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# FACTORS OF CORPORATE CAPITAL STRUCTURE

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**Abstract**

*Financial decisions represent the key decisions in any company. These decisions, above all, relate to finding additional sources for financing the existing scope of business, but also the growth and development of the company. Considering the fact that the goal of every company is its survival and growth, it is logical that financing decisions come down to decisions on corporate capital structure. Capital structure is conditioned by proprietary companies, but it also depends on a large number of other factors whose influence must be taken into consideration during the composition of corporate capital structure. The aim of the paper is to indicate the complexity of these factors.*

**Keywords:** capital structure, corporation, factors.

## INTRODUCTION

Capital structure is conditioned by the form of enterprise ownership and can be observed from the balance sheet liabilities. Bearing in mind that the basic forms of enterprise ownership are sole proprietorships, partnerships and joint-stock companies, it logically follows that their capital structures will differ significantly, mainly due to the specific form of a company. Similarly, in its capital structure, a sole proprietorship has its equity consisting of the capital of the proprietor and retained (reinvested) earnings and possibly certain types of long-term loans (with a repayment period of only a few years). A partnership in its capital structure has the capital of the partners, retained (reinvested) earnings and different types of long-term loans (long-term borrowed capital). A joint stock company is the dominant form of enterprise organization today, so this paper will deal solely with the capital structure of a joint stock company, i.e. corporation. In this regard, it should be noted that the capital structure of a joint-stock company (corporate enterprise) consists of: *firstly*, share capital (capital from the issuance of ordinary and preference shares, capital reserves and retained earnings) and *secondly,* long-term borrowed capital (different types of long-term loans and capital from the issuance of various types of securities).

## DECISIONS ON CAPITAL STRUCTURE

In contrast to microeconomic theory, which mainly deals with the ratio of the size of the effects and the scope of business activities of a company, taking capital employed as a fixed factor, the practice of management of company's finances (financial management) focuses on the dependence of the effects of the company's business activities on the amount of the capital engaged. In an effort to maximize the effects of business activities, financial management of the company tries to allocate the limited capital to alternative needs which promise the greatest contribution to the creation of new values of the company. Since in modern market economies, most large companies have a corporate form of organization, it is a key reason why in this paper the problems of

factors of capital structure are viewed primarily in terms of companies that have a corporate form of organization. Although the capital structure is less susceptible to changes than the structure of the company's assets, it does not mean that the management and decision-making on capital structure should not be the subject of constant attention of the financial management of the company. Namely, the size and pace of growth of a company continue to create the need for additional financing whose fulfillment implies the use of new sources of financing, and which change the relations in the current financing structure. For example, owned accumulation is an opportunity for quality support to the realization of the company's current operational plans as well as its growth and development, but it is limited by the profitability of current operations and decisions on the allocation of net income (dividend policy of the company). Therefore, the remainder of the required capital must be obtained from external sources, which will necessarily result in an outflow of cash from the company in terms of liabilities to these sources, with the inherently present illiquidity risk for the company. Meeting the needs for capital is a problem of structuring of the balance sheet liability, and resolution of the problem presupposes the selection of appropriate combinations of sources of corporate financing. In academic literature, relations in the financing structure of corporate enterprises are usually expressed, on the one hand, through the financial structure as an expression of the totality of engaged financing resources, and on the other hand, through the capital structure as the long-term aspect of the financial structure. However, company financing does not imply only a quantitative covering of needs for capital, but also a careful composition of an amount of capital of different backgrounds and maturity deadlines with the aim that the desired level of business operations of the company is balanced with the targeted cost-effectiveness, acceptable level of liquidity and risk, necessary financial stability, development prospects of the company, and financing opportunities. However, achieving such a complex goal which necessarily requires optimal use of economic resources of the company is not simple. If we leave aside the possibility that the capital required for the desired (most favorable) sources cannot be obtained at a given moment, then the design of the desired capital structure is the skill of the possible and involves two types of financial decisions, such as: (1) finding the best combination of owned and borrowed sources, i.e. the ownership structure of the source, which defines the profitability and current liquidity of the company, and (2) selecting individual sources of funding in terms of maturities which best meet the objectives of the company at a specific time.

In economic practice, combining different sources of financing is usually done according to the principles of financial policy of the company, the observance of which presents a condition that effects of the company are not below possible. Successful solving of problems of financial structure in terms of ownership and the maturity of the sources should result in the optimal capital structure of the company, which is characterized by the minimum weighted average cost of capital and the maximum market value of the company. Of course, in the process of finding a suitable, preferably optimal capital structure, one must not lose sight of the connection between the composition of sources of financing and the form of investment of capital. Similarly, the principles of financial policy of the company require specific forms of property to be covered by adequate financial resources. The importance of this connection in the management of company's finances enterprises (financial management) is clearly observed and emphasized through the formulation of the so-called horizontal rules of financing.

Given the scope and structure of needs for

capital, methods of company financing can vary significantly, which implies their highly complex financial structure. In the balance sheet liabilities, the structure is expressed through the global ratio of owned and borrowed sources of financing. In addition, owned sources are permanent, while borrowed sources (debts) have fixed terms of maturity. Depending on their maturity, debts are conventionally divided into long-, medium- and short-term debts. Owned sources of financing with long-term and medium-term debts consist of the so-called capital structure, which is a crucial component of the financial structure of the company. What will the ratio be of owned and borrowed sources in the financial structure, i.e. the capital structure of a specific company depends on many factors and some of the most important factors will be analyzed in the following text.

## FACTORS OD CAPITAL STRUKTURE

Capital structure is the ratio of owned and borrowed long-term funds. Capital structure is a narrower term than financial structure, which represents the ratio of owned and total borrowed funds (long-term and short-term). Since the short-term borrowed funds due to their short term nature cannot be used to finance long-term investments, taking into consideration the fact that long-term investments are significant for the survival, growth and development of a company, our attention in the following part of the paper will be given to the factors affecting the capital structure, but only in terms of strategic financial decision making in a corporate enterprise. In addition, in relation to the financial structure, capital structure is conceived as a narrower category, which is limited to the ratio of permanent components of funds (equity) and long-term components of borrowed funds (long-term loans). The capital structure of the joint stock company, i.e. corporation, can be understood as the ratio of equity and long-term borrowed capital (long-term debt) which maximizes the value of the shares, and well as the value of the corporation as a whole. The capital structure is conditioned by the form of enterprise ownership and can be seen from the balance sheet liabilities. However, apart from the form of enterprise ownership, capital structure depends on many other factors whose effects must be taken into account when composing the capital structure for a specific corporate enterprise. In this context, when defining of capital structure of a corporation, we should take into account a number of the most important factors that predominantly affect the composition of the capital structure, such as:

1. Respecting the rules of financing
2. Risk of business operations
3. Retaining control over the company
4. Preservation of the financing capacity
5. Stage of the life cycle of a company
6. Stage of the economic cycle

1. *Respecting the rules of financing* - in relation to the capital structure of the company, it is primarily related to the need to respect the so-called golden balance sheet rule, which requires that noncurrent assets are financed by long-term sources and current assets from short-term sources. The need for long-term sources to be used to finance noncurrent assets stems from the fact that the fixed assets typically require greater investments and that the investments can be achieved over a longer period of time through cash flows, depending on the size of investment and economic life of the duration of the asset. Therefore, there is no doubt that it would be unrealistic and very risky to promise creditors that their money would be returned in a shorter period of time than is required for the return through the cash flows generated from current business operations. Financing of fixed assets from short-term sources could lead to illiquidity and non-profitability of the company thus jeopardizing its survival. Consequently, it appears that the needs for working capital should also be financed from short-term

sources because it would be very unreasonable to use long-term sources to finance working capital, bearing in mind the fact that they are expensive and need to be repaid for a longer period of time.

2. *Risk of business operations of a company*- have to be taken into account when composing the capital structure of the company, since the estimated level of risk influences the ability of the company to use a smaller or larger volume of debt in its structure. Generally, we can say that the risk relates to the higher or lower uncertainty connected to the expected outcomes of business operations of the company. The essence of the uncertainty stems from the inadequacy and unreliability of information on the basis of which business decisions are made. Many of these decisions are made aimed at the achievement of future results of business operations, i.e. business and net profit. Similarly, the risk to which the company may be exposed can be either business or financial. *Business risk* is determined by the inherent presence of uncertainty with respect to the expected business profit, which is the result of a smaller or larger share of fixed costs in total costs. The frame of this risk consists of fixed costs of business operations that remain rigid, i.e. non-elastic to the short-term fluctuations in the volume of business operations of the company. *Financial risk* is determined by the uncertainty of future net profit and it exists when the company has borrowed funds in its structure. The frame of this risk consists of fixed costs of financing that cannot adapt to short-term fluctuations in business profit. In the above context, a company that engages both types of fixed costs (business and financial) is exposed to a double risk, both business and financial, and their combined effect is the so-called total risk. Company's exposure to business risk assumes identification of appropriate methods for its measurement and quantitative expression. One of these methods is the so-called *leverage* which helps estimate the effects of the company's business operations in the presence of the mentioned constant factors (fixed costs). In this regard, we can talk about business, financial and combined (total) leverage. In addition, it is necessary to bear in mind that the risk is measured by the following indicators: (a) *factor of business leverage*, (b) *factor of financial leverage*, and (c) *factor of total leverage*.

(a) *Business risk* is measured by the factor of business leverage which expresses the change in marginal profit with respect to business profit, i.e. the percentage change in business profit with respect to the percentage change in sales volume. The factor of business leverage is calculated according to the following form:

FBL = %CBP / % CSV
FBL - Factor of business leverage
CBP - Change of business profit
CSV - Change in sales volume

Higher factor of business leverage means greater exposure of the company to business risk, because the business profit can change significantly due to small changes in the volume of sales. Similarly, companies in which this is the case should try to lower the financial risk, since they will have difficulty accessing financing from loans because potential creditors cannot be sure that their money would be paid back. For example, reduction in sales volume leads to significantly greater reduction in business profit, which is why it may happen that the company cannot pay either interest or the loan.

(b) *Financial risk* is measured by the factor of financial leverage, which is determined as the ratio of the percentage change in profit before tax and the percentage change in business profit, i.e. as the ratio of business profit and profit before tax. The factor of financial leverage is calculated according to the following form:

FFL = %INP / % IBP
FFL - Factor of financial leverage
INP - Increase in net profit
IBP - Increase in business profit

Companies that are fully financed from their own sources are not exposed to financial risk. However, as most companies more or less use borrowed funds, it appears that they are constantly exposed to a greater or lesser financial risk. High factor of financial leverage means that on the basis of small changes in business profit a significantly higher change in net profit can be achieved. Companies with a high ratio of borrowed sources have a high degree of financial risk, and therefore, they should aim to lower the business risk or to repay a part of the debt.

(*c) Both leverage factors (business and finance)* act together in the same direction, to the increase or decrease of the company's exposure to the total risk, i.e. to the certainty regarding the realization of the net income as a return on equity. The effect of the complex leverage can be expressed by means of factors of complex leverage, and it is equal to the product of the business leverage and financial leverage, i.e.:

FCL = FBL x FFL
FCL - Factor of complex leverage
FBL - Factor of business leverage
FFL - Factor of financial leverage

Complex effects of the business and financial leverage should be analyzed within the expected fluctuations in revenues from sales according to the lower limit of profitability. When composing a specific capital structure of a company, it is necessary to take into account the possibility of the fluctuations in the volume of business in relation to the break-even point of profitability. Similarly, the issue focuses on observing the ever present dilemma in terms of the following: how to harmonize the requests for maximization of profitability with the necessity of maintaining the liquidity and solvency. In this regard, it should be borne in mind that the risk of illiquidity and insolvency commands the need for caution when combining effects of the business and financial leverage. This means that if the lower limit of profitability is high, while the area of business profits is narrow, and the volume of profit from sales exhibits signs of instability for whatever reason, it is not recommended to potentiate the factor of financial leverage together with the high factor of business leverage.

3. *Retaining control over the company* - is also an important factor in capital structure in case when the majority of shareholders are those who seek to retain control of the company. Specifically, to them the company financing by long-term loans and the issuance of preferred shares seems very attractive, since creditors and preference shareholders cannot influence the business policy of the company. However, the fact remains that such financing can only be used up to a certain limit because excessive indebtedness can lead to illiquidity, insolvency and gradual liquidation of the company. Therefore, upon reaching the upper limit of indebtedness, the financial management of the company has to turn to financing with capital which is obtained by additional issuing of ordinary shares, which represents a more expensive option of financing which may lead to a change of control over the company.

4. *Preservation of the financing capacity (debt capacity)* - is a very important factor in capital structure, because it allows companies to finance their asset requirements cost-effectively. To make this possible, the company should not be over-indebted, because this may lead to limited possibility of capital acquisition or capital acquisition under very adverse conditions in the future. In this regard, over- indebted company can find itself in such a situation that it cannot obtain any sources of funds to borrow and that it must be financed by issuing additional ordinary shares, which is very costly. With this in mind, the question is which capital structure, in terms of ownership, is acceptable to the company. In this regard, it can be said that according to the traditional rules of financing, the structure acceptable for the company is if the equity is 50% and borrowed capital is

also 50% of the sum of liabilities. This practically means that the ratio of equity capital and borrowed capital is 1:1, and the ratio between assets and liabilities is 2:1. It is believed that compliance with this rule provides sufficient security for the creditors in terms of possibility to collect their outstanding liabilities, since it is unlikely that the borrower will lose more than 50% of the invested assets, whereby until the loss exceeds the level of over 50% of invested assets, i.e. until the loss exceeds the level of the equity, the borrower can repay the debts. However, one should bear in mind that in reality there are always deviations from the theoretical rules, and accordingly, this rule should not be interpreted too rigidly.

5. *Stage of the life cycle of a company* - is a very important factor that affects the capital structure of the company. In addition, generally speaking, one should bear in mind that we can differentiate among four basic stages in the life cycle of company, namely: (a) the introduction phase, (b) the growth phase, (c) the maturity phase, and (d) the decline phase. *In the introduction phase*, it is characteristic that the capital structure consists solely of the owner's capital, as there is very small possibility that a company which has just begun operating manages to obtain capital from other sources (issue of shares and other long-term securities and long-term loans). *In the growth phase,* the capital structure of the company, apart from the initial capital of the owner, can also contain capital acquired by issuing of shares, since the main feature of the company at this phase is the existence of a low financial risk. *In the maturity phase,* the capital structure of the company is characterized, apart from the presence of share capital, by the existence of long-term debt (long-term loans and capital from the issuance of long-term bonds). Finally, *the decline phase* is characterized by a high share of long-term debt relative to the equity.

6. *Stage of the economic cycle* - is also an important factor that determines the capital structure of the company. Due to the importance of this factor, the company should strive to adjust its financial policy to changes in the economic cycle in order to achieve lower financing costs. Depending on the extent to which the company can adapt to changes in the economic cycle, it ensures its own survival and profitable business operations. For example, in the case of completing the stage of recession, the company would need to resort to debt policy because when it comes of out of recession it can relatively easily repay borrowed funds through the issue of ordinary shares or retained earnings. In this way, the portion of debt in the capital structure is reduced, which also contributes to improving the creditworthiness of the company in the future. What the company should never do is to borrow at the time when interest rates in the capital markets are starting to grow.

## CONCLUSION

The previous discussion has shown that the composition of an adequate capital structure of a company is a very complex problem. Traditional financial rule was that the ratio of equity and borrowed capital is 1:1. However, in the operating conditions of a modern corporate enterprise, the practice has simply disproved this rule and it was abandoned. Similarly, it is believed that a modern corporate enterprise should opt for such a ratio of debt and share capital which maximizes the value of ordinary shares, i.e. which maximizes the value of the entire enterprise. In addition, it is important to note the fact that changes in the value of the company present the same thing as the net effect on shareholders, and accordingly, the financial managers must always seek to find the capital structure which maximizes the value of the company.

The obligation of financial managers in corporate enterprises is to establish as flexible capital structure as possible which will be able to adapt to alternative methods of company financing. In addition, it is necessary to maximize the share price of

the company. Accordingly, long-term study of financial theory and business practice in the direction of finding a generally applicable model of establishing and maintaining the so-called optimal capital structure of the company did not give satisfactory results. Therefore, one of the conclusions is that relations in the optimal capital structure are, in fact, not possible to formulate in terms of a single general applicable standard, and accordingly, any corporate enterprise in specific conditions must search for its own solution of the optimal capital structure, at the same time observing all relevant factors.

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