assets.

The minimum demand for working capital shows the financial effort that the company has to do in order to create current assets, during each of the four quarters of the year, fulfilling this way the character of the permanent demand for financing.

A brief analysis carried out on several Romanian companies, illustrative of the national economy, highlighted the fact that the enterprises in which the equity capital have a consistent weight in the total of the resources invested by them have recorded positive results with regard to the activity's raised effectiveness and to the maintenance of the financial balance.

Table no. 1. The evolution of some ratios in the case of certain Romanian companies, over the period 2008-2010 (%)

No	*Company*	*The weight of the equity capital in the total company's invested capital*			*Rate of Return*			*Internal Rate of Return*			*Quick Rate of Return*			*Coverage of financial expenses from profits*		
		2008	**2009**	**2010**	**2008**	**2009**	**2010**	**2008**	**2009**	**2010**	**2008**	**2009**	**2010**	**2008**	**2009**	**2010**
1.	**SNP**	80.3	63.6	54.6	14.4	6.1	10.6	14.4	7.5	9.7	1.8	1.4	1.2	7.8	1.9	3.7
2.	**RRC**	10.5	7.2	8.4	-5.7	-5.3	-5.7	-15.2	-29.7	-41.1	1.0	0.7	0.4	0.03	0.03	0.04
3.	**ATB**	64.4	54.3	52.8	14.1	4.9	5.4	13.1	4.2	4.9	2.1	1.8	1.9	6.3	1.2	2.1
4.	**BIO**	91.2	88.4	90.4	21.6	-32.7	29.2	8.9	-16.4	14.4	4.8	4.8	6.6	3.4	1.6	8.2
5.	**STZ**	97.8	99.3	98.6	3.6	0.4	3.9	0.29	0.03	0.29	3.43	7.16	4.27	3.6	2.3	10.3
6.	**SCD**	77.3	80.7	88.0	2.1	10.6	-1.6	1.6	8.1	-1.0	4.0	4.8	7.3	1.8	3.8	0.05
7.	**AMO**	70.5	78.4	71.8	8.0	3.1	3.0	9.7	8.4	8.5	0.9	1.1	2.6	11.6	2.0	2.4
8.	**OLT**	15.2	18.9	20.4	-5.4	-12.0	-19.4	-7.4	-8.3	-16.8	0.57	0.35	0.37	0.05	0.09	0.05
9.	**AZO**	80.3	63.4	54.6	14.4	6.1	10.6	13.4	7.5	9.7	1.8	1.4	1.2	2.5	2.3	1.5

Source: The annual accounting balances of the studied companies

The first conclusion that derives from the descriptive study of the ratios presented in *Table no. 1* is related to the fact that the great majority of the studied companies show an important weight, of more than 50%, of the equity capital in the invested total capital. The proportion was also consistent after 2009, period in which the effects of the global crisis were felt. It is worth mentioning the fact that some enterprises (BIO, STZ and SCD) have a percentage of almost or even over 90% of the entire capital, situation which highlights an intensive savings process.

We think that, from this particular point of view, the enterprises mentioned above have had, generally speaking, a rational financial management. As a proof, for this purpose, let's take the evolution of the

rate of return. Even if it registered an inflection in 2009, it evolved positively especially in those companies that had a high level of equity capital savings.

The financial lever effect is an isolated phenomenon in the case of the Romanian companies, this fact being proven in the case of the studied companies, because of the rates of return, which are inferior to the bank interests' ratios. So, resorting to the loan capital was not beneficial for the enterprises, from the point of view of the evolution of the two financial profitability cases.

Similar conclusions can be drawn from the study of the impact of the own resources savings on the company's financial stability. If we keep an eye on the evolution of the immediate liquidity ratio index, which we consider illustrative for the study carried out, we can see a higher payment capacity in honoring the due obligations, in the case of the companies that are less indebted. A particular case is represented by the two enterprises, RRC and AMO, which also present the lowest level of accumulating the own resources, as it is shown in the analyzed sample, where the index mentioned above a disquieting evolution concerning the payment capacity and therefore, the bankruptcy risk potential.

The bankruptcy risk has been studied by means of the profit index, before reducing the financial expenses, reported to the expenditures owed by each company. In accounting, this numerator is called gross working surplus. It expresses, in the most comprehensive manner, the financial result of each company from which the obligations for bank, budget, shareholders and savings are about to be paid.

During the analyzed period, the evolutions of the index mentioned above show that the companies which are less indebted have increased possibilities of paying those debts, being implicitly better protected against the financial risk. The low weight of the bank loans in the invested capital did not deprive the studied companies from the positive effects of the financial lever, as a proof we can mention the data concerning the two profitability ratios. The main excuse, which in fact we haven't mentioned, is the high level of the bank interests compared to the companies' economic profitability.

4. Conclusions

We think that the study carried out represented a series of reasons concerning the highly important role of the equity capital in performing an efficient financial management. Increasing the equity capital, either by savings, either by shares issuance, represents the way to the consolidation of the main instrument available to the financial managers of the Romanian enterprises for the purpose of obtaining performances as high as possible, the loan capital having to cover only the temporary needs of their activities.

Although the use of equity can slow down business development, it provides greater security against the growing and vibrant risks of contemporary environment. During this period, some factors act with a deep random character, creating an unfavorable situation for a strictly ruled management policy, based on theory. Adapting effective management solutions to the requirements of a full security development, in financial management, is the central feature of Romanian companies. The most destructive risks to Romanian companies proved to be, in the current period, bankruptcy risk and financial risk.

To prevent the effects of both risks, equity has a critical role. To prevent financial risk, equity is essential since the establishment phase of production capacity, in which case he must be invested in fixed assets, fulfilling the first condition of financial balance. In the exploitation phase of the

company, equity should be used to finance another permanent expenditures, namely expressed by the minimum needed working capital.

As for financial risk, the mere presence of equity removes it. At least at this stage, for the Romanian companies, financial leverage does not occur. The causes were presented in the paper. We do not exclude the use of borrowed capital, but fought for it to be mobilized only to cover temporary needs. Increasing equity role in preventing the two risks is at the reach of any financial management staff of Romanian companies, if they have practiced a policy of prudent dividends, which involved primarily the accumulation and less consumption.

All the examples considered in the study revealed that there were companies where rational management policy provided them not just favorable financial results, but also good protection against risks.

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