Topic 2: Financial Mechanism

1. Structure and Functions of the Financial Mechanism.
2. System of the state financial funds.
3. Administrative methods of financial management.
4. Economic and financial leverages.
5. Financial structure of the enterprise.
6. Institutions and organisations involved in the area of financial activity.

REFERENCES

Andrei MULIC, Galina ULIA
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Didactic purposes:

* *Definition of the essence of the **financial mechanism**.*
* *Classification of the **enterprise capital**.*
* *Understanding of the **basic structural elements** of the financial mechanism.*
* *Classification of **monetary funds.***
* *Knowledge of process of formation the optimal financial structure.*
* *Comparison of financial forecasting methods.*
* *Analysis of the financial leverage effect.*
* *Identification of economic financial leverages.*

Keywords: *economic mechanism, financial mechanism, state financial funds, financial forecasting, financial instruments, financial leverages, financial methods, own capital, extra capital, financial leverage.*

1. The structure and functions of the financial mechanism.

* The financial mechanism represents a set of processes, the technics and instruments of regulation of social and economic activity. The financial mechanism represents the way of the organisation of financial cash flows and a methods of accumulation, distribution and use of monetary funds.

The basic structural elements of the financial mechanism include:

* 1. Financial funds,
* 2. Financial leverages,
* 3. Methods of financial management,
* 4. Financial discipline control authorities,
* 5. Financial legislation.

The main functions of the financial mechanism include the accumulation of the necessary financial resources for principal and non-principal enterprise activities, and also the control of their use.

2.The system of the state financial funds.

* **The system of the state financial funds** is a basis of the financial mechanism at the level of any country which reflects the general set of the monetary funds being in close interrelation.

There are following categories of monetary funds:

- **1) Depending on property type:**
- 1.1 The state financial funds (the pension fund, budgetary funds, off-budget funds, insurance funds, credit funds, financial funds of the state enterprises);
- 1.2 Private financial funds (funds of the enterprises with the private capital, insurance funds of the enterprises, investment funds of the enterprises, reserve funds).
- **2) Depending on the level of the administration of funds:**
- 2.1 the centralised funds (at macrolevel);
- 2.2 the decentralised funds (at enterprise level).

* **3) Depending on the role which is carried out in the course of reproduction:**
* 3.1 investment financial funds;
* 3.2 financial funds for consumption;
* 3.3 social financial funds.

* **4) Depending on the purposes of the use of financial funds:**
* 4.1 financial funds for the current consumption;
* 4.2 financial funds for replacement of fixed assets or financial investments.

* **5) Depending on the rights of use of financial funds:**
* 5.1 financial funds at the disposal of the state (the public central administration, authorities of the local public government, the state enterprises, finance of the state banking institutions etc.);
* 5.2 funds at the disposal of private economic agents.

3. The administrative methods of financial management.

* 1) Financial forecasting - activities for development of financial plans in which volumes of necessary financial resources are reflected, as well as forms and methods of their mobilisation ; certain financial indicators, proportions and sums of the monetary funds used in the operational and non-operational purposes.
* *Methods of financial forecasting*:
* A) a balance method – making the financial plan in the form of balance which includes the income and expenses.
* Б) a standard method - expenses are estimated with the help of certain norms and standards.
* *Instruments of financial forecasting:*
* A) norms of inventory holdings
* Б) norms of amortisation (depreciation);
* В) norms on expenses and costs.

* 2) <u>Financial control</u> - activities to check the observance of the legal norms regulating the financial activity. The main object of financial control are processes of formation, use and distribution of financial resources within the national economy.

4. Economic and Financial leverages.

- **Economic and financial leverages** – are the financial instruments of the state, for impact on the economy or on separate subjects for realisation of definite purposes or for the purpose of stimulation of a certain direction of development.

Financial leverages can be

- 1) <u>based on special categories of public finances</u> (certain technics of withdrawal of financial resources in favour of the state for the purpose of their subsequent distribution);
- 2) <u>operating at enterprise level</u> (the price, tariffs, a profitability rate, an exchange rate, profit, profitability, penalties, amortisation).

The financial mechanism is a set of methods, leverages and instruments, and also procedures of formation, accumulation and management of the enterprise capital.

Classification of financial instruments:

- **1)** Primary (money, securities, receivables and payables);
- **2)** Derivatives (financial contracts, futures, swaps, options - on purchase of currency or securities).

* **Financial methods operate in two directions:**
* 1. In the direction of management of financial resources;
* 2. In the direction of stabilisation of the commercial relations based on the equilibration of expenses and received resources, material stimulation and effective use of financial resources.

* <u>The basic structural element of financial methods</u> are financial leverages of management which include the credits, the income, dividends, depreciation charges, portfolio investments (at the investment of 30000 lei in one bank, there arises the essential risk of loss of this sum while the sum division between three different banks into 10000 lei, the risk to lose all the sum is minimised), an exchange rate.

5. The **financial structure of the enterprise.**

- **The classification of the enterprise capital :**
- 1. Own capital (Shareholders funds) - is formed as well as from external (contributions of owners, financial resources of the state), and of internal sources (retained income (profit), reserves, funds).
- 2. The loan capital – is divided into 3 categories:
- 2.1 *Long-term debt funds* (> 5 years) - investments in fixed assets:
- · bonded loans,
- · state loans,
- · bank loans.
- 2.2 *Medium-term loans* (1-5);
- 2.3 *Short-term loans* (<1 year).
- 3. The permanent capital – own capital + the long-term loan capital which covers the need for long-term assets.
- 4. Treasury resources which are formed at the expense of the bank short-term credits, commercial credit and exist for a covering of a part of the current assets.

* In the simplified form the financial structure can be presented by the relation of the own and debt funds.

$$\boxed{\text{Financial structure}} = \frac{\text{own capital (Shareholders funds)}}{\text{loan capital (borrowed capital) (Non-current liabilities + current liabilities)}}$$

In the course of formation of optimal financial structure it is necessary to calculate a number of financial performance (**indicators of debt level**):

* 1. *Factor of the general debt:*

$$\frac{\text{liabilities (Non current liabilities + current liabilities)}}{\text{Passive balance (Total shareh. funds \& liab.) sources of funds}} \leq \frac{2}{3}$$

$$\frac{\text{liabilities (Non-current liabilities + current liabilities)}}{\text{own capital (Shareholders funds)}} \leq 2$$

2. *Factor of long-term debt:*

$$\frac{\text{Non-current liabilities } (\textit{long-term debt})}{\text{permanent capital}} \leq \frac{1}{2}$$

* **permanent capital = own capital (Shareholders funds) + Non–current liabilities**

$$\frac{\text{Non-current liabilities } (\textit{long-term debt})}{\text{own capital (Shareholders funds)}} \leq 1$$

* If the enterprise reaches the maximum values of these indicators, it means that the enterprise has reached the maximum level of debt and cannot obtain the credits any more.
* It is enough, that one of the presented indicators exceeds the norm and the operation on crediting cannot be carried out.

The effect of a financial leverage represents positive or negative result which is received by the economic agent as a result of use of the loan capital, and is calculated according to the following formula:

* EFL=$\frac{borrowed\ capital(\text{Non current liabilities + current liabilities })}{\text{own capital (Shareholders funds)}}$* (Re-D)
* D - the cost of debt capital (cost of credit)
* Re-Economic rentability is characterised by efficiency of the means used in the process of production, despite the fact it is own or loan means.
* Re=$\frac{P/Lbefore\ tax(profit\ before\ tax)}{Total\ assets}$*100%
* Value of this indicator can be and negative.

6. Institutions and organisations involved in the area of financial activity.

Institutions

Non-specialized institutions

executive authorities	legislative authorities
President,	Parliament
Government,	municipal Concilia
City Hall	local Concilia

specialized institutions

at the macroeconomic level

National Bank, Ministry of Finance, Chamber of accounts, Tax Inspection, Anticorruption Centre

at the microeconomic level

financial departments of private and public enterprises