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Make Harmony Between Technology and Nature, and Your Mind will Fly Free as a Bird

SELF - FINANCING – THE MAIN SOURCE TO FINANCE AN ECONOMIC ENTITY

LESCONI FRUMUSANU, N[atalita] M[ihaela]; BREUER, A[dela]; LIGHEZAN BREUER, B[eatrix] G[wendolin] & JURCHESCU, M[ihai] D[orel]

Abstract: *In the present paper we tried to highlight the importance and the results of self-financing for the economic entities, defining and outlining the importance that the capitals do have in the development of the companies, and emphasizing the possibilities of self-financing through the use of the capital elements.*
Key words: *capital, self-financing, profit, self-financing capacity*

1. INTRODUCTION

Starting from the main purpose of economic entities, that is to make profit, and survival on the market, each economic entity depends on available funding. Financial policy adopted by the company may result in a profitable activity, or, on the contrary, due to an erroneous management and financial policies, it can lead to insolvency and bankruptcy.

A sound financial policy's primary purpose is to follow the burden that financing and debt funds have upon the whole resources of the economic entity.

The main element is treated as capital funding, which is seen as "a sum of money or wealth, due to generate an income over time."

There are also approaches which sustain that capital is defined in two ways, namely the economic, as the total production of durable goods used in production of other goods, and in terms of funding sources, capital is regarded as the amount of money invested by shareholders, in return they receive shares in the entity.

IASB's framework for preparation and presentation of financial statements (IFRS, 2009) gives the possibility to choose the financial statements between the two forms of capital presented, financial and economic respectively, indicating that the concept chosen indicates the determination of profit objective. Romanian legislation (OMFP 3055, 2009) does not entitle a choice between the two concepts of capital, providing that in preparing financial statements, financial entities have to adopt the concept of capital. Under this concept, capital is synonymous with net assets or equity of the entity, achieving profit only if the net asset value at the end is higher than the net asset value at the beginning of the period, after excluding any distributions to owners and any contributions from owners during the period.

In terms of sources of capital, it is divided into equity, from their own funds, and permanent capital, which, in addition to equity, also includes long-term loans.

Equity is defined as the residual interest of shareholders in the assets of an entity after deducting all liabilities. Given that equity funding source is internal, as constituted within (Ristea, 2009): share capital, share premium reserves, reserves, ±retained earnings, ± the result of financial year, -profit-sharing, -own-shares, ± earnings / losses recognized as elements of equity, + minority interests.

The importance of equity within the financial structure of an economic entity derives precisely from the desire that, the integrity condition of wealth requires that the size of equity have the highest share in total capital. Starting from the general equation of equilibrium patrimony:

$$\text{ASSETS} = \text{EQUITY} + \text{LIABILITIES} \quad (1)$$

and given the weight that equity capital must have within the total equity capital, we shall have:

$$\text{EQUITY} \geq \text{LIABILITIES} \quad (2)$$

Respecting correlation (2) provides the opportunity of the entity to honour its obligations at any time to third parties, i.e. to ensure the financial independence of the economic entity.

The second category of capital, the **permanent capital** is the result of summing equity with medium and long term loans. If internal financing should take into account the entity's financial policy, then we need to talk about political funding when the economic entity shall determine the amount of external financing by resorting to loans.

2. ECONOMIC ENTITIES' SELF-FINANCING

Positive financial results that the company records during the normal course of business economic exploitation, are the first resources to be used for development work. From these resources self-financing is realised, which requires "that [...] the entity ensures its development by using positive financial results, obtained in earlier years" (Cucoşel, 2010).

Some authors relate self-financing as "the enrichment of the company as a means of financing from own resources, which will strengthen its financial structure, increasing working capital"(Petrescu,2010). Starting with the way of constitution of the self-financing process, that is when the shareholders waive to dividends so that the economic entity can use its profits, the idea emerges that "self-financing involves prioritizing saving actions in a company"(Imbrescu, 2010).

In conclusion, we agree that self-financing represents the process of enriching the economic entities by using the positive financial results obtained in the previous financial exercises, due to the fact that the shareholders waive to dividends in order to strengthen the financial structure of the entity.

In order to achieve self-financing the following techniques are used:

- detention or retention benefits;
- a benefit policy allowing self-financing;
- use of available funds;
- use of temporary resources, having as major sources *the depreciation*, *the provisions* and *the net income*.

Self-financing process requires firstly that, in order to develop an activity, the economic entity makes a series of expenses, and secondly, it obtains receipts from the sales executed simultaneously and from financial incomes (interest, equity, income liquidation of assets, etc.). Costs refer to current tasks of the operation (raw materials, wages, taxes, etc.), as well as financial expenses and exceptional expenses.

The difference between revenue and expenses (excluding depreciation) will acquire different destinations (corporation tax, dividends, workers participation to profits). The remaining part will be assigned to the company, i.e. the depreciation and the reserves fund will be created.

Self-financing can be viewed from two perspectives:

- ✓ Self-financing of maintaining the property level – it refers to those amounts placed on hold as they will be used in future in order to maintain the level of net assets. Among the self-financing sources used to maintain the self-financing, the main importance is given to normal depreciation which corresponds to actual loss of property value, along with special and depreciation provisions, notably those created to cover price increases.
- ✓ Self-financing to increase net assets - is established as part of the gross self-financing exceeding the capital required for the recovery of capital assets and fully used and which generates an increase of assets as well as of the shareholders' wealth. Net self-financing consists primarily of undistributed profits and reserves (legal, statutory and other reserves), not assigned until the redistribution, i.e. those that remain after deduction of tax benefits, dividends, salary incentives.

Because self-financing sources is determined by the growth of sources obtained from its work and will remain permanently available to the economic entity to finance future work, it depends on two factors:

- ➢ Surplus of financial resources, represented by self-financing capacity;
- ➢ The share of these resources distributed to shareholders as dividends.

The Self-financing capacity is represented by the part which belongs to the company after having paid its partners: staff (salaries), state (taxes), creditors (suppliers and other creditors), shareholders (dividends), and is designed to provide the financing of certain financial needs, increase in working capital, funding new investments, etc.

It results that self-financing is determined by the formula:

$$\textbf{SELF-FINANCING} = \textbf{Self-financing capacity} - \textbf{Dividends distributed} \quad (3)$$

In determining the level of **dividends to shareholders**, the following issues should be considered:

- too low a shares level would definitely displease shareholders
- too high a shares level would affect the company's ability to ensure its financial resources, which would lead to lower self-financing.

Very often self-financing is considered to be free. But self-financing consists primarily of net income reinvested and switched to reserve. As long as reinvested profits remain in the reserves, we can say that shareholders do not ask directly for remuneration of reserves (but only of the old shares). Incorporating reserves in the capital and allocation of free shares, the profits reinvested become directly remunerative. Thus, self-financing costs by switching back profit is equal to the cost of equity.

The importance of self-financing for the future development of economic entities is linked to some essential aspects in maintaining the company on the market, namely the financing activity:

- ✓ The entity is privileged through self-financing because, in order to achieve economic growth it does not need to rely on external funding sources or to convince shareholders to buy shares or to increase the nominal value of existing shares, nor on capital or financial market;
- ✓ Using their own benefit for development (increase of equity), a higher degree of independence against banks is also carried out;
- ✓ Shareholders benefit without making any financial effort, because the stock value and the shares value of the economic entity increase, thus increasing the shareholders' wealth;
- ✓ Make a lower tax because the total profit achieved by the economic entity is taxed less because it is used for development, thus being exempted from tax or impose a lower tax rate;
- ✓ The self-financing capacity can be used to determine a series of indicators that will tell the entity's position and financial situation, such as its financial debt repayment capacity, coverage rates for the income year, the rate of investment financing, rate cover dividends, etc..

3. CONCLUSION

In conclusion, the economic capital of the entities has a particular importance, from the company's establishment until its disappearance of the market, due to its many uses, the most important being: the social capital losses and the use of other parts of the capital. Also, on self-financing terms, we believe that these represent the enrichment process of the economic entity by using positive financial results achieved in earlier years due to shareholders giving up deliver dividends in order to strengthen the entity's financial structure. We believe that, before resorting to external financing, by obtaining bank loans or other sources, companies should use effectively all internal sources of financing, thus highlighting once again the importance of self-financing.

4. ACKNOWLEDGEMENTS

The empirical studies, conducted in various entities, revealed that self-financing is not a priority approach to ensure funding sources. Thus, we propose to stress upon the importance of this means of funding, primarily through increased self-financing concept in law and literature, and secondly through practical examples to show the benefits of using domestic sources of financing, such as reducing costs with fees and interest, simplifying information systems, reducing workload, etc..

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