EE
Euro Economica
Issue 1(22)/2009 ISSN: 1582-8859

THE ENTERPRISE SELF-FINANCING – THE TAXATION IMPACT UPON SELF-FINANCING DECISION

Nicoleta **BARBUTA-MISU**
Dunarea de Jos University, Romania

Abstract.

This work study the self-financing problematic, with particular emphasis on their benefits for the enterprise, but also for shareholders, on domestic or external factors that influence the self-financing decision and its level, on the relationship between self-financing and depreciation, degree of debt and profitability and not in the last line on the self-financing cost. In the factors that acting on the self-financing decision was granted a special attention to taxation, whose impact has been analyzed for various amounts of the tax on dividend and the tax on capital gains.

Keywords: *cost of capital, profitability, own capital, retained profit, dividends.*

Jel Classification: M1

1 Introduction

Self-financing is one of the most used sources of financing by Romanian enterprises. One reason would be the high cost of other sources of financing which generate debts to enterprises, such as the bond loans, bank loans, leasing or even a new issue of shares that generate payments of dividends.

Donaldson specify that the politics of financing a business cannot be fixed by a combination of general rules, which can determine of the followed direction, according to the circumstances and own objectives of the enterprise but is based on the observed structure of the enterprise flow of funds (Roux, 1983).

2 General issues concerning self-financing

Self-financing, representing "the accumulation of the capital generated during the accounting year concluded, is the most effective solution for financing of the permanent needs" (Vintila, 2000).

As domestic source of financing, *self-financing* is particularly important in ensuring of the financial autonomy. The formation of funds through self-financing will appear on the conditions under which the firm obtain incomes from its business to cover all expenses, and also to generate a profit, from which a part to be used to increase fixed assets and the exploitation assets.

2.1 The self-financing components

Seen from the point of view of its components, the self-financing known as usual and total or gross self-financing is composed of the *maintenance self-financing* (consist of depreciation of the tangible assets corresponding to real loss of their value and the provisions constituted to increases in prices in order to compensate for risks) and the *net self-financing* (consist of the net profit allocated for its own funds, i.e. of the profit that remain after the participation of employees to the profits as well as the associates and shareholders remuneration and from the depreciation fund which exceed the real depreciation of the fixed assets) (Ana, 2001). The net self-financing has the effect of the enrichment, the growth of the enterprise heritage in the future, i.e. of the owners' wealth.

2.2 The self-financing advantages

In a market economy, self-financing plays a key role in the strategy for financing of a business activity, taking a number of advantages, including:

- constitutes a secure means of financing, an independent and stable source, because in certain short-term circumstances the enterprise have difficulties in collecting of the capital by the monetary and financial market(Onofrei, 2003);
- could ensure the repayment on loans of the enterprise, self-financing constituting the fundament which can build a viable policy of financing (Ciotei, 2000);
- allow braking of the debt burden and, hence reducing the financial expenses. In fact, the self-financing level depends on the arbitration conducted by the enterprise between use of capital and reserves or the debt;
- a satisfactory level of the self-financing appears to be a basic condition for obtaining other sources of financing. No capital increase and no loans cannot be achieved if enterprise is not demonstrated a capacity for self-financing enough. Foreign financing appears so that as a supplement and not as a substitutability of resources procured through self-financing;
- self-financing being obtained through the enterprise work, it appears that the only guarantee for financial autonomy and stability, a insufficient self-financing reducing opportunities for foreign financing (Ciotei, 2000). Thus, self-financing is a decisive factor in the opening access to the capital market and attracting of the foreign capital;
- allows the measurement of the own capital yield , i.e. the return on equity;
- making growth at the enterprise level in obtaining higher financial results, in discovery and mobilizing of the domestic reserves, in the rational use of resources, in the establishment of the most efficient structures for the production and funds (Bistriceanu et al, 2001);
- the enterprise development is subordinate their own activities;
- gives the enterprise a high degree of freedom related to investments choice, to optimal economic criteria and not to waste of resources;
- defend the freedom of action of the company, meaning that financial autonomy gained through self-financing gives it the independence of the management of shareholders and financial and credit institutions, which carries a thorough inspection to ensure the security of the capital granted as loan;
- self-financing is considered the most correct financing source for the enterprise development; its size provide information about enterprise performance, create the capacity for repayment of the enterprise debts and give a measure of risk assumed by the funds suppliers;
- the capitalisation of a part of the profits, increasing the market value of the enterprise, increase the share price, becoming more attractive on the market;
- the reinvested profit is exempted from paying the tax on profits which creates opportunities for higher reinvestment.

Self-financing presents numerous advantages and for the enterprise managers: availability, flexibility, lack of explicitly control from the capital providers. Moreover, contribute to reducing of the capital mobility and its maintenance to the sector of origin that was released (Ginglinger, 1991).

However, the practice shows that it is appropriate the reconciliation in use of the own funds and loans. Self-financing in an exclusive makes the enterprise to be cut off from the capital financial market (Florea, 1997).

Also, one cannot speak of a general optimal of the self-financing policy. Worldwide, there were so periods in which a good financial structure is characterized by low level of debt burden, placing emphasis on the self-financing and other own resources, as well as periods in which a good financial structure is characterized by a "normal" character of the debt burden.

Thus, the self-financing policy of the enterprise is linked up by the politics of distribution: the decision to pay a significant part of the benefit to shareholders in the form of dividends determined the reduction of the amounts to remain at the enterprise disposal for investments (Colasse, 1993).

3 Factors influencing of the self-financing decision and its level

The self-financing decision and its level are often influenced by ***external and internal factors*** (Toma & Alexandru, 2003), such as: taxation, various constraints on access to the financial market or various legal constraints, the information asymmetries and constraints of shareholders and managers, politics waged by the banks of crediting business, credit costs, the degree of profitability and intentions to obtain the economic growth of the enterprises.

3.1 Taxation

In *terms of taxation* we can talk about a relationship of type *high taxation – high self-financing* and vice versa, meaning that a policy of oppressive taxes stirs the enterprise to proceed with the capitalisation of a higher part of the profit, finding in this destination conditions less-imposing. Although for shareholders should not be a difference between the distribution and retention of benefits because it belongs to them all, due to the fiscal treatment of dividends isn't identical to the profit, this double neutrality is rarely observed (Tudoreanu & Secareanu, 2006).

To reflect the ***taxation impact***, we assume the next example (Pike, 2006):

The enterprise "A" S. A. is financed entirely by equity capital (shares) and future cash-flows have the present value of 300,000 lei starting with 2006. During the year 2006, the enterprise wins 50,000 lei – for simplification we believe that all transactions are in cash, so that it has cash of 50,000 lei. The profit is taxation with 16 percent such as enterprise "A" S. A. must distribute 8,000 lei to pay the profit tax, remaining $(84\% \times 50.000) = 42.000$ lei available for distribution. The enterprise will be evaluated at $300.000 + 42.000 = 342.000$ lei.

What must do the enterprise "A" S. A.: to distribute the profit or to get him?

The answer depends on 3 factors: the marginal tax of shareholders; the relative rate of tax on dividends to tax on capital gains and of the nature of tax regime.

After the classic taxation system, profits are taxed twice if they are distributed, once as simple ***profit tax*** and the second time that ***tax on dividend*** paid by investors. Suppose that the enterprise carried out a full distribution and considering 2 rates of tax on dividend (5 percent and 20 percent), we get:

- if the investor pays a tax of 5 percent, the tax on dividend is $5\% \times 42.000 = 2.100$ lei, and the total expenditure to the tax is $8.000 + 2.100 = 10.100$ lei (or 21 percent of gross profit);
- if the investor pays a tax of 20 percent, in the value of $20\% \times 42.000 = 8.400$ lei, the total expenditure to the tax will be $8.000 + 8.400 = 16.400$ lei (or 36 percent on income before taxation).

Thus, seems better to retain profits in the enterprise, in the second case, but the decision also depends on ***the tax rate to earnings in the capital***.

Suppose the tax rate on capital gains of 16 percent. To show the effect of investment decision, we assume that the enterprise invests in projects with zero net present value and the enterprise value will increase from the 300,000 lei at the beginning of the year to 342,000 lei at the end of the year. The tax on capital gains for the payment is thus $16\% \times 42.000 = 6.720$ lei. Together with the profit tax, the total tax payment is $8.000 + 6.720 = 14.720$ lei.

Of course that, shareholders paying income taxes by 20 percent would prefer retention of the profit and vice versa in the case in which they pay tax on dividend of 5 percent.

Under a tax system for charging, the relative attractiveness of distribution or retention depends not only the relative rates of the tax, but if it is a ***full or partial charging***. In case of a total charging, investors get a full credit for the profit already paid by the company.

In the first case of above, on the tax on dividend of 5 percent, the investor must not deal with the profit tax, but can even obtain a reduction in tax, according to the fiscal regime since the tax rate of the company is higher than the rate of income per person.

In the second case, referring to the tax on dividend of 20 percent, the investor get credit for the enterprise tax already paid and thus must deal with some additional costs to income tax of $20\%-16\%\times 42.000=1.680$ lei. With these particular situations, the investor will be whether if profits distribute or will be retained.

In the partial charging, is less clear reduction of relative opportunities to distribute and profits retention depends on the degree of charging as well as the rate the taxation.

3.2 Constraints on access to the financial market

Another factor to depend on self-financing consists of the *constraints on access to the financial market*, which refers to the fact that companies no quoted on stock exchange may not appeal to the financial market for procurement funds to economic growth and therefore remains the alternative of banking loan, the self-financing or the growth of the capital by external own funds. If the firm has collected funds through capital increase, freely and without costs then she could substitute to the increases in capital exactly the total amount of dividends distributed.

3.3 The various legal constraints

The *various legal constraints* concern the General Meeting decision to distribute dividends or to reinvest the profit. Usually, companies are restricted in distributing dividends by the size of the profit.

3.4 The information asymmetry and constraints between shareholders and managers

Also, dividend can play an *informative role* for shareholders, keeping dividend in case of the fall in profit being interpreted as a *favourable signal* by the financial market. Managers through autonomy care are interested to privilege the self-financing on the distribution of dividends. This means that managers must undertake more often to raise the capital: they are subject to discipline exerted by the financial market.

4 The relationship between self-financing and debt, depreciation and profitability

Under ***financial aspect***, the link between self-financing and debt is complex because the self-financing is almost always a necessary condition for obtaining a loan. It is the same time a security and a means of repayment. The increase in the capacity of self-financing is possible only in conditions in which economic profitability rate is higher than the interest rate (Florea, 1997).

As far as the correlation between self-financing and depreciation, in fact, we can say that the depreciation has a neutral influence on self-financing: increasing the costs to depreciation is reduced the profit and vice versa, so it cannot count on another amount of resources for self-financing than that it can be generate by exploitation.

The policy on sharing profits is a policy of liquidity: if it constitutes a reserve fund then grow the enterprise liquidities and therefore the possibilities of self-financing; distribution of higher dividends lead to reducing the liquidities and hence the possibilities of self-financing.

Although self-financing is a sound financial policy and desirable, is not appropriate to exaggerate in this direction, the self-financing may have on enterprise the following consequences: the loss of link with the financial market, reducing of the capital mobility and the need for increase of return on assets, which the most times it is difficult to be carried out so as to satisfy investors.

Any decision for self-financing must be analyzed in terms of profitability which is obtained from reinvested profit. If profitability of the new projects covered by self-financing is equal to the profitability claimed by the shareholders, the policy of self-financing is neutral for enterprise. Only when investors profitability covered by self-financing is higher than the remuneration required by shareholders, the self-financing has a positive effect for enterprise, the sense that it increased its financial value (Ciotei, 2000).

In conclusion, a high profitability generated by overall activity is the objective base of an important level of self-financing, while its low level should not lead automatically to the conclusion that the effective of the exploitation process of the company is small (Sandu, 2000).

It is not appropriate to exaggerate in the strand of self-financing, whereas there is the risk of rupture of the enterprise by financial market. In certain circumstances becomes more advantageous for enterprise to resort to external financing resources, in place of self-financing (Onofrei, 2003).

5 Self-financing cost

In fact, in Romania, as in other countries, the non-distributed profit is one of the most important sources of investment capital in the long term of the enterprises (Lumby & Jones, 2003). Whereas the retained profits arise from internal sources of the company, and not from the external (such as a new issue of shares) in the temptation is to believe that this source of capital is somehow more "cheap" or even "free". "However, in terms of shareholders or associates (which are the owners of the enterprise) the retained profits represents a cost of opportunity because, if the realized profits would have been fully paid as dividends in cash, shareholders could invest the money at a rate of income on the market to ensure that time" (Hoanta, 2003).

Thus, the "cost" of retained profits or expected minimum profitability that it should generate their use in investment projects is exactly the same with that resulted of the expected profitability required by the shareholders, holders of new issued shares: ***cost of share capital***.

Although, the self-financing seems to be a free resource and by incorporating reserves in the share capital and award of free shares the reinvested profits become remunerative directly. Even remaining of the reinvested net profits in the reserves is indirectly remunerated. The reinvested profits will be made for projects of the more profitable and which determine an increase in average remuneration to shareholders. The self-financing cost, by passing the profit in the reserves, is equal to the ***own capital cost***.

On the other hand, the *market value* of the share reflects both the nominal value of the share capital of an enterprise, and the amount of retained profits; in practice the retained profits being regarded as a source of capital slightly cheaper than a new issue of shares because of the costs of the issue.

Whereas self-financing has the resources and the depreciations and provisions calculated, they may consider cash-flows of all activity of the enterprise, funded by both in equity capital and borrowed capital. Consequently, the cost of self-financing from depreciation and provisions is equal to the ***weighted average cost of capital*** (Andreica et al, 2003).

Whereas each firm has a certain structure of the capital which is a mix of equity capital, common and preferential shares, liabilities, this determine a value of the enterprise capital that must be maximize. So, for maximising of the enterprise value should be established an optimal structure of the capital so that new increases in capital to take place in such manner as to maintain the optimal structure of the capital in time.

The weighted average cost of capital is based on the cost of each component net by the effect of taxation to the enterprise level for that component. Since we are interested in cash flows after the tax level of the enterprise, the specialty literature and practitioners concerns on WACC that a WACC after tax.

Proportions set for capital and reserves, i.e. for common and preferential shares, and for debts, in the total capital of enterprises, along with the costs of those capital components are used to calculate the ***weighted average cost of capital*** (Stancu, 1997). If joining the diversity of financing sources in two major groups, *capital and reserves* (CP) and *borrowed capital* (D), then *weighted average cost of capital* (WAAC) is calculated as:

$$WACC = k_{CP} \times \frac{CP}{CP + D} + k_D \times \frac{D}{CP + D}, \text{ where:}$$

k_{CP} = the own capital cost, equivalent to return on equity expected by shareholders;

k_D = the cost of debt, before tax, equivalent to the interest charged by lenders.

On the formula for calculating the weighting average cost of capital, presented above, we must add that those two costs are expressed in different times: while the own capital cost is determined taking into account the net profit (profit after tax), the cost of debt (interest) is determined before tax, which is why we proposed the correction of the formula above to the second term, with $(1-\tau)$, highlighting the economy of tax obtained through deductibility of interest charges and, in fact, sharing the opinion of *Gh. Sandu* in *Enterprise financing*, thus:

$$WACC = k_{CP} \times \frac{CP}{CP + D} + k_D \times \frac{D}{CP + D} \times (1 - \tau).$$

If we consider the capital components from three sources, i.e. common share, preferential shares and debts, then the formula of weighted average cost of capital (Pratt, 2002) will be:

$$WACC = k_c \times \frac{C_c}{C_c + C_p + D} + k_p \times \frac{C_p}{C_c + C_p + D} + k_D \times \frac{D}{C_c + C_p + D} \times (1 - \tau), \text{ where:}$$

k_c = the capital cost of the common share;

C_c = the market value of the capital in common shares;

k_p = the capital cost corresponding to preferential shares;

C_p = the market value of the capital in preferential shares;

τ = the quote of profit tax.

The formula above, it appears that the determination of weighted average cost of capital is relatively simple. However, its calculation raised serious problems in its application in practice, such as: determining of the specific costs of each source of capital and the choice of the weights system of the sources of capital. But these difficulties can be mitigated by fixing the management of the enterprise has an optimal financial structure which will maximize the value of the enterprise and will lead to its maintenance in time.

6 Conclusions

In terms of economic rationality, the self-financing is an expensive resource. The cost of self-financing is the return on assets, what must be greater than the average rate of interest to have financial lever. If the business that generated sources is sufficiently profitable, means that their investment is the best placement which the market provides it. The self-financing limit is given by the *principle of placement diversifying*. The placement diversifying is actually a factor in reducing the risk. The risk measure of a portfolio allows the sightings of he factors which determine the importance of this risk and shows the influence of the coefficient of connection between the various rates of return of the shares.

7 References

1. Ana, Gh. I. (2001). *Finantele si politicile financiare ale intreprinderilor*. Bucharest. Economica.
2. Andreica, M., Andreica, C., Mustea-Stefan, I., Mustea-Stefan, R. (2003). *Decizia de finantare in leasing*. Bucharest. Cibernetica MC.
3. Bistriceanu, Gh. D., Adochitei, M. N., Negrea, E. (2001). *Finantele agentilor economici.* Bucharest. Economica.
4. Ciotei, C. N. (2000). *Finante: finante publice, finantele intreprinderii, moneda-credit,* Bucharest. Expert.
5. Colasse, B. (1993). *Gestion financière de l`entreprise: problématique, concepts et methods*. Paris. Press Universitaires de France.
6. Florea, S. (1997). *Gestiunea si managementul activitatii financiare din intreprinderi*. Bucharest. Victor.
7. Ginglinger, E. (1991). *Les financement des entreprises par les marches de capitaux*. Paris. Press Universitaires de France.
8. Hoanta, N. (2003). *Finantele firmei*. Bucharest. Economica.
9. Lumby, S., Jones, C. (2003). *Corporate Finance: Theory and Practice.* 7th edition. London. Thomson High Holborn House.
10. Onofrei, M. (2003). *Finantele intreprinderii*. Bucharest. Economica.
11. Pike, R., Heale, B. (2006). *Corporate Finance and Investment Decisions and Strategies.* Fifth Edition. Prentice Hall.
12. Pratt, S. P. (2002). *Cost of Capital. Estimation and Applications*. New Jersey. John Wiley & Sons Inc.
13. Roux, D. (1983). *Analyse économique de l`enterprise*. Paris. Bordas.
14. Sandu, Gh. (2000). *Formarea capitalurilor firmelor private*. Bucharest. Economica.
15. Stancu, I. (1997). *Finante – Teoria pietelor financiare, finantele intreprinderilor, analiza si gestiunea financiara.* Bucharest. Economica.
16. Toma, M., Alexandru, F. (2003). *Finante si gestiune financiara de intreprindere*. Bucharest. Economica.
17. Tudorache, D., Secareanu, C. (2006). *Finantele publice. Finantele firmei*. Bucharest. Universitara.
18. Vintila, G. (2000). *Gestiunea financiara a intreprinderii.* Bucharest. Didactica si Pedagogica.