Chapter 8

CHAPTER 8 Business Financing

INTRODUCTION

Every business requires funds. Each source of funds also has its costs. Business enterprises finance their operations and projects through direct (internal) and indirect (external) sources. This chapter shall therefore examine:

- Sources of funds for business.
- Basic instrument for business fi nancing.
- Meaning and types of shares, debenture and other securities.
- Problems of business fi nancing in Nigeria.

OBJECTIVES

At the end of this chapter, students should be able to:

- Mention the sources of funds for business enterprises;
- Identify and explain the instruments of business finance;
- Define shares and debentures;
- Mention different types of shares;
- List the problems of business financing.

8.1 Sources of Funds for Business

The ability to utilise various fi nancial sources depends on the circumstances of each organisation. Generally the sources are as follows:

Personal financial resources: Th is includes personal savings and contributions by groups that form the organisation.

Loans from individuals: Th is can be from friends and relatives.

Loans from fi nancial institutions: Financial institutions such as the Nigerian Industrial Development Bank and commercial banks provide loan facilities for business organisations that are legally established.

Ploughing back profi ts: Profi ts made by the business can be set aside for reinvestment.

Trade credit: This means supply of goods or services on deferred payment.

For instance, when creditors supply materials to a company for a period of time without payment, they are financing the company indirectly while the credit lasts.

Equity shares: Th is is the main source of fi nance to the joint stock companies. They obtain funds from the general public by issuing shares and giving the shareholders certifi cate of subscription in ownership of the corporation.

Debentures: Th ese are long-term loans obtained from the general public at a fixed interest. Debentures may be redeemable by the subscribers after the expiration of the loan period.

Government subsidies: Subventions, grants and subsidies take different forms. The government can supply material inputs at a price lower than the market price and the government can also wave import and export taxes for goods imported or exported by the firm. The money which the fi rm would have paid as tax can now be retained and used for further development.

Grants: Th ese are sums of money the government may give a firm to enable it carry on with its projects.

Tax holidays and rebates: Th is is to allow a new firm a period of time within which it is exempted from the payment of company tax. This will allow the firm to be established properly.

8.2 Basic Instruments for Business Financing

8.2.1 Shares

The word “share” means participation in the provision of capital to the company. A share is a unit of capital invested in a business allocated to an individual and it is also a unit of ownership of a business concern.

Types of shares

Ordinary shares: Th ese are also known as the risk, equity or capital because their holders receive their dividend after all the other shareholders are fully settled and relevant expenses are all met. The holders are the residual risk bearers. If the business also flourishes, they stand at an advantage. They are the real owners of the business.

Preference shares: Holders of this type of shares are given preferential treatment in the distribution of dividends. In the event of folding up of a company, they are given preference in repayment of capital. They receive a fi xed rate of dividend from the total profi t of the company. Preference shares are further divided into cumulative preference shares, non-cumulative preference shares, redeemable preference shares and deferred or founders shares.

8.2.2 Debentures

A debenture is a certifi cate issued by a company to an individual, showing that the company owes money to the holder. It is a mechanism used by a company to raise a long-term loan, from the members of the public. The holders are not part of the owners of the company like shareholders, but they are creditors to the company. They are paid interest on the money they have lent to the company and they are not entitled to the company’s profit. The interest must be paid before the distribution of the dividend takes place.

Types of debentures

Mortgage debentures: These are debentures that are secured on the company’s property. Th is means that if the company goes bankrupt, the holders of these debentures are entitled to part of the firm’s property in exchange for their loans.

Naked or simple debentures: These are the opposite of mortgage debentures. They are also called unsecured debentures.

Secured debentures: Th is is one in which repayment is assured through a collateral security provided by the borrower.

Redeemable debentures: Th ese are the debentures the company agrees to pay on or before the fi xed date of repaying the loan.

Irredeemable debentures: Th ese do not have any fi xed date for their payment.

8.3 Difference Between a Share and a Debenture

◆ A share is a unit of capital allocated to an individual while a debenture is a certificate issued by a company to an individual showing that the company owes money to the holder.

- While a debenture is a loan from an individual to a company, a share is not.
- A shareholder is one of the owners of the public limited liability company who sold the share, while a debenture holder is simply a creditor to the company.
- While a shareholder receives shares from the profi t of the company in the form of dividend, a debenture holder receives interest for the money lent to the company.
- If the company did not make profi t, the shareholders may receive nothing depending on the type of share, while a debenture holder receives his interest whether the company makes profi t or not.
- A shareholder has liability in the company while a debenture holder has no liability.
- The interest of a debenture holder is paid before the distribution of dividend to shareholders takes place.

8.4 Problems of Business Financing in Nigeria

◆ **Amount saved for investment is usually small:** Per capital income is low in Nigeria and, as a result, workers may prefer to spend than to save.

◆ **Ploughing back profi ts:** Making profi ts at times may be irregular or difficult. At other times, profi ts made are consumed instead of reinvestment.

◆ **Borrowing:** In many cases, borrowing is not easy; small businessmen, such as the sole proprietor, may not be able to provide the collateral security required for obtaining loans from financial institutions. The amount raised from friends and relatives may also not be enough.

Summary

(a) Sources of business fi nance:

- Personal savings
- Loans
- Credit system
- Retained profi ts
- Shares and debentures

Class Activity

Students should identify the different ways in which money can be raised to finance businesses.

Revision Questions

Objective Questions

1. All the following are sources of fi nance to a joint stock company except:
(a) Bank loans (b) Equity shares
(c) Debentures (d) Preference shares
(e) Co-operative thrifts **(SSCE 1989)**

2. Th e reward of a debenture holder of a public company is a fixed rate of:
(a) Interest (b) Return (c) Dividend
(d) Rent (e) Allowance **(SSCE 1989)**

3. A government treasury bill is a form of debt instrument which falls due for repayment after:
(a) 3 months (b) 9 months
(c) 2 years (d) 5 years
(e) 10 or more years

(b) Problems of business financing:

- Small amount saved for investment
- Ploughing back profits may be difficult
- Borrowing from financial institutions, friends and relatives may not be easy

4. The reward for shareholder-ship of a company is its:
(a) Wages (b) Interest (c) Dividends

5. The type of shares that will get dividend and repayment of capital after meeting the claims of preference shareholders is known as
(a) Equity (b) Preference
(c) Bound (d) Business Instrument

Essay Questions

1. Mention and briefly discuss the sources of funds for business enterprises.
2. What are the basic instruments for business financing?
3. Briefly discuss the differences between a share and a debenture.
4. What are the problems facing business financing in Nigeria?

Glossary

Trade Credit: This is the supply of goods or services on deferred payment basis.
Debentures: These are long-term loans obtained from the members of general public at a fixed rate of interest.
Tax Holiday: This is allowing of new firms a period of time within which they are exempted from taxes.
Share: A unit of capital.