

SOURCES OF LONG-TERM (LT) AND SHORT-TERM (ST) FINANCE AND THEIR ASSOCIATED RISKS AND RETURNS.

Long-Term Sources of Finance.

Long-term sources are those utilized by a firm for a period of more than one year and therefore long-term funding is required to finance a firm's long-term assets. The long-term sources of funding may include the following;

1. Retained Earnings.

Retained earnings refer to the accumulated profits that a company reinvests in its business rather than distributing them as dividends to shareholders. As a long-term source of finance, retained earnings provide an internal method of funding growth, expansion, or other investment opportunities without relying on external debt or equity financing. An increase in retained profits adds to equity reserves.

Advantages of Retained Earnings.

⇒ No Processing Fees.

Retained Earnings do not attract floatation or processing fees as may be the case with other sources of funds.

⇒ Readily Available and a Convenient Source of Fund.

The funds are already at the disposal of the firm and therefore does not require any additional processes to acquire it. The firm only require the consent of the board of directors to put the fund to intended usage.

⇒ Operational Freedom.

Retained earnings like the ordinary share capital gives management the freedom of operation. There are no serious restrictions that a firm faces when using the funds especially in the regards to choice of investment and payment of dividends.

⇒ Non-Refundable.

Retained Earnings are considered permanent source of funds since it has no maturity date and therefore not refunded. The firm is expected to use the fund to create value for its shareholders and distributed as dividends later, but the funds are not returned to the owners.

⇒ No Dilution in Control.

Usage of retained earnings to finance operations ensures that existing shareholders maintains their influence and control of the firm.

Disadvantages.

⇒ Discourages potential investors.

Usage of retained earnings may send a mixed message to potential investors and a firm maybe perceived to be unsure of its future cashflows since excessive retention may signal low levels of dividends.

⇒ Uncertainty of the funds.

It is only available to profitable firms and those making losses are not able to use it. Firms that do not make profits on a continuous

2. Lease Financing.

Lease financing is a method of acquiring assets where a company (the lessee) obtains the right to use an asset for a specified period by making periodic payments to the owner (the

lessor) instead of purchasing the asset outright. This arrangement allows businesses to use expensive equipment, machinery, or property without requiring large initial capital investments.

Features of Lease Financing.

- **Ownership Retention.** The lessor retains ownership of the asset while the lessee uses it.
- **Periodic Payments.** The lessee makes fixed payments (lease rentals) over an agreed period.
- **Flexible Terms.** Lease agreements can be structured to suit business needs, such as operating or finance leases.
- **Tax Benefits.** Lease payments are often tax-deductible as business expenses.
- **End-of-Term Options.** Depending on the lease type, the lessee may have the option to purchase the asset, renew the lease, or return the asset to the lessor.

3. Long-term bank loans.

A long-term bank loan is a type of financing provided by a bank to a borrower for an extended period, typically exceeding one year, often ranging from 3 to 30 years. These loans are commonly used by businesses and individuals to finance major expenditures such as business expansion, equipment purchases, real estate investments, or infrastructure projects.

Advantages.

- ⇒ **Lower Interest Rates** – Compared to short-term loans, long-term bank loans usually have lower interest rates, making them more cost-effective in the long run.
- ⇒ **Improved Cash Flow Management** – Since repayment is spread over several years, businesses and individuals can manage their cash flows more effectively without facing significant financial strain.
- ⇒ **Larger Loan Amounts** – Long-term loans provide access to significant capital, which can be used for business expansion, real estate purchases, or long-term projects.
- ⇒ **Builds Credit History** – Consistently making payments on time improves the borrower's credit rating, increasing their ability to secure future financing.
- ⇒ **Ownership Retention** – Unlike equity financing, long-term loans allow businesses to raise capital without diluting ownership.
- ⇒ **Tax Benefits** – Interest payments on long-term loans are usually tax-deductible, reducing the borrower's taxable income.

Disadvantages.

- ⇒ **Long-Term Debt Obligation** – Borrowers must commit to repaying the loan over several years, which may become a burden if financial circumstances change.
- ⇒ **Collateral Requirement** – Banks often require valuable assets as collateral, putting businesses and individuals at risk of losing them in case of default.
- ⇒ **Interest Costs Add Up** – Although interest rates may be lower, the total interest paid over an extended period can be substantial.
- ⇒ **Restrictive Loan Covenants** – Banks may impose conditions (e.g., maintaining a certain debt-to-equity ratio or restricting additional borrowing), limiting financial flexibility.

- ⇒ **Complex and Lengthy Approval Process** – Securing a long-term loan involves extensive paperwork, credit assessments, and due diligence, which can be time-consuming.
- ⇒ **Impact on Future Borrowing Capacity** – Having an outstanding long-term loan may reduce the ability to secure additional financing in the future.

4. **Venture Capital.**

Venture capital (VC) is a form of financing provided by investors to startups and small businesses with high growth potential in exchange for equity (ownership stake). It is typically used by early-stage companies that lack access to traditional bank loans or capital markets but have innovative business models with significant growth prospects.

5. **Preference Shares.**

Preference shares (also called preferred stock) are a type of equity security that gives shareholders preferential rights over common shareholders in terms of dividends and asset distribution in the event of liquidation. However, preference shareholders usually do not have voting rights in company decisions.

Features of Preference Shares.

- ⇒ **Fixed Dividend** – Preference shareholders receive a fixed rate of dividend before any dividends are paid to ordinary shareholders.
- ⇒ **Priority in Dividend Payment** – Preference shareholders have a preferential right to receive dividends before ordinary shareholders.
- ⇒ **Priority in Liquidation** – In case of company liquidation, preference shareholders are paid before ordinary shareholders but after debt holders.
- ⇒ **Non-Voting Rights** – Generally, preference shareholders do not have voting rights in company decisions, except in special circumstances (e.g., when dividends are in arrears).
- ⇒ **Convertible or Non-Convertible** – Some preference shares can be converted into ordinary shares after a specified period, while others remain preference shares.
- ⇒ **Cumulative or Non-Cumulative.**
 - **Cumulative Preference Shares** – If dividends are not paid in a particular year, they accumulate and must be paid before ordinary dividends in the future.
 - **Non-Cumulative Preference Shares** – If dividends are not declared in a given year, they are forfeited.
- ⇒ **Redeemable or Irredeemable** –
 - **Redeemable Preference Shares** – The company has the right to buy back these shares after a certain period.
 - **Irredeemable Preference Shares** – These shares exist indefinitely unless the company is liquidated.
- ⇒ **Participating or Non-participating.**
 - **Participating Preference Shares** – Shareholders may receive additional dividends beyond the fixed rate if the company earns high profits.
 - **Non-Participating Preference Shares** – Shareholders are entitled only to the fixed dividend.

⇒ **Marketability and Transferability** – Preference shares can be traded in the stock market, though they are less frequently traded than ordinary shares.

6. Long term bonds or Debentures.

Long-term bonds **or** debentures are fixed-income securities issued by companies or governments to raise capital, with a maturity period typically exceeding 10 years. They represent a loan made by investors to the issuer, who promises to pay periodic interest (coupon payments) and return the principal amount at maturity.

Features of Long-term bonds or Debentures.

⇒ **Fixed Interest Payments** – Bonds and debentures typically offer a fixed interest rate (coupon rate), which is paid periodically (e.g., annually or semi-annually) until maturity.

⇒ **Long Maturity Period** – These instruments have a maturity period extending beyond one year, often ranging from 5 to 30 years.

⇒ **Repayment at Maturity** – The principal amount (face value) is repaid to the bondholder at the end of the maturity period.

⇒ **Secured or Unsecured.**

- **Secured Debentures (Bonds)** – Backed by specific assets of the issuing company as collateral.

- **Unsecured Debentures (Bonds)** – Not backed by collateral but rely on the issuer's creditworthiness.

⇒ **Tradability** – Bonds and debentures are traded in the secondary market, allowing investors to buy and sell before maturity.

⇒ **Callable or Non-Callable.**

- **Callable Bonds/Debentures** – The issuer can repay them before the maturity date.

- **Non-Callable Bonds/Debentures** – Cannot be redeemed early by the issuer.

⇒ **Convertible or Non-Convertible.**

- **Convertible Debentures** – Can be converted into equity shares of the issuing company at a specified rate.

- **Non-Convertible Debentures** – Cannot be converted into equity.

7. Ordinary Shares.

Ordinary shares (also called common stock) represent equity ownership in a company, giving shareholders voting rights and a share in the company's profits through dividends. These shares carry the highest risk but also offer the potential for significant returns if the company performs well.

Features of Ordinary Shares.

⇒ **Ownership Rights** – Ordinary shareholders are the owners of the company and have a residual claim on assets and profits after all obligations are met.

⇒ **Voting Rights** – Ordinary shareholders typically have voting rights in company decisions, including electing the board of directors and approving major corporate actions.

- ⇒ **Variable Dividends** – Unlike preference shares, dividends on ordinary shares are not fixed and depend on the company's profitability and board decisions.
- ⇒ **Last in Liquidation** – In case of company liquidation, ordinary shareholders are paid last, after creditors, bondholders, and preference shareholders.
- ⇒ **Limited Liability** – Shareholders' liability is limited to the amount they have invested in the shares; they are not personally responsible for the company's debts.
- ⇒ **Marketability and Transferability** – Ordinary shares are publicly traded in stock exchanges, making them easily transferable.
- ⇒ **No Maturity Date** – Ordinary shares do not have a fixed maturity date, meaning they exist as long as the company operates.
- ⇒ **Potential for High Returns** – While riskier than bonds or preference shares, ordinary shares have the potential for higher returns through capital appreciation and dividends.
- ⇒ **Preemptive Rights** – Shareholders may have the right to purchase additional shares before they are offered to the public, maintaining their ownership percentage.
- ⇒ **No Guarantee of Dividend Payment** – If the company does not generate sufficient profits, it may choose not to pay dividends to ordinary shareholders.

8. Hire Purchasing Financing.

Hire Purchase (HP) financing is a method of acquiring goods or assets through installment payments. Under this arrangement, the buyer (hirer) pays an initial deposit followed by regular installments. Ownership of the asset is transferred to the hirer only after the final payment is made.

Features of Hire Purchasing Financing.

- ⇒ **Ownership Transfer at Final Payment** – The buyer (hirer) does not own the asset until the last installment is paid. Ownership remains with the seller or financier until full payment is made.
- ⇒ **Installment Payments** – The cost of the asset is paid in periodic installments (monthly, quarterly, or annually) over an agreed period.
- ⇒ **Down Payment Requirement** – The hirer usually makes an initial down payment, with the remaining balance paid in installments.
- ⇒ **Interest Component** – The total cost includes both the principal amount and interest, making it more expensive than outright purchase.
- ⇒ **Right to Use the Asset** – The hirer can use the asset while making payments but does not own it until the final installment is cleared.
- ⇒ **Possibility of Repossession** – If the hirer defaults on payments, the seller or financier has the right to repossess the asset without refunding the installments already paid.
- ⇒ **Fixed Agreement Terms** – The terms, including installment amounts, interest rate, and payment period, are agreed upon at the start of the contract.
- ⇒ **No Immediate Large Capital Outlay** – Suitable for businesses and individuals who cannot afford a large upfront payment for an asset.
- ⇒ **Option to Purchase Early** – Some agreements allow the hirer to pay off the remaining balance early and take ownership of the asset.

- ⇒ **Common for Durable Goods** – Hire purchase is often used for acquiring vehicles, machinery, electronics, and household appliances.

SHORT-TERM SOURCES OF FINANCE.

1. Trade Credit.

Trade credit is a short-term financing arrangement where a supplier allows a business to purchase goods or services and pay for them at a later date, typically within 30, 60, or 90 days. It is an essential source of working capital for businesses, helping them manage cash flow without immediate outlays.

Advantages of Trade Credit.

- ⇒ **Improves Cash Flow** – Businesses can acquire goods or services without immediate payment, allowing them to manage cash flow efficiently.
- ⇒ **No Interest Cost (If Paid on Time)** – Unlike loans, trade credit often comes with no interest charges if payments are made within the agreed period.
- ⇒ **Boosts Business Growth** – Businesses can invest in production and sales before making payments, supporting growth and expansion.
- ⇒ **Strengthens Supplier Relationships** – Consistently using and repaying trade credit helps build strong relationships with suppliers, leading to better terms and discounts.
- ⇒ **Easier to Obtain than Bank Loans** – Trade credit is often available to businesses without the need for collateral or extensive documentation.
- ⇒ **Flexibility in Payments** – Depending on the terms, businesses can adjust payments based on their financial position.

Disadvantages of Trade Credit.

- ⇒ **Short-Term Obligation** – Payment must be made within a relatively short period, which can strain cash flow if not managed well.
- ⇒ **Limited Availability for New Businesses** – Suppliers may hesitate to offer trade credit to new or unestablished businesses due to a lack of credit history.
- ⇒ **Potential for Higher Costs** – Suppliers may charge higher prices to compensate for the credit risk, making trade credit more expensive in the long run.
- ⇒ **Risk of Supplier Dependency** – Overreliance on trade credit can create dependency, limiting a business's ability to negotiate better terms or diversify suppliers.
- ⇒ **Impact on Credit Rating** – Late payments can damage the business's credit rating and affect its ability to secure future credit.
- ⇒ **Possible Legal Action** – Failure to meet payment terms could lead to legal action, penalties, or loss of supplier trust.

2. Short Term Bank Loans.

Short-term bank loans are loans provided by banks or financial institutions with a repayment period of less than one year. These loans help businesses and individuals cover immediate financial needs, such as working capital, inventory purchases, or emergency expenses.

3. Bank Overdraft.

Bank overdraft is a short-term financing facility that allows an account holder to withdraw more money than is available in their bank account, up to a pre-approved limit. It provides businesses and individuals with immediate access to funds to cover short-term cash flow shortages.

4. Debt Factoring.

Debt factoring, also known as invoice factoring, is a financial arrangement where a business sells its outstanding invoices (accounts receivable) to a factoring company at a discount in exchange for immediate cash. This helps businesses improve cash flow without waiting for customers to pay.

5. Invoice Discounting.

Invoice discounting is a short-term financing method where a business uses its unpaid invoices as collateral to receive an advance from a lender. Unlike debt factoring, the business retains control over customer payments and is responsible for collecting them.

6. Certificate of Deposit.

A Certificate of Deposit (CD) is a fixed-term financial instrument issued by banks or financial institutions that allows individuals or businesses to deposit money for a specified period in exchange for a fixed interest rate. CDs are considered a low-risk investment and are commonly used as a short-term or medium-term financing tool.

7. Commercial Paper.

Commercial paper is an unsecured, short-term debt instrument issued by corporations, financial institutions, or large businesses to raise funds for working capital or short-term liabilities. It typically has a maturity period ranging from a few days to 270 days.

8. Treasury Bills.

Treasury Bills (T-Bills) are short-term debt securities issued by the government to raise funds and manage short-term liquidity needs. They are considered risk-free investments since they are backed by the government's credit.