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Debt Financing In Business

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Abstract: A business or company needs to have a balance between equity and debt financing. The risks and advantages of using each of these methods of financing are analyzed in several ways and in this paper; we will analyze the use of debt finance. This is a case whereby the company or business borrows money to use in the business operations and later pays the money at a certain rate of interest. The financial distress is usually a challenge to many businesses and the threat is enough to bring down an existing business. A well-informed use of debt finance helps to mitigate the impacts of financial distress and helps many businesses to achieve their targets. The management makes the right corporate decisions after their analysis to determine how well to balance the debt and equity level, depending on the costs and benefits.

Keywords: Debt, loan, finance, enabler, barrier, business, organizations, benefit

Introduction

To operate efficiently, any business requires having the working capital and there are several ways of financing the activities undertaken by a business. The most common one is use of borrowed money or debt. The interest expense is tax deductible and therefore used of debt in business makes it less expensive and more profitable in business financing (Jensen and Meckling, 1976). Debt finance has been a better option to most of the businesses with most of the startups relying on it. There are many advantages and disadvantages of the debt, which are discussed below in brief. The financial institutions usually ask for a collateral or security when giving out loans to the customers, which becomes a challenge to most of the small business owners, which becomes a barrier. When the business fails to make enough money to pay the interest they are supposed to pay, the lenders may seize the collateral (Hamlin & Lyons, 2003).

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Advantages of Debt Finance

Use of debt has several advantages, which include the following; debt enables the business to grow, since the cost of debt is lower than that of equity. Equity is also associated with a higher risk than debt, since the shareholders always expect a share of the profits in form of dividends as compared to debt (Coyle, 2002). It also provides an emergency liquidity, whereby the business may use it to finance a requirement that was not planned for in the annual budget. Debt also keeps the business save from the dilution of rights. When compared with equity, debt retains the freedom of the management since in the case of equity; the management has to follow the requirements of the shareholders. The other advantage is that the costs are fixed and well known, since the rate of interest is counted even before the debt is given. In most cases, this rate remains constant and the fluctuations are minimal if any. Lastly, the interest is tax deductible and therefore the business saves on the cost of operations (Hamlin & Lyons, 2003).

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Disadvantages of Debt Finance

One of the major disadvantages of the method is that the business is at a high risk of defaulting and therefore losing the freedom to control the financial decisions. For example if the business makes losses and fails to pay the loan in time, there is a high probability that the funders may seize the assets that were given as collateral so as to repay their loan. This way the business will not have a right to decide when to sell the assets but will rather have to agree with the outcomes. The other disadvantage is that the business will lose the trust and the good relationship with the funders in case of a default, reducing the chances of getting any financial support in future. Lastly, the loan may be a source of failure for the business in case of mismanagement or over borrowing (Sharma, 2010). This is common in the seasonal businesses and in case of a misfortune that could be economic or a natural disaster.

Sources of Debt

There are two categories of sources; the public and the private sources. They include the following; the most common private sources are the trade credit and the bank debt. Trade credit is whereby the business gets a short loan from their supplier. They get the supplies without paying immediately, a loan that mostly goes for a month. If the business pays before the month is over, they get a discount of 10% and a penalty of 1.5% for every month after the first one. The bank debt is whereby the business borrows from a commercial bank and pays at an interest.

The public sources that are mostly used in the businesses are the commercial paper and the corporate bond. The commercial paper refers to a short term unsecured loan that is offered by corporations to finance inventory, the accounts receivable and the payroll finances. The commercial paper is only issued by a few qualified corporations. The corporate bond is given by the large corporations at a given interest. The loan can be a fixed or a floating loan depending on the rate of interest, whether it varies or it is fixed. For the business to get the corporate bond, they have to be competitive enough. The advantage about them is that the business does not need a good relationship or collateral to attain the loan (Sharma, 2010).

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Conclusion

The use of debt determines the leverage ratios of a company, which are used to give a reflection of the performance of a business. The cost of using the debt finance is lower than that of using equity but requires a good planning to avoid defaulting. Debt management requires proper skills to determine the amount to borrow and when to borrow. For most of the businesses that use debt and equity to finance their operations, they also need to have a good balance between the two so as to remain competitive and with no financial constraints (Sharma, 2010). Banks are the major sources of debts as they target borrowers to make interest from them. The higher the rate of interest, the more expensive it is to service a loan. The legal restrictions may also be a barrier or a limitation when

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a firm is seeking to have a debt. The size and volume of operations also determines the accessibility and amount of loan.

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