FINANCING AND CAPITAL STRUCTURE

Trajanka Makrevska
International Slavic University "Gavrilo Romanovich Derzhavin", North Macedonia,
makrevska_art@yahoo.com

Abstract: The capital structure denotes the composite blend of debt and equity utilized by a business entity.
In the past, the concept of capital structure was commonly categorized as a highly specialized and technical aspect of corporate management that pertained to a limited number of individuals within an organization.
In the perspective of a conventional business individual, the likelihood of this vicinity to produce ample profits was rather low.
The generation of considerable revenue is observed to be comparatively pronounced in certain financial domains, such as appropriately identified investment initiatives, when juxtaposed with other areas of financial pursuits.
In recent times, there has been a substantial transformation in the prevailing circumstance.
The area of capital structure has garnered significant attention and interest within academic discourse.
The present discourse concerns both the theoretical and practical aspects of finance.
The utilization of said funds may be extended towards facilitating the comprehensive functioning of the enterprise and executing investment operations. The various forms of capital structure commonly recognized include equity share capital, debt financing, preference share capital, and vendor financing.
The present study aims to examine various aspects related to capital structure, including the challenges associated with the precise measurement of capital structure. Additionally, individual authors suggest that there exist numerous intriguing areas for future exploration in this domain.
Anticipated outcomes encompass factors such as the provision of capital from the supply side, the correlations between capital structure and labor agreements, financial contracting, the dynamic trade-off theory, and the rate of capital structure adjustments. The aforementioned concepts will be subjected to scrutiny to evaluate their potential applicability as findings for research purposes.
Some emphasis is also placed on the issue of asymmetric information and moral hazard that may arise between the parties involved in a given scenario
The role of investors and issuers of diverse securities is fundamental in the financial domain.
In the following, we also examine the three fundamental principles underlying the concept of capital structure in the realm of finance. The concept of capital structure irrelevance, the significance of the debt tax shield, and the interrelationship between the financing decisions and firm value represent essential themes in the field of finance.
Attention is also focused on the expected financial costs associated with insolvency and their impact on determining the optimal capital structure.
These ideas try to figure out if a firm can make more money by changing how it gets its money. Each idea has a unique answer, which means capital structure is a complex but interesting subject.
Keywords: capital structure, debt financing, finance.

1. INTRODUCTION

Don't forget that ''capital structure'' is the mixture of debt and equity resulting from decisions on financing operations. . Dividend (or, more generally) equity policy. The only value created by debt is the fact that it forces managers to improve enterprise value.
A company's main goal is financial value generation through profitable investments that exceed the required rate of return and match the risk level, potentially leading to higher share price or worth. Otherwise, the structure may destabilize. Creating lasting value is difficult according to market equilibrium theory. Realized rates of return converge with required rates due to technology and deregulation, reducing entry barriers and economic rents. Managers try to create and protect money they earn, even though they will eventually stop making it. Diversification and indebtedness don't benefit investors with the ability to do so without expenses. The required rate of return for an investment is not dependent on its portfolio. Value comes only from industrial synergies, not financial ones. Value doesn't just come from profits. It's based on economic principles, like distorting markets for a rent. The market equilibrium theory falls short in explaining corporate finance. Signal and agency theory address its limitations. Signal theory assumes uneven information distribution among agents, often leading to negative consequences like poor assessments or investment strategies. Financial signals are used to disrupt imbalanced information, which can have negative consequences for the initiator if they are proven to be unsubstantiated. Agency theory disputes the belief that all parties within a company aim to create value; shareholders, managers, and creditors do not have

similar objectives. It highlights the mismatch between managers' and shareholders' interests. Corporate decision-making and financial instruments, such as stock options, can involve reconciling conflicting stakeholder interests or protecting creditors. Agency theory underpins academic discussions on corporate governance.

The key inquiry in this section pertains to determining if there exists a perfect capital structure that can optimize enterprise value by striking a balance between net debt and equity. Can we identify a capital structure that minimizes the Weighted Average Cost of Capital (WACC).

The common belief is that using debt and its leverage in a well-thought-out manner results in an ideal capital structure that maximizes the value of a company. The company can reduce its cost of financing through this method, known as minimizing the weighted average cost of capital.

What makes us say so? It is due to the sufficient proof indicating that the companies' leverage is relatively stable. If companies are not frequently adjusting their leverage, it suggests that they are content with the amount of debt in their capital structure.

The ideal markets theory regarding capital structure is in conflict with the practical approach in the actual world. The assertion is that there is no single ideal capital structure, provided that no aberrations are present.

The overall cost of equity or weighted average cost of capital (WACC) stays consistent, independent of the debt policy of the firm, implying that there is no ideal capital structure.

The theorem operates on the basis of several key assumptions including: the limitation of companies to issuing solely risk-free debt and equity securities, the absence of impediments in financial markets, the nonexistence of both corporate and personal taxes, the complete elimination of transaction costs, the impossibility of firms going bankrupt, the equal possession of knowledge by insiders and outsiders, and the exclusive representation of shareholders by management..

In an ideal marketplace, it would be rational for them not to compensate firms for tasks that they can manage internally without incurring any expenses.

Envision two companies that are identical in all aspects except for their financial structure. Although the debt and equity values differ between the two companies, their combined enterprise values are equivalent.

It was demonstrated that the worth of a business remains unchanged regardless of whether it has incurred debt or not. Although investors will receive a lower share value for a leveraged company, they must first repay the debt or purchase it in order to obtain the enterprise value.

Ultimately, they will have covered the cost of the enterprise value, inclusive of equity's worth and net debt repayment, either through direct or indirect means. Consider the financial manager tasked with raising funds through securities issuance to enhance the value of the business. Whether the manager opts to issue a mixture of bonds and shares or solely shares, the outcome will ultimately be the same - an increase in enterprise value.

The value of a company is determined by its future earnings potential and how the market perceives the level of risk associated with these non-diversifiable risks. Although the theory appears to be well-structured, it fails to fully account for the practical functioning of things.

This begs the question, why would it be advantageous to expand sources of funding? This section examines two fundamental interpretations of occurrences in the real world. Initially, biases arise under the same market logic, which can elucidate the motives behind companies' borrowing activities and their limitations.

Taxes, financial difficulties, and agency costs are the underlying causes for these biases. The collaborative investigation will result in the creation of the "trade-off model". However, the optimal capital structure can be influenced by the expenses associated with borrowing. Uneven distribution of information. The function of debt as a means of enforcing discipline. The ability to adjust and adapt financially.

Typically, traditional models that involve trade-offs focus only on the advantages and disadvantages of tax shield benefits versus financial distress costs. We hold the view that there are several more components to the equilibrium than just these two aspects.

The concept of information asymmetry and the theory of the pecking order are closely related.

To examine how informational imbalances affect decisions regarding capital structure, it is necessary to introduce two fresh concepts: internal and external capital.

Internal capital refers to the income that is not distributed among shareholders and is generated within the company, while external capital is obtained from sources outside the firm such as financial debt or equity from new investors.

Typically, those within the company such as directors, management, significant shareholders, and employees have greater knowledge about the organization compared to external stakeholders. The imbalances have a tendency to inflict a disadvantage on the company when it seeks to acquire external funding.

External lenders possess a more limited amount of data and harbour doubts regarding the ability of insiders to disseminate all of their relevant information.

This could take on two different forms.

An increased expense for the funds required for investment or business activities.
The limitation of raising a reduced amount of funds is known as capital rationing.
The company is not subject to any cost or quantity penalties by using its own internal capital. Nonetheless, the inclination towards utilizing surplus funds and the remaining ability to borrow can result in decreased financial adaptability, which could potentially hinder the company's forthcoming financial stability.
When a company borrows money, it can pay less in taxes on the interest it owes. However, if the company might not be able to pay back its debts and go bankrupt, investors will think about this risk when deciding whether to invest in the company.
In simple words, going in a long circle brings us back to the idea that we should have some debt, but not too much. The perfect amount of debt is when the money saved on taxes from borrowing more balances out the cost of potential financial trouble and bankruptcy. Shareholders want to predict how much it will cost if the company runs into money trouble. They aren't happy with how they calculated how much trouble will cost them because they need to consider how likely the trouble is to happen.
If a company can't pay its debts, it's called financial distress or bankruptcy. The cost of this happening is called CFD. The probability of bankruptcy (we use bankruptcy and financial distress synonymously for the sake of simplicity) is given by the probability that, internally, cash flows could be insufficient to face the contractual commitments of creditors.
External funding comes with two primary drawbacks, namely the increased expenditure due to informational asymmetry, and the loss of authority resultant from selling shares to new stakeholders at a reduced rate or from debt agreements that contain covenants and responsibilities.
If a company announces the utilization of extra bank debt, it is possible for stock prices to respond positively. This might occur because banks maintain an impartial association with entities that communicate quality information. A bank's possession of sensitive client data, ability to manage liquidity, and participation in board governance make it an appealing option for companies seeking funding of superior calibre.
When companies declare their intention of offering new shares to their shareholders, the outcome is completely distinct. The market commonly perceives these declarations in a negative manner, and it is supported by evidence that demonstrates a notable unfavourable response from investors. One can obtain debt through either a public offering or a private placement.
It can be logically argued that private placements, being inherently more focused than public debt, carry two significant benefits: firstly, they enhance the influence of external parties in the organization, and secondly, they offer greater adaptability in case contract alterations or reorganizations are deemed necessary.
Companies that have less of an informational discrepancy tend to opt for public financing more often, while small, nascent, and family-run companies opt for intermediated debt solutions more frequently. After confirming that uneven access to knowledge incurs an expense, our subsequent objective is to identify the most economical funding method concerning this issue. Undoubtedly, internal financing is the unquestionable winner as it does not involve any complex processes.
The main benefit of it is its straightforwardness. The subsequent step would be to acquire debt, but it should entail low-risk and have ample assurances and conditions in place to limit the creditors' risk and make it more acceptable to them. After that, more hazardous types of liabilities and mixed securities are pursued.
The final step is the increase in capital, as it tends to be viewed as an unfavourable indication without any further assessment. Their top priority is securing funds through internal financing.
Due to fluctuations in earnings and investment prospects, firms may need to utilize their cash reserves. In case there is insufficient funds and there is a need for external financing, risk-free bonds are offered. Credit lines remain accessible in order to enable their utilization whenever necessary.
If a company is unable to rely on conventional loans, it will release securities in a stepwise manner, beginning with the least hazardous type and gradually progressing up the hierarchy. In the event of all other attempts being unsuccessful, the organization resorts to releasing shares. The corporate manager chooses financing options with caution and without much enthusiasm, as they all have similar costs in relation to their risk. The hierarchy is established through the principle of minimum exertion. It is unnecessary for managers to seek internal funding increases and they will continuously try to reduce inter mediation expenses, as these expenses are at their maximum value on share releases.
The individual engaging in simulations of the principal financial parameters, with the aim of discerning the variances stemming from utilization of debt versus equity financing, must bear in mind that said simulations predominantly reveal the effects of financial leverage:

- raising the breakeven point; .
- accelerating EPS growth;

- increasing the rate of return on book equity;
- degrading solvency; .
- affecting liquidity in a way that varies with the term of the debt.

Going beyond the debt–equity dichotomy, the quest for financial flexibility will require the finance director to open up different capital markets to the company. If a company maintains communication with bond investors and has already released securities on the bond market, it can easily return to the market to take advantage of investment opportunities that may arise. The wide range of financing options available, including bank loans, securitized receivables, bonds, convertibles, and shares, give organizations the opportunity to increase their financial agility to a greater extent. However, there are two constraints that hinder the effectiveness of this approach. To guarantee ample liquidity for investors, problems affecting various markets have to be significant in size. Having numerous diverse sources of funding, potentially at various levels within a group organization, creates a more complicated capital structure, which can be challenging to handle, especially in times of limited cash availability. Although it may be challenging to determine its exact worth, having the ability to be financially flexible is deemed valuable.

If the cost of capital differs by source of funds, the availability of finance will likely have an effect on the investment practices of some firms. In financing hierarchy models like, the availability of internal funds allows firms to undertake desirable investment projects without resorting to high-cost external finance. In addition, to the extent that a firm seeks debt finance at the margin, greater internal cash flow enhances its balance sheet and net worth positions, lowering the cost of new debt.

When deciding between using debt or equity, there is no perfect answer. It depends on many things. Companies choose when their debt is due based on making sure it matches up with their ability to pay and to avoid the risk of needing to refinance during tough time.

2. OVERALL ECONOMIC SITUATION

When interest rates are high and the economy is not growing much, companies will want to reduce their debt. If the economy is growing fast or the interest rates are low, it will be easy to borrow money.

The inclination to maintain a certain degree of financial adaptability in order to promptly capitalize on any potential investment prospects. Equity financing is an advantageous method for raising capital as it enables the augmentation of borrowing capacity and avoids any potential constraints on future decision-making. In contrast, in cases where the current borrowing capacity has been exhausted, equity remains as the sole means of financing, the availability of which is contingent upon the stability of share prices. However, the guaranteed assurance of such stability is not always a given.

Industry maturity and competitors' capital structure determine financing options for start-ups (equity) and established companies (borrowing). Businesses copy each other to avoid being left behind.

Opportunities for obtaining financial assistance. Creating a reliable financial plan for things that are inherently uncertain and unexpected can be a challenging task. When these situations arise, the ability to obtain funds at a lower than average cost becomes feasible, however, investors who have misguided themselves end up paying the price.

Shareholder preferences. Some will favour borrowing so as not to be diluted by a capital increase in which they cannot afford to participate. Others will favour equity so as not to increase their risk. It is all a question of risk aversion.

If someone is trying to predict financial outcomes by using different methods of funding (borrowing or investing), they need to understand that the results will mostly show how borrowing money affects the company.

After the company decides how much money they will borrow versus how much they will get from investors, the financial manager should think about other ways to arrange their capital structure.

The main things that decide how the organization will set up its finances are when the payments are due, what the payments are based on, and what currency they will be paid in. When it comes to making decisions about three things, you can use either the "matching principle" or the "hedging principle". These principles help you pick the best way to borrow money so that you can pay it back at the right time.

The design of capital structure depends on maturity, basis, and currency. Follow the 'matching principle' or 'hedging principle' to align debt with cash inflows/outflows.

3. CONCLUSION

If the objective is value creation, the choice of investments is much more important than the choice of capital structure. Because financial markets are liquid, situations of disequilibrium on them do not last. Arbitrages inevitably occur to erase them. For this reason, it is very difficult to create value by issuing securities at a price higher than their value. Is there a ‘‘once-and-for-all’’ optimal capital structure? The answer is clear: no, the optimal

capital structure is a firm-specific policy and changes across time. At the same time, there are a few loose ideas on the subject that the reader will have absorbed. Otherwise, how could one explain why the notion of what constitutes a ‘‘good’’ or ‘‘balanced’’ capital structure should have changed so much, and so often, over the course of time? In other words, a company that has made investments at least as profitable as its providers of funds require will never have insurmountable financing problems. If need be, it can always restructure the liability side of its balance sheet and find new sources of funds. Inversely, a company whose assets are not sufficiently profitable will sooner or later have financing problems, even if it initially obtained financing on very favourable terms. How fast its financial position deteriorates will depend simply on the size of its debt.

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