MODULE SIX: RESOURCE NEEDS FOR ENTREPRENEURSHIP

Sources of Business Finance

The entrepreneur may obtain finance from the following main sources.
Debt financing
Equity financing
External and internal sources
Debt financing requires a borrowing system and the entrepreneur is bound to pay back the funds borrowed together with interest payable.
Debt financing can be long term or short term. Depending on the lender collateral, may be required.
Equity financing does not require collateral and offers the investor some form of ownership position in the business.
Internal financing are funds generated from several sources within the company, they include profits sale of Assets, reduction in the working capital accounts receivable, retained profits e.t.c
External sources of finance may come from family members, credit suppliers, government programmes, and grants e.t.c.

Equity Finance

It the largest source of finance to a business organization and usually forms the base of which other finances are raised.
Equity is the total sum of the business ordinary shares plus the retained earnings also known as revenue reserves.

a) Ordinary share-capital

It is that finance contributed by ordinary shareholders of a business. It is raised through the sale of the company's ordinary shares. It is from people who are the real owners of the business.

The finance type is only raised by limited companies and is permanent in nature and can only be refunded in the event of liquidation.
It earns ordinary dividends as a return to the investments.
The investors carry voting rights and usually each share is equal to one vote.

The ordinary shares are quoted at the stock exchange where they are sold and bought.
The finance carriers the highest risks in the company because it gets its return after other finances have got their and also in the event of liquidation is it paid last.
The ordinary dividends are not a legal obligation on the part of the company to pay.
Where the profits are good ordinary shareholders get the highest return because their dividends are varied.

This type of finance grows with time and this growth is equity which basically is facilitated by retained earnings.

Advantages of Ordinary Share Capital to Shareholders

Ordinary shares have a right to vote and their votes influence the company's activities.

Ordinary shareholders can use their shares to secure loan.

Ordinary shares are easily transferable.

The owners of the ordinary shareholders earn dividends in perpetuity.

The fluctuating nature of dividends is earned.

The ordinary shareholders benefit from the residual claim in the event of liquidation.

Disadvantages of Ordinary Shareholders

Carry variable returns in case of low or non-profit dividends are not paid..

In case of liquidation an ordinary shareholder may lose everything.

The sale of more ordinary shares dilutes ownership of the existing shareholders.

The dividends of an ordinary shareholder are double taxed.

b) Retained earnings (revenue reserves)

This is a source part of equity finance which arises out of undistributed profits over and above dividends paid to shareholders.

It is a cost free source of finance and its cost is opportunity cost in terms of foregone dividends to ordinary shareholders.

The retained earnings constitute growth in equity which is a cost of equity because the company may declare retained earnings as extra dividends or inform of bonus issues.

Arguments in Favour of Retention

Acts as a stabilizer to future dividends (ordinary dividends) especially when profits perform poorly;

No cost are incurred for its acquisition

It is able to be raised at no notice especially during unforeseen events e,.g

a. Abrupt increases in the prices of raw materials

b. Fire hazards e.t.c

Promotes savings promoting investments and growth

Large volumes of retained earnings influence the company's shares positively.

A good source of finance to those very urgent short-term ventures whose returns are immediate

They boost the company's creditability to the company's creditors.

The advantages of using retained earnings as a source of finance to the company.

- It is the largest internal source of finance which the business will use without paying any costs.
- The use increases the equity base of the company making it possible to generate more debt finance.

- Retained earnings are used to finance new fixed assets whose value cannot be met by other sources
- It is used without pre-conditions or restrictions making it the most flexible source of finance.
- It boosts confidence among the company's creditors
- It is a permanent source of finance to the company to be used on long –term investments.

The disadvantages of using retained earnings as a source of finance to the company.

Easily misused by the management as it may be invested in areas which are prejudicial to majority shareholders?

Retained earnings once used will leave not shield to take care of contingencies exposing the company.

The finance can easily be mis-invested in areas of quite low returns.

The source involves a lot of sacrifice to the ordinary shareholders inform of opportunity cost

Easily invested in high risk investments

Debt Finance – Loan

This is the type of finance which is obtained from persons other those actual owners of the company i.e creditors to the company. The finance can be in any of the following forms;

Loans

Debentures

Bank overdrafts

Trade creditors

Borrowing against bills of exchange

Lease finance

Mortgage finance

Hire purchase finance

All the above finances have a legal claim or change against the company's resources or assets.

Requirements a Company must meet before raising Debt Finance.

- The company must provide a summary of history of the business and its nature. This is used to assess the risk of the company's business line.
- Details of management – names, ages, qualification and experience of managers and directors. If these are of questionable integrity, such as a company may not get debt finance.
- To produce five years audited accounts which will reflect the company's financial ability to service debt finance.

- The purpose of the loan must be; within the lender's priority and within the government areas of priority for development purposes.
- Furnish lenders with cash flow forecast and proposed trend of repayment.
- Major shareholders of the company must give consent to the loan.

Reasons why Commercial Banks prefer to lend short-term

- Majority of deposits with these banks are subject to withdrawal on demand and short-term notice these cannot be lent long term. The violation of this principle leads to the downfall of a number of financial institutions.
- Commercial banks are subject to sudden credit squeeze imposed by the central Bank and as such they have to keep their investments in short-term investments to meet the requirements of the central bank.
- Short-term forecasts are usually accurate and also short-term investments are less risky which is thus preferable to commercial banks.
- Short-term investments are usually more profitable to the banks e.g overdrafts which carry higher rates of interest than long-term loans.
- Usually short-term investments are not secured e.g overdrafts and thus are easier ad more flexible go give.

Limitations of debt finance/ disadvantages of using debt finance to the company.

- Interest is a legal obligation and failure to pay it may lead the company into receivership and consequently liquidation.
- Using debt finance entails conditions and restrictions to its use and this makes it non-flexible finance which can only be invested in those ventures approved by the lenders.
- Its use on large scale increases the company's gearing level which exposes the company to incidences of receivership and thus liquidation.
- It is not usually long-term finance and the payment of principal leaves the company in financial strain and may cause liquidity problems to the company.
- The use of excessive debt finance i.e beyond 67% level puts the company at the mercy of the lenders because they can come in to control their interests which dilute the control of owners and this may lead to lower share prices.
- Moreover, this finance calls for a security i.e it is usually secured against a collateral security which may be rare or lenders may be rare or lenders may restrict the use of such asset thus reducing the company's operations and thus its profit.

- The lenders usually insist that the security be compressively insured which will compound the cost of this finance as it will entail an implicit cost to the company.
- This finance is available only in big businesses which are known to lenders and as such small companies will not be able to raise it easily as they are assumed to be risky and are in most cases unknown to lenders.

Advantages of using Debt Financing

- Most debt financing is short-term and as such it will not burden the company‵s cost of financing for long i.e. cost is short-lived.
- Interest on debt is a tax-allowable expense and thus the effective/real cost of debt will be equal to interest less tax on interest i.e. interest is less by the much of tax on it. (refer to cost of finance)
- The principal is later reduced in real monetary values by much of inflation on it i.e the company pays less on long- term loans by virtue of inflation reducing the real monetary value of the principal and interest.

- The use of debt finance does not necessarily entail dilution of control to existing shareholders are these shareholders may only lose the control if the company has used 67% of debt finance in its financing i.e in its total capital employed.
- It is usually invested in viable ventures whose return is higher than its cost, thus it is used with a good investment policy
- This finance does not call for a lot of formalities in its use in as much as it does not involve a lot of floatation costs.

Circumstances under which a company should use short-term debt finance.

Under situations when the company has identified a venture which calls for finance on short-term notice and will pay back early enough to facilitate repayment of the loan.

Under situations where the company's venture promises higher returns that the cost of debt finances.

Under high debtor's turnover where the company wants to boost sales through further investment in stock.

Under boom conditions when the company's cost of debt is relatively lower as profits will increase relatively and the company can be able to service debt finance. This will raise the earning per share of the company's shares.

Characteristics of Debt Finance

- It is a fixed return finance i.e interest on debt is fixed regarding less of the profits made by the company.

- Interest of debt finance is a legal obligation on the part of company to pay and failure to pay it may lead the company into receivership in the extreme.
- It is usually given on conditions and restrictions except for overdrafts.
- It carries a first claim on profits and assets before other finances.
- It does not carry voting rights and as such it does not participate in the decision making process of the company.
- Its use rises the company's gearing level.
- It is always refundable except for irredeemable debentures.
- It is usually a secured type of finance
- Interest on debt finance is a tax-allowable expense.

Classifications of debt Finance.

Short-term finance

This ranges from 1 month up to 4 years and is given to customers known to the bank or to lenders. The agreement of this loan will mention both the repayment of principal and interest, and must identify whether it is simple or compound interest. For principal, it has to be paid over some time. This finance usually secured and the terms of the loan will be restrictive. Usually be invested in an area acceptable to the bank or lender. Usually this finance should be used to solve short-term liquidity problems.

Medium –term finance

This finance will be in the business for a period ranging between 4-7 years. This term is relative and will depend upon the nature of the business. This type of loan is used for investment purpose and is usually secured but the security should not be sensitive to the company's operations. The finance obtained must be investigated while respecting the matching approach to financing i.e the term and payback period must be matched. This type of finance if the most popular of all debt financing because most of the businesses will need it both in their growing stages and also their mature stages of development;

Long-term finance

This is a rare finance and is only raised by financially strong companies. It will be in business for a period of 7 years and above. This finance is used to purchase fixed assets in particular during the early stages of a company's development. It is always secured with a long-term fixed asset usually land or buildings. Its investment, however must obey the matching approach. In all, the companies needing such finance do not have to be known to the lenders.

Reasons why long term loans are difficult to raise/ limitations of using long-term debts.

- This finance calls for long-term securities such as land and buildings which most businesses may not have.

- There are no long term savings to back-up these loans due to low income of average business people and as much most of the savings are short-term and cannot be made available on long-term basis.
- Most businesses are agro-based and these are risky and as such lenders cannot avail their finance to such businesses of long-term.
- The central bank has tended to stimulate the development of money markets than capital markets which have not been fully developed to avail such finance to meet the development needs of industry and commercial sectors of the economy.

- Long-term loans are not usually profitable because interest and principal repayment are eroded by the by the impact of inflation and thus banks may be reluctant to give such.
- The size of the businesses in Rwanda and other developing countries is small and such businesses are not going concerns so as to be able to attract this finance on long term basis.
- A number of companies in Rwanda are multinational companies which obtain long term finances from parent companies abroad and this has limited the development of capital markets in Rwanda as demand by such companies is low.
- There has been a tendency by the financial institutions to avail long term debt for building purposes and little attention has been paid to long-term finances for businesses.
- This finance is given on conditions and restrictions to avail long-term debt for building purposes and little attention has been paid to long-term finances for businesses.
- This finance is given on conditions and restrictions which make it less ideal for profitable ventures as such restriction may reduce profitability of companies concerned.
- Long-term forecasts by commercial banks are inaccurate and filled with a lot of uncertainties thus the banks are very reluctant to shield such potential risks and prefer to lend short term finances which they can forecast with some degree of accuracy and certainty.

Solutions to the above problems

The government should diversify the security such that the same asset acquired acts as its on security and also to allow guarantees as securities in particular personal guarantees The government or individual commercial banks should undertake mass education campaigns to businessmen so as to induce them to save/keep their money in banks so as to avail such money of long –term lending.

The government should participate in the development of this capital market by;
Allowing some parastatals to go public i.e. to sell shares to the public

Selling or purchasing long-term debt instrument or creating a market for these and allowing the forces of demand and supply for money to operate freely in Rwanda so as to determine the prices of securities in the financial market.
The government should introduce insurance schemes to cover agro-based industries so as to reduce their risk and so as to be open to long-term finance.
There should be diversification in the economy from over-dependence on agro-based industries to manufacturing which will create employment and thus boost the incomes of average Rwandans and thus saving which will be available for lending.
The government should stabilize the value of the Rwandan currency so as to attract foreign long-term investors and aim at exporting more as means of gaining foreign exchange which can be used to stimulate long-term growth through importation of more capital goods and less consumer goods.

- **General Limitations of Debt Financing**
- The economic life of the asset to be used a security act as an outer limit to debt financing both the terms of principal and the term.
- If the balance of debt outstanding in the company's capital structure is high it means that the company is highly geared and this cannot allow lenders to give further finance to such a company as it will be viewed as risky.
- Debt financing may be expensive because it carries both implicit and explicit costs. These may out-weigh the returns from the investments.
- Ordinary shareholders may limit the much a company can use in debt financing as the level of the gearing is influenced by this finance thus putting them at risk.
- The size of the company may influence its ability to raise debt finance this size works better for quoted companies and unquoted companies usually find it difficult to raise such finance.
- General economic conditions may limit the availability of debt finance because in recession it is quite dangerous to use large sums of debt finance as these may not be serviced under conditions of low profits and may lead to the company's receivership in extreme.
- The management for the company may also limit the availability of this finance either by virtue of its nature (if its integrity is questionable) or if it is conservative in the use of debt.

Advantages of using an Overdraft

- It can be used to bail the company out of short-term financial liquidity problems

- Usually it is not secured as the company's goodwill is all that matters in obtaining this finance as long as the company is known to lenders.
- It is used without pre-conditions or restrictions which makes it a flexible source of finance,.
- It can be raised fast thus very useful in emergency financing endeavors.
- It is not expensive to raise i.e there are no costs paid to obtain it such as floatation costs. `
- Its cost and financial constraints are short lived.
- It can assist the company to meet its obligations in particular short term obligations thus sustaining the goodwill from creditors.
- Overdraft finance does not increase the company's gearing level, at least in the long run.
- Overdraft finance is used without consent of shareholders thus it is flexible as it can be used as and when it is needed.

Disadvantages of using Overdrafts

- It is very expensive finance and its lending rate is usually 1-2 % higher than the usual lending rates.
- Its constant use of a sign of bad/poor financial management policy and this may endanger the company's ability to raise long-term finance as long-term lenders view constant use of overdrafts as a sign of lack of overdrafts as a sign of lack of cash forecasts and budgeting policies on the part of the economy.
- It is not easily available to every business thus it is obtained by companies know better to the bankers.
- In some cases this finance may be used in a manner flexible to the management which most cases may not be in the interest of shareholders it may be used in areas which may not directly benefit shareholders i.e
- It is only available is small quantities and as such may not be useful for bigger ventures.
- The bank may recall this overdraft in part or in whole at any time and this may inconvenience the Company affected.
- Overdraft finance may only be used to finance non-profitable operations e.g working capital and cannot be used to finance fixed assets which are the most important ingredients in the company's production and profitable operations.