

# IMPLICATION OF DECISIONS OF FINANCING POLICY ON THE FINANCIAL PROFITABILITY AND STABILITY OF THE COMPANY

**Pop Mugurel Gabriel Sorin**

*“Dimitrie Cantemir” Christian University Bucharest Faculty of Economic Sciences of Cluj-Napoca*

**Stăneanu Gheorghe**

*“Dimitrie Cantemir” Christian University Bucharest Faculty of Economic Sciences of Cluj-Napoca*

*The present study aims at analyzing the influence of decisions on financing policy of the current activity on profitability and financial stability of the company.*

*Of course, the realization of such a research is not possible without a pertinent analysis on the concepts expressed in the literature of this field. In relation to this matter, we find that each author has his own concept about the subject under review. These expressed views, based on previous research, are related to the domain under analysis.*

*Our research is in the current phase, a theoretically applied one. It is based on the comparisons we make between different means of financing the company's current activity. We are convinced that an accurate determination of the influence of decision on financing policy on the profitability and financial stability, helps the financial management, by facilitating the process of adopting the most appropriate funding decisions.*

*Our research results are outlined in the information provided on financial management of the company that will lead to a better substantiation for decision-making policy-related process on funding.*

*Key words: policy of funding, decision, modalities of financing own resources, attracted resources, self-financing, leverage ratios, influence*

*JEL Code: G 32*

## **1. Introduction**

In the structure of own and attracted resources we include the part of the net profit allocated to self-financing, amortization for tangible and intangible fixed assets in operation, undistributed profit for the financial exercise, legal and statutory reserves and provisions not yet incorporated in the capital, increase of own asset value from revaluation and certain operating liabilities. Such conception is found in the work of other authors (Chebac 2008: 406) with interests in financing arrangements for company activity.

Using a part of the net profit for the current financing and afferent amortization of tangible and intangible assets related operating that compose the resource, in which the economic and financial theory and practice (Brezeanu 2009: 208; Bistriceanu, Adochiței & Negrea 2001: 229; Toma & Alexandru 2003: 112), is known as *self-financing*.

Self-financing is generally the pivot of firm's finance and for some of them it is the exclusive source of funding in critical phases of development. The fundamental nature of this resource holds to the fact that this is the item under which the external funding will be sought and attracted by the firm. This status of self-financing takes into two fundamental reasons, namely:

- on one hand, its size (in absolute and relative value), which provides information about the company's performance. A high self-financing assures the financial investors on possible financial compensation and enhancement, by the company, of the funds that they have invested and will invest in the future;

- on the other hand, self-financing creates the company's debt repayment capacity and provides a measure of risk, which lenders of funds assume.

According to almost unanimously accepted opinion, self-financing capacity reflects the financial potential released by profitable business activity at the end of the reporting period, intended to pay for own capitals (in dividend payment) and to finance expansion investments (share of profits set aside in reserves and fund of development). At the same time, it shows us the way to use amortization as the main pathway for renewal of physical assets in future financial exercises.

In essence, self-financing capacity is an indicator that expresses the company's financial independence, reflecting a potential or actual flow of availability. Its size depends on one hand on the profitability of the company and on the other hand, on the firm's investment policy and methods of amortization of fixed assets. Regardless of the intensity of amortization process (resulting from the applied amortization methods), the amortization included in costs and recovered through sales entirely becomes a self-financing source.

## 2. Financing current activity

The whole economic and financial activity of the company, directed to reaching its goals, runs on a macroeconomic environment dominated by uncertainty and risk. Attitudes exhibited by macroeconomic decision factors have been copied almost faithfully by managers in the period of analysis to which we refer. Some reckless manifested by financial managers are explained by Mugur Isărescu because of two causes: "(...) first was that the decision makers felt that the "good times" came once and for all, which obviously means that the expansion of costs could be permanent. The second was the election year 2008, which boosted expenses even more. The lax fiscal policy of spending set the basis for an involuntary fiscal contraction in the event of economic downturn" (Isărescu 2010: 9).

It goes without saying that between gross profit and net profit there are differences as there are differences between total assets and own capital. To deepen the analysis of the current financing of the company Alfa we select (in the table no. 1) information based on data from the company's financial statements.

Table no. 1

**Financing of the company's current activity**

No.	INDICATORS	UM	The period of analysis			
			2008	2009	2010	2011 (preview)
1.	Global self-financing rate	%	13,90	14,19	14,14	14,88
2.	Indebtedness rate	%	22,06	14,16	12,87	13,48
3.	Financial return	%	8,44	5,80	5,10	5,56

*Source:* authors' own calculations.

Noting a decreased appetite of the firm for borrowing, we observe (according to the table of data) a timid growth to self-financing orientation. The phenomenon can be explained by the relatively low level of profit achieved by the company in the analyzed year and by the fact that all these years, the company has paid dividends due to previous administration periods. A slight recovery is expected for 2011 both on self-financing and on the access of loans appropriated to the exploitation cycle.

The findings can be presented graphically as follows:

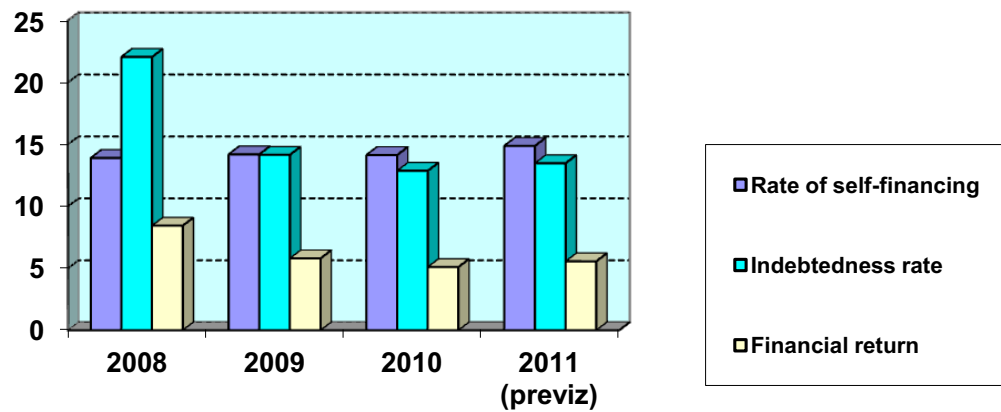


Chart no. 1. The evolution of self-financing, debt and financial return

### 3. Resources of finance of current activity. Their structure

In the period under review, self-financing with debt were important resources to cover the company's current financial needs. If the company had not had stable own resources (positive net working capital) accumulated in previous years, its financial stability would have been affected. The current status of ruling the funding cycle of exploitation of the Alfa SA company is presented in the following table (Table no. 2):

Table no. 2

Resources for financing the current activity						
No.	INDICATORS	UM	The period of analysis			
			2008	2009	2010	2011 (preview)
1.	The need for funding	%	100	100	100	100
2.	Global self-financing	%	13,90	14,19	14,14	14,88
3.	The degree of indebtedness	%	22,06	14,16	12,87	13,48
4.	Own stable resources	%	64,04	71,65	72,99	71,64

Source: authors' calculations performed by the information in financial statements.

The dynamic analysis of company's financial resources for the period under study shows the great confidence manifested in its own stable financing resources of and in the current self-financing (or maintenance) ones. We must admit that, as it happens in reality, due to permanent resources, we cover permanent needs, most of which being represented by the fixed assets. Current operating needs for the exploitation cycle are represented by the size of circulating assets. Separating the two kinds of needs we can analyze to what extent the permanent resources of the firm have been used for the ongoing needs or cyclical needs. We consider here that the cyclical needs have to be covered by cyclical resources (mainly loans), and ongoing operating needs must be covered by the continuing financial resources (own net working capital). We attempt such an analysis presenting the information in the following table (table no. 3):

Table no. 3

**Structure of own resources to finance current activity**

No.	INDICATORS	UM	The period of analysis			
			2008	2009	2010	2011 (preview)
1.	Total fixed assets	thousand lei	98.217	93.492	81.726	93.985
2.	Total ongoing assets	thousand lei	32.358	30.804	36.972	42.518
3.	Total assets	thousand lei	130.575	124.296	118.698	136.503
4.	Total self-financing + loans	%	35.96	28.35	27.01	28.36
5.	Total need covered by self-financing and loans:	thousand lei	46.955	35.238	31.790	38.712
	- for fixed assets	thousand lei	35.319	26.505	22.074	26.654
	- for ongoing assets	thousand lei	11.636	8.733	9.716	12.058
		thousand lei				
6.	Own stable resources	%	64.04	71.65	72.99	71.64
7.	Total needs to fill from the stable resources of which:	thousand lei	83.620	89.058	86.908	97.791
	-for fixed assets	thousand lei	62.898	66.987	59.652	67.331
	-for ongoing assets	thousand lei	20.722	22.071	27.256	30.460
		thousand lei				

Source: authors' calculations performed by the information in financial statements

The analysis of data from the table above indicates that due to these ongoing resources the company needs to cover ongoing needs and a significant part of cyclical needs (current assets). Because permanent needs (mainly fixed assets) have some consistency over time, the variation of cyclical needs will entail variations in self-financing needs and current loan of the exploitation cycle.

#### 4. Financial stability of the company

We will try to follow the extent to which the company's current financial stability was achieved at the expense of own resources (net working capital). For this we draw the following analysis table (Table no. 4).

Table no. 4

**Achieving the financial stability of the company**

No.	INDICATORS	UM	Symbol / Method of calculation	The period of analysis			
				2008	2009	2010	2011 (preview)
1.	Fixed assets	thousand lei	$A_i$	98.217	93.492	81.726	93.985
2.	Ongoing assets	thousand lei	$A_c$	32.358	30.804	36.972	42.518
3.	Permanent capital	thousand lei	$C_{perm} = C_p + DTL$	107.909	112.060	103.424	118.938
4.	Current liabilities (less than one year)	thousand lei	$DTS$	22.666	12.236	15.274	17.565
5.	The need for current funding resources (working capital)	thousand lei	$NFR = C_{perm} - A_i$	9.692	18.568	21.698	24.953

	needs)						
6.	Resources of coverage, from which:	thousand lei	-	9.692	18.568	21.698	24.953
	- own (working capital fond)	thousand lei	FRP = NFR - DTS	-12.974	6.332	6.424	7.388
	- DTS	thousand lei		22.666	12.236	15.274	17.565

Source: calculations based on data from annual financial statements

The presented data show that in 2008, the company lacked sufficient resources to finance their current operating activity on the exploitation cycle. This prompted the call to attracted resources that are mainly represented by short-term loans. Call for debt is generated by the fact that in 2008 the company recorded a negative net working capital (a lack of own resources for funding). The size of debt is 22.06% of total necessary resources (according to table no. 2). In subsequent years, the company intensified the call for own resources (especially self-financing) gradually giving up debt (as shown in the data of table no. 2) which will lead to the restoration of financial balance. The information provided by the table no. 4 (row 6) shows that the company has its own resources to cover their financing needs that are growing and together with borrowed resources, it will result in a policy of funding the cycle of exploitation, which is to maintain the upward trend of the expected financial return for 2011 and onwards.

Our research (supplemented by a careful study of domestic and international bibliography specialized in the field) leads us to the possibility of formulating several conclusions about the basis for policy decisions to finance the companies with the development of complex financing process and the factors that stimulate or inhibit the employment of resources, attracted in companies' own circuit.

A first observation is that the economic *sector or branch*, to which the company belongs to, influences the overall risk of debt that is the sum resulted from the economic and financial risk.

A second finding regards the *taxation level*, which is manifested in the national economy and which is not neutral in relation to financial and fiscal situation of the firm (Chen 2004: 1349).

A third finding relates to the *economic situation* and *monetary policy* promoted by financial and banking institutions. As other authors state (Reinhart & Rogoff 2012: 235-236; Mătiș 2010: 132; Manolescu 2005: 388), the credit cheapens or is more expensive as the institutions mentioned to promote an expansive or restrictive policy of credit, which directly influences the financial structure of the company.

Recent researches (Isărescu 2010: 10) have concluded that within the same sector of activity, the *size of companies* and their *asset composition* differs. According to some specialists (Reinhart and Rogoff 2012: 239-241, Rajan and Zingales 1995: 1438) these characteristics exert influences on leverage degree and ultimately on the financial return of firms.

As other authors state, (Rajan and Zingales 1995: 1439) *the company* influences the permanent or temporary resource level. By joining the assets, liabilities composition is not conditioned only by the distribution of assets in fixed or ongoing ones, but also on the liquidity degree of different asset positions. The banking financial institutions generally give more difficult loans to companies, which have a higher proportion of fixed assets, whose market value decreases with time, becoming lower to the accounting value, comparison that is made in case of reaching the insolvency (or bankruptcy).

Discussions with specialists (money managers) have created the impression that a debt rate with a higher value in the hands of competent managers may involve less financial risk than a significantly lower one managed by inexperienced managers. Competent managers will find solutions so that company can handle a high volume of loans, with beneficial implications on financial profitability. Top managers have a unique style in business administration of the company and superior ability to collaborate with banks and, at the same time, a unique way to

convince them to grant new loans (respecting the allowed limits) for the financing of companies that they run. To this, we add the importance of achieving a profit large enough so that, on the basis of management decisions with a solid argumentation, it can support both self-financing and debt effects on the company.

#### **4. Conclusions**

Based on our research we found a similar behavior of companies on policy decisions to finance ongoing operations. There is established a specific correlation between the ratio of self-financing and leverage and technological and branch particularities of the companies. In conclusion, we can say that in the financing behavior of the analyzed firm, there are shown the same attitudes in the order of priority of the call made to funding resources. Thus, current funding is provided from retained earnings at first, then from own capitals and, ultimately, by calling on bank loans.

Regarding the restoration of financial balance (if needed) the firm calls for intervention of banks (using credit limits in the company's treasury), observing a slight tendency of development of business operations on the capital market through exchange operations.

#### **5. References**

##### **Books:**

1. Bistriceanu, Gheorghe, Adochiței, Mihai and Negrea, Emil. *Finanțele agenților economici*. București: Editura Economică, 2001;
2. Brezeanu, Petre. *Finanțe corporative*. vol.II. București: Editura C.H.Beck, 2009;
3. Mătiș, Eugenia, Ana. *Managementul bancar*, Cluj-Napoca: Editura Casa Cărții de Știință, 2010;
4. Reinhart, Carmen și Rogoff Kenneth. *De data asta e altfel. Opt secole de sminteață financiară*, București: Editura Publica, 2012;
5. Toma, Mihai și Alexandru Felicia. *Finanțe și gestiune financiară de întreprindere*, Ediția a-II-a. București: Editura Economică, 2003.

##### **Magazine articles:**

1. Chebac, Niculina. "Tabloul explicativ de variație, balanța mutațiilor și tabloul plurianual al fluxurilor de trezorerie". *EIRP Proceedings*, 3(2008), Danubius University Pres, Galați: (2008);
2. Chen, Jiong. "Determinants of capital structure of Chinese-listed companies". *Journal of Business Research* 57 (2004);
3. Isărescu, Mugur. "Finanțare și ajustare în economia României". comunicare susținută în Mai 2010 la Universitatea "Al.I.Cuza" din Iași, cu ocazia decernării titlului de Doctor Honoris Causa, Iași: (2010);
4. Manolescu, Irina. "Estimarea ratei optime a îndatorării în condițiile unui mediu instabil". *Analalele Științifice ale Universității Al.I.Cuza*, tomul 50/51, Iași (2005);
5. Rajan, Raghuram și Zingales, Luigi. "What do we know about capital structure? Some evidence from International Data", *Journal of Finance* 50(1995).