PRINCIPLES OF FINANCE 2

LEARNING JOURNAL UNIT 4

BUS 4404-01 PRINCIPLES OF FINANCE 2 - AY2024-T3

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1. Select three short-term financing instruments and three long-term financing instruments. Please explain them and describe how they work. When explaining the long-term financing instruments, address the concept of tax savings in terms of how they are achieved and why they occur when using one instrument and not another. Support your answer with sources/evidence.

SHORT TERM FINANCIAL INSTRUMENTS:

Short-term investments are financial assets that can readily be turned into cash, generally within a timeframe of five years or less. These types of investments, also referred to as marketable securities or temporary investments, are typically sold or liquidated into cash after a holding period of anywhere from three months to a year. Some of the most common short-term investment vehicles are certificates of deposit (CDs), money market accounts, high-interest savings accounts, government bonds, and U.S. Treasury bills. The defining features of these short-duration investments are that they tend to be of high quality and remain highly liquid. This gives investors the flexibility to convert the investments to cash conveniently and with minimal loss of principal whenever they desire to do so within the short-term window (Segal, 2023).

Three short-term financing instruments are commercial paper, bank lines of credit, and accounts receivable financing. Commercial paper is an unsecured, short-term debt instrument issued by a corporation, typically for the financing of payroll, accounts payable and inventories. Bank lines of credit are short-term loans made directly by a bank to a company. Accounts receivable financing allows a company to borrow against the value of its accounts receivable.

LONG TERM FINANCIAL INSTRUMENTS:

"Long-term finance can be defined as any financial instrument with maturity exceeding one year (such as bank loans, bonds, leasing and other forms of debt finance), and public and private equity instruments" (World Bank Group, 2017).

Three long-term financing instruments are bonds, preferred stock, and common stock. Bonds are debt securities that corporation's issue to raise capital, usually with maturities over 5 years. They provide interest payments that are tax deductible. Preferred stock is a hybrid instrument that provides fixed dividend payments and higher claim to assets and earnings than common stock. Common stock represents ownership shares in a corporation and provides residual earnings after debt and preferred claims are paid. Dividends on common stock are not tax deductible.

The key difference in taxes is that interest paid on bonds is tax deductible at the corporate level. This provides a tax shield or tax savings benefit. Dividend payments to preferred and common shareholders are not tax deductible and do not provide tax savings.

Tax savings can vary substantially across different types of long-term financial instruments due to differences in how they are taxed. When evaluating long-term investments for tax planning, three key factors drive potential tax savings: capital gains tax rates, tax-deferred compounding, and tax exemptions.

One major source of tax savings comes from the preferential tax rates on long-term capital gains and qualified dividends. For investments held over one-year, long-term capital gains are usually taxed at more favorable rates compared to ordinary income. For example, in 2022 the top long-term capital gains tax rate was 20% compared to 37% for ordinary income

(IRS, 2021). This differential enables tax savings when the increased value of investments like stocks and equity funds are realized. Municipal bonds also offer tax savings since their income is exempt from federal taxes (Kurt, 2022).

Tax-deferred retirement accounts like 401Ks and IRAs can create savings by allowing investment returns to compound over time without an annual tax bill. Taxes are only owed when money is withdrawn. Tax-deferred compounding benefit produces an average increase of 18% in accumulated savings. Taxable investments do not receive this compounding advantage (Burnette, 2024).

2. Imagine yourself as a financial manager in a company, and you are requested to provide a financial report including the calculation of the current market rate of return from the investor's perspective for each of the four investment options, taking into consideration the followings:

Common stocks available for investment are:

2,500,000 shares of common stock, with a par balance of $1 per share.

The current market value of the common share is $24.43 per share.

Annual earnings per share $1.95.

Bonds available for investment

$1,750,000 bonds (A) with an interest of 6.25%, with a current market value of $104 per bond (price of $104 per $100).

$2,250,000 Notes B, with an interest rate of 5.75%, with a current market value of $94.50 (price $94.50 per $100 note).

The corporate tax rate is 35%.

Preferred shares available for investment

950,000 outstanding preferred shares with a par value of $10 with a preferential dividend payment set at 5%. The current market value is $15.63 per Preferred Share

Following are the market rates of return for the investment options:

COMMON STOCK:

- Annual Earnings Per Share = $1.95
- Market Price Per Share = $24.43
- Earnings Yield = Earnings Per Share / Market Price Per Share

  = $1.95 / $24.43 = 8%

BOND A:

- Annual Interest Payment = 6.25% of Par
- Market Price = $104 per $100 Par
- Current Yield = Annual Interest / Market Price

  = (6.25% x $100) / $104 = 6%

BOND B:

- Annual Interest Payment = 5.75% of Par

- Market Price = $94.50 per $100 Par
- Current Yield = Annual Interest / Market Price = (5.75% x $100) / $94.50 = 6.08%

PREFERRED STOCK:

- Annual Dividend = 5% of $10 Par Value = $0.50 per share
- Market Price = $15.63 per share
- Dividend Yield = Annual Dividend / Market Price = $0.50 / $15.63 = 3.2%

Therefore, the common stock has the highest earnings yield at 8%, followed by Bond B (6.08%), Bond A (6%), and the preferred stock (3.2%). These yields represent the returns investors can expect from each instrument at current market prices.

Word count: 723

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