Week 9 & 10 Financial Reporting: Sources of Finance

External sources of finance:

→ LONG TERM

- Ordinary shares: higher return = higher risk: Shares depend on how well the business performs in terms of profits.
- Preference shares: fixed dividend = less risky than ordinary shares
- Borrowings
- Finance leases
- Hire purchase agreements
- Securitisation of assets

→ SHORT TERM

- Bank overdraft
- Debt factoring
- Invoice discounting

Advantages/Disadvantages (Mura et al., 2012)/ (Berry, 2011)

Businesses need to be aware of the risk element of long-term financing:

- Sources that are cheap in terms of servicing costs (loans) are riskier than those that are more expensive (Equities)
- High returns = high risk

→ ORDINARY SHARES

- The shareholders' stake in the business
- Shareholders only obtain dividend if profits available for distribution still remain after other investors and lenders have received their share of the profits. (Atnill et al., 2011)
- Stake in the business is reflected by the control that they have over the business.
- Large element of business financing, mainly from retained profits
- Expensive for the business as a large proportion of profits has to go to shareholders = low risk, Risky for shareholders as the level of return is not fixed and depend on the business's performance.
- Only receive a dividend if profits available for distribution remain after other investors (preference shareholders) receive their dividend.
- Dividends are not tax deductible to the business but taxable in the hands of shareholders – before the shareholder receives the dividend, the profit goes through tax and has to be divided between shareholders, which is then taxed once the shareholder receives it. = individual shareholder is taxed on company profit and on the dividend.
- Shares are easy for shareholders to liquidate if listed on stock exchange, otherwise it is difficult as it is more private and more difficult to sell the shares.
- <u>ISSUING ORDINARY SHARES:</u>
- Issues to the public are rare.
- IPO premium is a big cost to the issuing business