

## OPTIMAL FINANCIAL STRUCTURE, BANKRUPTCY RISK AND THE RIGHT TO A NEW BEGINNING

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### 1. Contents of the financial structure and notions about the bankruptcy risk

The fundamental objective of any economic entity is to obtain profits in the conditions of maximization of enterprise value and minimize the risks associated with the business. Optimizing the financial structure of the enterprise is a perfect correlation between personal capital and borrowed one, defined in terms of yield and risk so that the value of the enterprise is at a maximum.

Many are the theoretical attempts of determining the optimum financial structure, but the work itself shows that an optimal financial structure or an ideal one is impossible to establish.

Optimal financial structure has evolved as a concept, over time. If in the 50s specialists in economic theory believed that the optimal financial structure requires as low a debt as possible, between the 60s-70s a "good" financial structure also had to take into account the debt up to the level of personal capital. Starting with the 80s a good financial structure should lead to a progressive decrease of the degree of indebtedness, improvement of self-financing and financial profitability.

The large risks involved in increased indebtedness as a method of financing, in the sense of the risk that the enterprise can no longer meet the payment obligations, can attract the company's insolvency.

Business activity is always subject to risk, but risk should not be seen as something bad, it must be known and managed.

The main risks are related to the loss of the amount invested and, implicitly, the loss of the business. Any

business involves the materialization of investor expectations, manager's expectations, which can become true or not.

The degree of risk becomes even more powerful in the current economic crisis, when it is impossible to determine and anticipate changes in the environment. In similar circumstances managers take different decisions, some companies have profits, others bear losses. There are views according to which there are no profitable and unprofitable businesses, instead businesses are well managed or poorly led. The failure or the success of their business ultimately depends on the ability of the management to take effective decisions in optimal terms, and risk is an important factor in the decision-making process.

Risk can induce extraordinary opportunities for those who know how to manage it. The answer is not complete avoidance of the risks, risk avoidance, but avoiding the little understood risks.

However, with the development of the ideological economic ensemble, there was a significant increase in terms of determination, calculation and handling of risk.

In recent years, in global practice, the concept of risk management has become highly developed and enjoys a tremendous attention.

Gains have worked as a barometer of performance in the past, with little attention granted to the risks assumed for those earnings. The general trend is that sophisticated investors have focused more on the quality gain, better assessing the relationship between risk and gain.

Depending on the way in which risk is formed, it is:

- economical risk, representing the inability to adapt in time and at less cost to the variations of the environment.

- financial risk, it is related to the degree of indebtedness of the economical agent.

- risk of bankruptcy (of insolvency), representing the inability of any businesses, banks to face the obligations come to maturity.

In the system of financial-economic analysis, the analysis of the enterprise's capacity to be solvent and to overcome the risk of bankruptcy occupies a central place.

Any disorder of the payment obligations generates prejudices and requires urgent intervention. Financial balance is absolutely imperative, that can not be missed under any motivation.

In economic practice, we can conceive that a business going through more difficult times temporarily gives up some objectives for growth, economic or social ones, but it can not renounce the goal of ensuring solvency, which is the financial condition of survival.

The company's ability to meet with the obligations on time is assessed differently, according to the concrete economic and financial conditions of activity.

An enterprise may have occasional or temporary difficulties caused, for example, by the non-payment, on time, of an important debt or by the accelerated payments in a period of rapid increase in activity.

In this case, payment difficulties arise as an expression of temporary differences, which do not affect the image of the enterprise.

Simple solutions can allow to overcome these difficulties and to reinstall the continuity of payments: obtaining additional terms from the suppliers, delaying financial debt, obtaining short term loans.

The enterprise may meet periodic financial difficulties, for example

late payments at certain times of the year or periods of accelerated growth.

Even if the viability of the business is not put in danger, its image can degrade due to periodic disturbances.

Permanent difficulty of sustaining the payment of obligations is an expression of economic and financial structural fragility.

They can generate restriction of activity, reduce the number of employees, restructuring of management or in very serious cases, the bankruptcy.

Ignoring risk or treating them superficially can lead to some major financial difficulties or even bankruptcy of the firm.

It is necessary therefore to call to the appropriate instruments for the prediction of the risk of bankruptcy, to provide the decision-maker with the possibility of identifying in advance the symptoms of financial difficulties, reflected, usually in the degradation of the financial situation and the level of financial rates.

The study of firms in difficulty is particularly important today in our country, being of interest to banks, which are concerned with the quality of loan portfolios held by them, and for different categories of shareholders, investors, creditors and business partners.

The main problem arisen by the practice is to choose the moment to begin the liquidation procedure, which should not be neither anticipated nor delayed too long. If the moment will be set too early, the enterprise will not be able to search for easier recovery solutions and will suffer irreparable loss of image.

Economic theory provides us with a number of means by which professionals propose methods for determining the risk of bankruptcy.

These include: risk analysis of bankruptcy based on patrimonial balance, risk analysis of bankruptcy rates based on solvency, bankruptcy risk analysis based on scoring method.

## 2. The right to a new beginning

Global economic crisis and the financial disaster that struck companies in the world have made financial analysts to be more careful when giving information or making estimates about the financial statements. They now avoid using too hard terms in their lectures, which may lead to the collapse of society in a time when tensions on financial markets are enormous.

For most investors the financial crisis we have been crossing in the last months was also an opportunity to learn more about how an economy works.

However for specialists, in this period, it offered a real lesson in semantics.

Each day comes with new happenings which show that most financial services companies are particularly vulnerable to decreasing levels of confidence among creditors, business partners, investors and customers.

For this reason, the rumors, fears and speculation released in the press can seriously affect a company in a very short time.

Consequently reporters and editors, so often accused of exaggeration and of alarming the financial system when it is not necessary, are in the position of choosing their words very carefully.

In most articles we see such actions called "slide down", and markets go "down", in any case we no longer use words like "crash". Companies are "shaking" or "are in difficulty", rather than towards collapse or bankruptcy. We are trying to avoid as much as possible the use of words like "crash" or "free fall", said Ali Velshi, a business correspondent at CNN, adding that "if someone wants to say that markets are in free fall, we prefer to discuss this first", and the result will most likely be a change in the words.

Specialists say that there is a significant difference between their duty to make public what is happening in

markets and banking institutions and the rumors which are causing panic. In fact, "panic" is the word that occupies the first position among the terms which the news agencies have avoided to use, since it can lead to a so-called self-fulfillment of bleak prophecies. "Crash", "panic", "hell", "apocalypse" are just some of the terms we are trying to avoid.

At the same time, none of the specialists want to be accused of making the dangers seem insignificant.

On the first page of financial publications, the financial crisis appears to be the most serious since the Great Depression, and newspapers prefer to show every day titles that occupy the full width of the page, after not having resorted to this method of promotion for some time.

If car manufacturers and real estate developers would face problems, for example, the main question for those working in the media would be: "Who's next?".

But now journalists have become very cautious in launching predictions regarding the possible bankruptcy of some financial institutions - in fact, several articles written during the autumn of 2008 and which predicted the collapse of certain banks have avoided saying which one was more exposed to this risk.

Sometimes you can not avoid stating the names, as in the case of rumors related to the development of "KRAFT FOOD", which occurred several months before the financial institution declared itself bankrupt, but even then journalists tried to not make predictions. In the middle of summer 2008, an article in the FINANCIARUL described "KRAFT FOOD" as "in distress" and "unsafe", but does not explicitly mention the possibility of collapse or bankruptcy. No further than November 2008 the company "closed the chocolate factory in Brasov."

We can not avoid describing in real terms the situation and the fact that it was really in trouble", "said Realitatea.net, adding that "but we will not say that there are three or five institutions that may fall next week."

It is one thing to say that an industrial company is having problems in paying the debts, and is something else to say this about a financial institution.”

The situation has not changed at present, but in the last few weeks, reporters from ANTENA 1 began to emphasize the fact that part of what they said was other people’s opinion, and that the source which issued the piece of information could later motivate the reasons for the statements and if the is not consistent or may prove wrong.

On the other hand, almost half of the employees in Romania can not sleep because of the stress at work, shows a study conducted by “**Sinectik**”, specialized in market studies, opinion polls, sociological studies, a global provider of e-learning . According to the analysis, at the beginning of a year which is announced to be difficult, 92% of Romanian employees are stressed at work, while 31% fear that in 2009 they will be overworked.

Also, because of stress, almost one third of employees in Romania have become very emotional, while 15% began to drink in order to cope with the pressure.

There is a feeling of insecurity regarding job stability, and people are nervous because they do not think they have the qualities needed in order to maintain their jobs. The study also reveals that almost one quarter of employees feel that they lose control over the day, one third feel frustrated by the atmosphere at work, while 15% think that they didn’t have enough hours of training to enable them to do their job as they would wish.

The study was conducted in late November 2008, on a sample of 3,000 respondents from 14 business sectors.

Recession in Romania is more severe than anticipated by the government, which admitted being wrong when estimating that the local economy will recover by the second half of this year.

I believe that now must wait until the end of this year or early 2010 to see a return on growth of the economy.

The Government estimates for this year a decrease of 3% of the economy, a forecast that might be announced by the authorities with the presentation of the budget. The new projection shows the most pronounced economic decline after the Second World War.

Romania's economy will face, over the next year, a record level for the past three decades, while housing prices are reduced at their fastest pace after 2002, according to “**Sinectik**”.

The rapidity and global nature of the crisis suggests that it is almost impossible to make certain previsions for the future.

What is clear now is that the short and shallow recession we expected a few months ago could be deeper and longer.

The Governor of Bank of Romania, Mugur Isărescu, declared that Romania is probably in the midst of a recession, just one week after the central bank’s strategy diminished the interest of monetary policy by 1.5 percentage points.

The Romanian Leu depreciated strongly, reaching the lowest level of trading in relation to the euro, as investors had relied on the fact that the deterioration of the Romanian economy would intensify.

Global financial crisis has led banks to reduce the number of loan contracts in order to preserve capital.

Approvals for mortgages have reached the minimum level in January 2009 and the prices of houses have decreased by 15% in February, announced the National Bank of Romania.

**Sinectik** anticipates that Romania will suffer a difficult economic downturn, but believes it should avoid a major collapse, due to relatively low debt of the private sector and reduced

dependence on external trade, states Mediafax.

There is ample evidence that the economy is at present at a slow rate, and it is happening rapidly.

The export-oriented sectors are reducing production and the construction industry is going worst. Liquidity on the local market has improved somewhat compared to the month of February, but the National Bank of Romania still maintains high interest levels, in order to support the currency. In such a situation **a second chance after the bankruptcy** is an option which must be exercised by investors.

For example, the European Commission wants to encourage those who go bankrupt to try again. EC is measuring the costs of prejudices that are attracted by bankruptcy and is analyzing four groups of barriers for the creation of a new business after bankruptcy.

The premise for the Commission's Communicate is that bankruptcy is not necessarily a symptom of fraud, and the past mistakes tend to make the entrepreneurs wiser.

The European Commission proposes four major approaches for removing the stigma attached to bankruptcy:

- changing mentalities: improving public image through education and media;
- the role of insolvency law;
- active support of companies who are risking bankruptcy;
- active support of those who want to reopen their company.

EC shows that although only one of 20 bankruptcies involves fraud, the European public tends to believe that those going bankrupt are corrupt. But bankruptcy is a natural phenomenon of the market economy.

Germany presents an example of good practice in encouraging the principle of the second chance for establishing a business. German Agency for enterprises set up, two years ago, a START prize for the creation of new

companies, which has a RESTART division, for those who set up a company after they went through a bankruptcy.

The Commission's view on **insolvency law** is that in many EU Member States bankruptcy law treats all bankruptcies in the same way, whether they are accompanied by fraud or not. There are also many restrictions for people who go bankrupt, and the procedures for the reestablishment of a company are more cumbersome.

The Commission shows that it is vital to create a legislative framework which, while protecting the interests of all parties involved, should recognize the right of a contractor to slip and start again. This means that bankruptcy laws should include a clear distinction between the treatment of fraudulent bankruptcies and of the others.

For example, entrepreneurs who have not made any kind of fraud in bankruptcy may receive in court a declaration of non-fraudulent bankruptcy.

For example, in Great Britain, all those who go bankrupt are subject to restrictions during the legal proceedings for bankruptcy, but after this period the restrictions are removed for those who have not committed fraud.

The European Commission provides solutions and support for those who want to reestablish the company by providing financial support, ensuring the possibility of those non-fraudulent bankrupt companies to contract loans, or by ensuring equal access of these people to public auctions.

### **3. Conclusions**

Although finding the optimum financial structure of the enterprise is a difficult goal to reach for most businesses, financial management is required to regularly and frequently monitor the financial situation of the company in situations of economic crisis, to determine the most appropriate methods for predicting bankruptcy, and if this undesirable phenomenon should

occur, to be ready for a new beginning, a new approach of the business.

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