CONSIDERATIONS REGARDING THE ROLE OF CAPITAL IN THE FINANCING DECISION

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Abstract: Establishing the financing sources exerts, under the conditions of market economy, a significant impact on the development of business activity. In this way it is decided upon the financial structure of the company and measures are taken to ensure its optimal character.
Because preserving financial independence and autonomy is a major aspect in the process of choosing financing sources, one can observe the security offered by equity used as financing sources in the operating activity. However, the company cannot use only equity financing because the rational objective is to maximize the entity's value, and the cost involved in raising capital will be higher than the cost of the existing one.

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1. INTRODUCTION

Under market economy conditions, it becomes obvious the fundamental role played by enterprises within it, given that they are considered the main legal instrument used to direct human and financial energies towards achieving social goals.

Given its quality of basic institutional unit in the national economy, the enterprise operates as a system where the human factor fulfills an active role in relation to other resources.

Taking under consideration this aspect and the fact that between the resources of a company there are close interconditioning relationships, the financial practice emphasizes the importance of financing sources and of establishing an optimal financial structure since the main concern is the functioning of the enterprise within the normal parameters.

The financing structure of a company can be defined as the complex and organized set of different sources of financing used by the manager in the process of covering the financing needs. It also expresses, at the enterprise level, its capital structure or all the capital's components, which is why it is also known as the company's capital structure.

Relevant to the financial structure is the permanent capital, consisting of the equity to which the long-term debts are added, because they are destined for both the operating cycle and the investment cycle.

Equity, although it involves the participation of "capital investors" in the process of net profit distribution, is a stable source of financing, permanently available to the economic unit. Besides ensuring financial autonomy, it also contributes to eliminating the risk of unpredictable withdrawal of capital.

According to the General Accounting Regulatory Framework in Romania, equity is defined as "the residual interest of the shareholders in the assets of a company, after deducting all its debts"[1].

Also, another definition of equity presents them as "financial resources attracted from the owners (shareholders or associates), as well as those constituted from the profits gained"[2].

The specialized literature mainly exposes two approaches to equity, namely[3]: It represents an accounting estimate of the value of investors' ownership rights, respectively company owners,

It represents the company's debt to its owners.

A conclusive definition regarding the role of equity in the financing process highlights it as "the overall financing brought by the owners of economic entity, either through direct contributions or by giving up all or part of their remuneration in the form of dividends, respectively by self-financing"[4].

2. GENERAL ASPECTS REGARDING CAPITAL

One of the fundamental aspects of deploying under optimal conditions the activity of economic entities is the raising and use of the company's capital in order to achieve the object of activity and to obtain favorable final results.

A company's capital consists of various sources and is used according to its own rationality, which influences the overall efficiency and, therefore, differentiates companies with the same activity profile and a similar level in terms of the capital advanced in the economic circuit.

For these reasons, it can be noted that the financial structure, the average cost of the capital employed and the management mode used in the functioning of the economic entity's financial mechanism are of particular importance for the company.

Capitals are resources contributing to the economic activity of companies. With their help, the company provides the necessary economic means: machines, buildings, means of transport, stocks of raw materials and materials, inventory items, goods.

In a broader sense, it is also known under the name of permanent capital, being the basic component of the balance sheet liabilities intended to finance in a sustainable manner the assets (wealth). They are formed at the establishment of the company, over time they increase or decrease, as the case may be, and at the cessation of activity they are liquidated.

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[1] Cadrul general de reglementare a contabilității în România

[2] Avram M., Contabilitatea financiară a firmei, editura Universitaria, Craiova, 2009, p. 38

[3] Matiş, D., Bazele contabilităţii. Fundamente şi premise pentru un raţionament profesional autentic, Editura Casa Cărţii de Ştiinţă, Cluj Napoca, 2010, p.375

[4] Berceanu D., Berceanu O., Sichigea D., Finanţarea firmei, Editura Didactică şi Pedagogică, Bucureşti, 2006, p.11

Therefore, capital can be considered all sources of funding available to the economic entity which can be used to purchase patrimonial assets.

3. EQUITY STRUCTURE

Equity defines the financial resources constituted by contribution of the owners, shareholders or associates in their capacity of capital investors, self-financing through profit capitalization and from other non-reimbursable resources established by law.

Specifically, they are identified by the share or social capital, as the case may be, the premiums related to the capital, the company's reserves, the revaluation reserves, retained earnings, the current financial year result.

More specifically, equity represents the right of equity holders (shareholders or associates) on the assets of an entity, after deducting all debts.

Equity is characterized by the following features:

- its remuneration is provided from the balance of the company's activity, respectively from the net profit, and the simple ownwership of shares in the form of equity gives the right to this result; in case of liquidation of the company, the owners of equity shares are compensated from the possible liquidation value or the liquidation value remaining after the payment of all the creditors;
- its exigibility is unlimited and occurs at the moment of liquidation;
- it grants the holders of equity shares the possibility of administrating and even managing the company, respectively defining the strategies and the directions to follow to achieve these strategies.

Share capital, the first and most important component of the equity of a company, represents the source of capital with the longest term of exigibility, being constituted at the establishment of the firm and increased or diminished over time.

Reflected in a certain number of shares, it can be subscribed by the contribution in cash and in kind of the shareholders or associates and remains permanently in their ownership.

Share capital can be considered the prerequisite for setting up an enterprise, since this notion is "*inseparable from the word company*"[5], constituting for the company and its shareholders or associates the legal basis in their relations with third parties.

The secondary component of equity, namely non-nominal equity, represents, in a complex form, the capital accumulated by the entity as a result of a profitable economic activity and it includes:

- Capital Premiums
- Reserves
- Revaluation reserves
- Retained earnings
- Result of current financial year

These elements, regardless of their destination, as long as the need for which they were established did not occur, are used to finance the assets of company.

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[5]Berceanu D., Berceanu O., Sichigea D., Finanţarea firmei, Editura Didactică şi Pedagogică, Bucureşti, 2006, p.14

The capital premiums represent the contribution supplement not incorporated in the share capital. Depending on how they were constituted, they can be grouped as follows:

a) Issued premiums correspond to the surplus between the issue price of new shares and the nominal value of social shares

Issued premiums serve a dual function:

- To cover the costs of issuing shares
- To equate the rights of new shareholders with those of old shareholders, by offsetting the difference between the nominal value and the book value of old shares.

b) Merger premiums represent the difference between the value of the contribution resulting from the merger and the value with which the share capital of the absorbing company has been increased.

c) Contribution premiums are calculated as the difference between the contribution value and the nominal value of share capital with which these contributions were remunerated.

d) Conversion premiums are established on basis of the surplus between the nominal value of the convertible bonds and the value of issued shares.

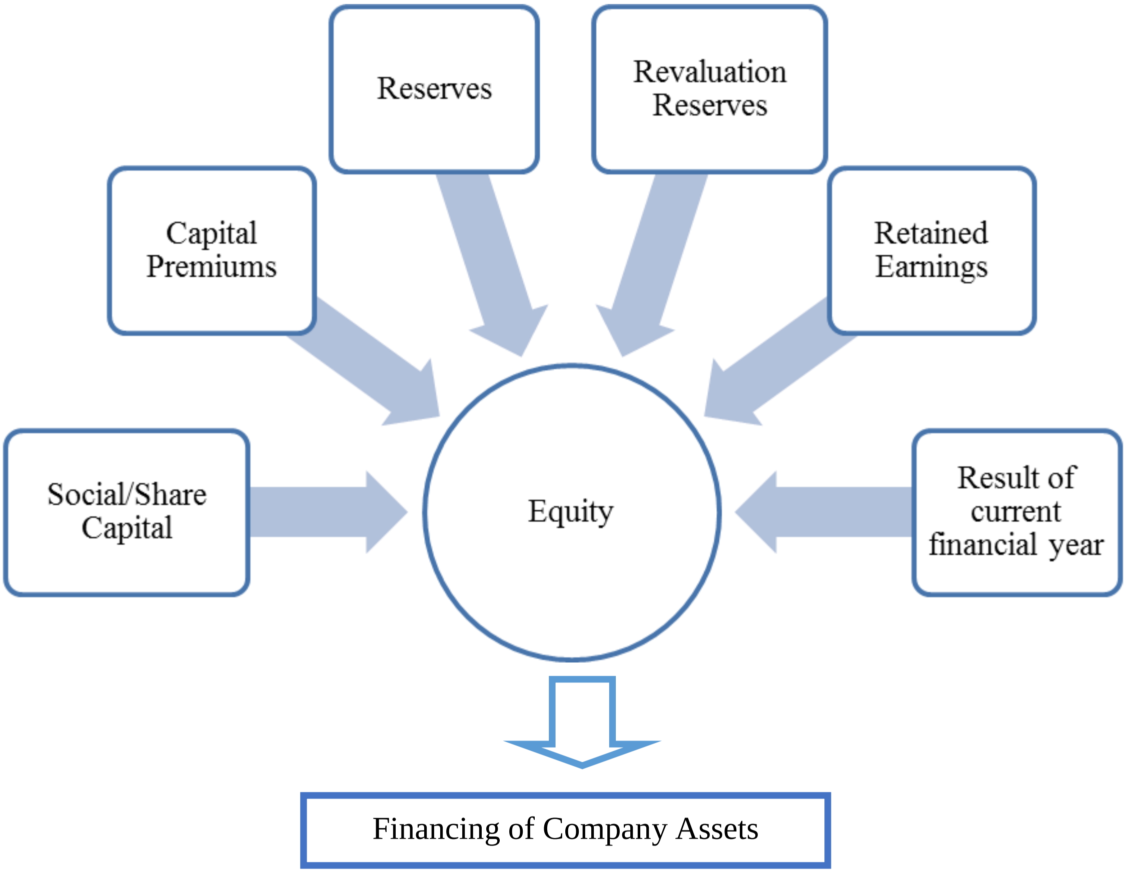

Figure no. 1 Equity Financing Process

Economic entity reserves are divided into two groups:

1. Revaluation reserves, having an indivisible/non-distributable nature, reflect the plus or minus resulted from the revaluation of tangible assets.
2. Reserves created within the company that can be:
    - **legal reserves** that are constituted by taking a share of 5% from the gross profit each year until it reaches 20% of the share capital. Normally they do not have a specified destination, but they can be used to cover losses for which no other reserves have been set up, with the obligation to reconstitute them.
    - **statutory** or **contractual reserves** are established annually out of the entity's net profit, according to its articles of association. They are used to cover losses or to increase the share capital.
    - **other reserves** that are not provided by law by the articles of association and which can be constituted by companies optionally, on the basis of net profit, to cover the accounting losses or for other purposes, according to the decision of the General Meeting of Shareholdersor Associates.

Retained earnings represent the undistributed profit, respectively the loss uncovered from previous financial years. The deferred profit is to be distributed by destination in the following financial years, and the deferred loss is to be covered from the profit of future financial exercises, from reserves or from share capital, according to the decision of the General Meeting of Shareholders or Associates.

Result of the financial exercise, in financial-accounting terms, means the difference between revenues and expenses and can be materialized in:

a) Profit, when revenues exceed expenses.
b) Loss, if expenses exceed revenues.

4. THE FINANCING PROCESS WITHIN THE COMPANY. OWN SOURCES OF FINANCING

Financing is the process of providing the funds needed to carry out the activity of the company.

This is of particular importance for the survival and development of business.

The sources of financing are adapted to the needs of each economic entity and can be found within the patrimonial structures of liabilities under the name of capital.

Since maintaining the independence and financial autonomy of any business is a key issue in the choice of funding sources, it can be said that own sources or equity are the most reliable source of financing.

The main own sources of financing are: self-financing, transfer of assets, capital increases and other sources that can be assimilated to equity.

4.1. SELF-FINANCING

Internal financing or self-financing can be defined as the accumulation of capital released during the accounting year that ended and is the most efficient solution for financing the needs of an economic entity.

This determines the increase of equity by retaining all or part of the amount representing the annual remuneration due to shareholders in order to cover the financing needs of the economic entity and the amount corresponding to the participation of fixed assets in the creation of new utilities in the form of depreciation.

According to some authors, *"the self-financing corresponds mainly to the share of net profit capitalized in the company and to the depreciation of the fixed assets"*.[6]

As an internal source of financing, self-financing is of particular importance in the process of ensuring financial autonomy. The accumulation of funds through self-financing is encountered when the company obtains revenues from the activity carried out which will allow it to cover all the expenses and also to have a profit from which a part can be used to increase the fixed assets and the operating assets.

In the specialized literature, self-financing *"expresses the internal accumulation capacity of a company which, after paying its obligations to suppliers and employees and acquiting the taxes, obtains a profit that will serve, at the same time, as a remuneration of the employed capital and will allow investments that contribute to maintaining or increasing the company's competitiveness".* [7]

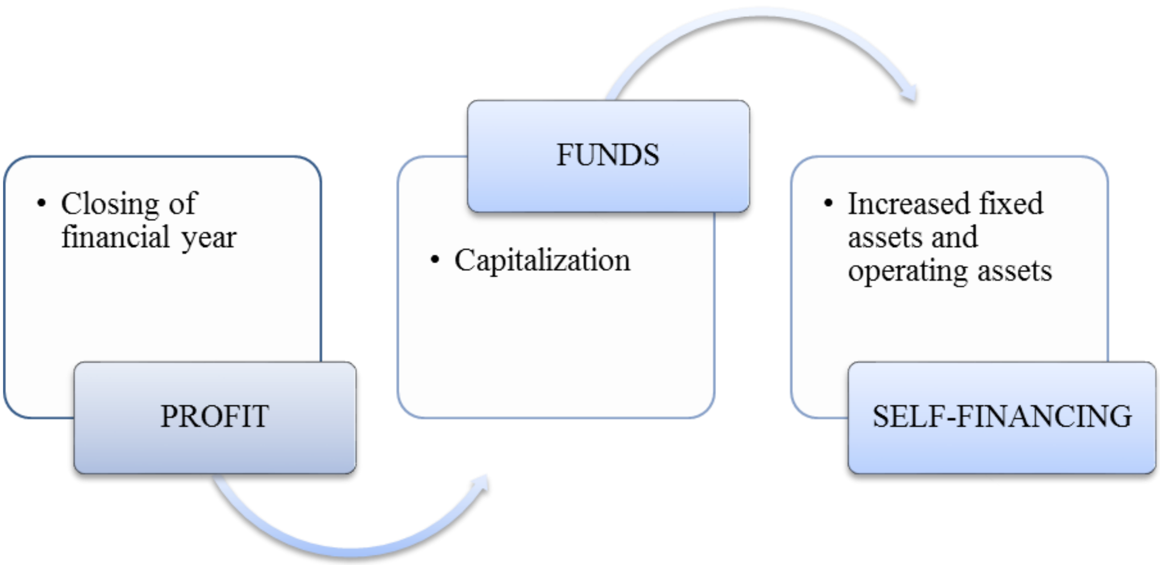

Figure no. 2 Self-financing Process

In the market economy, the process of self-financing presents important advantages, of which can be listed:

- It is a reliable means of financing, as companies face difficulties in certain situations in collecting capital from the financial and monetary market;
- Company's freedom of action is protected in that it ensures the independence or autonomy in the management process in relation to the shareholders, financial

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[6]Berceanu D., Berceanu O., Sichigea D., Finanţarea firmei, Editura Didactică şi Pedagogică, Bucureşti, 2006, p.32

[7]Brémond,J., Gélédan, A., Dicţionar economic şi social, Editura Expert, Bucureşti, 1995, p.194

institutions and credit bodies that are exercising strict control to ensure the security of the capital lent.

4.2. FINANCING BY RAISING THE SHARE CAPITAL

The raising of share capital represents an own source of financing found when it is necessary for the company to create own funds in order to cover some losses, when the equity is insufficient or when the firm targets the development of its activities or the adoption of new projects that are aimed at economic growth in order to increase its profitability. The financing of enterprises by raising their share capital demonstrates their viability and has a positive effect on the third parties (banks, contract partners), enhancing their confidence in the enterprises.

The contribution in kind and the increase resulting from merger or absorption are indirect financing operations. Nor is the conversion of receivables a direct financing operation because it does not have the effect of obtaining liquidity, but it has the effect of changing the financial structure of the company and transforming a debt into non-chargeable capital.

Figure no. 3 Ways of Raising Share Capital

A. *Raising Capital through New In Cash Contributions*

There are two possibilities for raising in cash capital:

- increasing the nominal value of old shares: requires recourse to existing shareholders and their agreement to supplement with funds the share capital. This process is difficult to achieve both due to the dispersion of the shareholders in the territory and the need to convince them to bring in new capital;

- issue of new shares: shares available on the market can be bought by anyone, but the old shareholders have preferential right of purchase. The difficulty that arises here is determining the issue price.

Raising capital through new in cash contributions have a number of characteristics:

- ❖ it represents a means of financing from almost their own funds, coming either from old shareholders or new ones;
- ❖ the issue of new shares influences the dilution of wealth (capital) per shareholder, the dilution of profit per share and the dilution of the power exercised by the shareholders;
- ❖ they are different from self-financing because self-financing is an internal financing, through the own efforts of companies (capitalizing a part of the profit) while the raising capital is an external financing through own funds brought from outside the company by the associates; that is why the capital increases were classified as quasi-own sources;
- ❖ it leads to the raising of the companies' financial means, to the increase of financial liquidity, in contrast to other modalities that only modify the legal structure of liabilities;
- ❖ it leads to the consolidationof company's working capital, in other words to strenghtening the financial balance.

B. Raising Capital through Incorporation of Reserves

Raising capital through the incorporation of reserves does not bring new financial resources for businesses. These are operations without financial flow since, until incorporation in the share capital, they have the respective amounts accounted for in reserves.

As a result of raising capital through incorporation of reserves, either the nominal value of the old shares is increased or a new number of shares of equal value are issued. In the second case, after incorporation of reserves, each shareholder has more shares, but the profit will be divided according to the number of shares so that the dividend per share value depends on the total size of the profit. If the profit does not increase, the total amount distributed as dividends is maintained, but the return per share decreases; if, however, profit increases, both the total volume of dividends and the return per share increase.

This operation of raising capital by incorporating reserves helps to strengthen the trust of contract partners and banks in the companies.

C. Raising Capital through Debts Conversion

Raising capital by converting debts involves the transfer to equity of an amount previously included in debt accounts without altering the overall size of financing sources.

The purpose of this operation is to reduce the debt without resorting to the treasury, to restore the indebtness /debt capacity and the financing capacity.

5. ADVANTAGES AND DISADVANTAGES OF EQUITY FINANCING

Equity offers the advantage of higher security - it will not be withdrawn in case of a worsening financial situation, as can be the case with a bank loan, it is not necessary to have a detailed exposition of the business plan in front of external partners nor their approval for important decision making.

Therefore, this source of financing ensures flexibility, security and independence. At the same time, in the perspective of attracting external financing sources, the commitment of own funds represents a guarantee of the entrepreneur's motivation to ensure the business success.

The disadvantages of financing from own sources are also important:
- equity is generally quite limited and may jeopardize business development;
- in case of failure, the loss will be borne entirely by the entrepreneur;
- company will be little known by the financial institutions and will find it difficult to raise funds in special situations.

6. CONCLUSIONS

Financing the operating cycle is carried out based on a decision-making process, since on its basis is established the finality of the equilibrium to be ensured between the financing needs of the operating cycle and the sources mobilized for this purpose. In this sense, a permanent source of financing at the disposal of the economic entity is the equity, my means of which assets can be purchased.

From a legal and accounting perspective, equity does not appear as cost generator, because it does not incur any legal obligation to remunerate the profit for the benefit of company’s associates or shareholders. It is the reason for which the payment of dividends is not considered by accounting as a money expense deductible from the result, but as a deduction made on the result already calculated, after taking into account the total income and expenses.

Thus, although the use of equity does not entail any legal constraints on remuneration for the company, it nevertheless implies an economic constraint, which requires it to ensure a certain remuneration of its shareholders or associates in order not to preclude any future possibility of financing by own sources.

Equity, though involves owners in distribution of net profit, represents stable and steady sources that ensure the economic entity's autonomy, as well as the conditions for reducing the risk of unexpected withdrawals of capital.

However, there may be development opportunities that the enterprise will not be able to capitalize on, as equity is limited. Therefore, financing activities must be carried out after the completion of an analysis of all factors that can influence the financing decision.

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