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A STUDY ON THE IMPACT OF DEBT ON CASH FLOWS

FK MUSWEU*

ABSTRACT

Most entities are bothered about the effect that debt finance may have on their cash flow and therefore wealth once used to finance their operations. Theyare particularly concerned about the advantages and disadvantages of debt finance as a method of funding projects as well as the characteristics of debt finance and comparison of debt with other sources of finance.

The information in article is entirely collected through secondary research, specifically from scholarly articles accounting and finance, various text books in accounting and finance and journals from professional bodies. The paper is mainly focused on the effect debt finance on cash flows of companies with emphasis on Zambian institutions.

KEYWORD: Debt Finance, Access To Finance, Credit Bureaus, Credit Reporting, Credit Rating, Financial Capability, Borrowers Of Funds, Providers Of Funds.

INTRODUCTION

The article discusses the advantages and disadvantages of debt finance as a method of funding projects as well as the characteristics of debt finance and comparison of debt with other sources of finance. The major emphasis is on the impact of debt finance on the wealth and cash flows of business entities.

WHAT IS DEBT FINANCE?

Debt is the main alternative form of finding and can be used for both short and long term purposes. Debt may be secured or unsecured and usually does involve the payment of interest.

CHARACTERISTICS OF DEBT FINANCE

The holders of debt instrument have a priority in interest payments compared to other sources of finding in the financial structure of the company. Interest on loan is fixed, so the holders of debt finance receive the same interest regardless of the earnings of the company. However if the company fails to pay interest payments together with the loan repayments the holders of debt finance have the right to effect the winding up of the company through the courts of law.

The holders of debt finance are not entitled to voting rights at the general meetings and annual general meetings and are not entitled receive notices to the meetings.

ADVANTAGES OF DEBT FINANCE

Debt finance is cheaper than equity as it is the less riskier source of funding than equity finance. The holders of debt finance will accept a lower rate of return than shareholders. Furthermore interest on debt is an allowable expense in

*Department of Commerce and Management Studies, DMI St Eugene University.
Correspondence E-mail Id: editor@eurekajournals.com

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determining the taxable profits and therefore it does act as a tax shield by lowering the amount of tax the company has to pay.

Cost of debt finance is limited to the stipulated interest payment apart from loan repayments.

The issue of debt finance does not result in the dilution of control and thus the impact on the financial and operating policy decisions of the company is minimal. It has no impact on the voting patterns on financial and operating policy decisions at the general meetings and annual general meetings of the company.The use of debt finance will reduce worries on the shareholders about their ability to make financial and operating decisions of the company which could be affected by the dilution of the ownership in the company when equity finance is used as a source of funding. The basis of this statement is from the fact that acquisition of shares, ordinary shares in particular entitles there holders to ownership in the company.

DETERMINING THE LEVEL DEBT

The statement of financial position is the source of information on the levels of debt an institution possesses.

In addition financial leverage ratios act as an aid in measuring the overall debt load of a company. It shows the level of debt the firm has accumulated in comparison to the capital employed or the shareholder's funds depending on the ratio we are using to determine the level of debt. If it is the total gearing ratio we are using the level of debt is compared to capital employed that is total assets less current liabilities. If it is the debt to equity ratio being used the level of debt is compared to the shareholder's funds that is share capital plus reserves.

Although when calculating the financial leverage or gearing ratios preference share capital is treated the same way as debt implying that preference share capital is added to debt to represent the gearing of the company which is a numerator in debt ratio calculation.

In addition the interest coverage ratio measures the rate at which the company is able to pay interest on the loans.

The formulars are shown below:

The total gearing ratio = Long term liabilities + Preference share capital x 100
Capital employed

Debt to Equity ratio = long term Liabilities + Preference Share Capital x 100
Equity (Ordinary share capital) + Reserves

Interest coverage ratio = Income (or Profit) before Interest and tax (EBIT or PBIT)
Interest expense

ACCESS TO FINANCE

It is vital to state that access to finance plays a critical row to the development of a country. Lack of funding has been an outcry for most organisations particularly, the small and medium scale enterprises (SMEs). The small and medium scale enterprises are one of the major contributors to GDP of most economics on the continent of Africa as well as employing the largest share of workers. Specifically the small and medium scale enterprises (SMEs) have played the row of fostering innovation, generating employment and increasing competition, however SMEs in the continent face several challenges to growth and it is important that these issues are resolved as this will result in SMEs increasing their contribution to economic development. Limited access to finance is not just a problem to the small and medium scale enterprises (SMEs), this also extends to large institutions, including government. Government and several other institutions are constantly searching for funds to carry out various projects and activities that contribute to a health and safe lifestyle of the citizens.

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Access to finance alludes to the accessibility of financial services. Physical access, reasonableness or qualification is imperatives to the entrance to finance. Furthermore little and medium scale businesses may experience issues in meeting qualification criteria, for example, the capacity to give insurance or strict documentation necessities. Most substances have constrained access to formal financial services because of cost boundaries in type of high transaction fees. State that the absence of access to subsidizing has required most establishments like the ones portrayed above to get obligation finance as a methods for subsidizing there tasks, ventures and exercises. The following passage sets out the past and current foundation.

THE PAST AND CURRENT DEVELOPMENTS

In Zambia like many African countries most of the public sector institutions in the early years after independence had depended on funding from the government. In several circumstances the finding from government mainly constituted borrowed funds from the cooperating partners commonly referred to as donors.

The public sector institutions were crippled by poor management, wasteful of resources and generally inefficiencies. Most of the companies did not utilize the borrowed funds in such a manner as to yield positive cash flows due to the syndrome stated above. This created a dependence syndrome where there was so much dependence on debt from the donors while little was been done to improve efficiency management of the entities, public sector entities in particular.

On the other hand a lot of people had little knowledge on investments and generally business management. Borrowing for consumption was common phenomena. Little investment and more consumption by the borrowers of funds ultimately led to negligible cashflows being yielded on the investment. Limited cashflows meant borrowers failing to honour the obligation of debt repayments, hence increasing the levels of defaults on debt repayments by the borrowers. This has had negative impact on the providers of funds as the defaults by the borrowers led to such institutions accumulating a lot of bad debts.Bad debts have had tremendous negative impact on a number of lending institutions, particularly banks. According to research in financial servicescredit riskis among the major risks that contribute to bank failures.

The major concern has been to enable trade and commerce to carry on while providing protection measures to reduce on possibilities of closures of lending institutions such banks due to bad debts which could arise due to high levels of defaults by the borrowers.

The major limiting factor is thatfinancial infrastructure in most African countries including Zambia is generally in its infant stages of development. In addition most of the people lack financial capability.According to research in financial services, financial capability is defined as the understanding, knowledge, attitudes and behaviors which consumers need to display in order to manage their money well, take advantage of financial opportunities as they arise and adapt to new financial circumstances. In Zambia and many other countries people need the skills and confidence to manage their money well.Financial capability is an essential ingredient to strengthen financial inclusion in Zambia and many countries in Africa.Therefore empowering people on the capability of managing their investments is an essential goal of financial capability. Enhancing financial capability ultimately aims at empowering people and changing their behavior in relation to management of investments and finances. In addition tostrengthening financial capability governments also has a role to play in protecting consumers by ensuring that financial

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intermediaries apply appropriate codes of conduct and standards. Recognizing the need for consumer protection is of paramount importance in enabling financial capability. Government need to enable provision of information on the prices and risks involved in the services from financial intermediaries so that consumers to make informed choices.

To reduce on credit risk financial intermediaries have been applying a cautious approach to only lend out to borrowers with the ability to pay back the loan. Financial intermediaries have engaged in credit reporting of individuals which is done Credit bureaus. The process involves collecting details on an individual borrower's obligations from a variety of sourcesthen cross-checked to produce a comprehensive credit report to obtain an individual's credit history. Credit bureaus are essential to the expansion of credit of most economies. According to research between 2002 and 2007, important legal changes were made in Zambia and many African countries to enable private credit bureau operations.Cardinal challenges in developing credit bureaus are often the lack of identity cards by most nationals and the absence of physical addresses.

On the other hand credit rating of institutions, including governments can be obtained. This is done by credit rating agencies. Experts in financial services describe credit rating as an opinion on the debtor's credit worthiness i.e. the ability and willingness to service the debt in full. It is important to confirm that Zambia and many economies in the sub region have been credit rated in the past few years and it is an essential ingredient when government needs to obtain funding in form of debt.

CONCERNS BY THE BORROWERS

The concern about debt finance from the borrower's perspective is the financial risk that comes with debt finance. Financial risk is the risk that the borrower may fail to honour its commitments of the debt repayments. It is a well-known fact the debt repayments are an obligation by the borrower and are not negotiable by law. Accordingly the debt repayments can be a burden if the borrower is not generating cashflows sufficient enough to honour the debt repayments.

However gearing can be a financially sound part of a business capital structure particularly if the business has strong, predictable cash flows "BPP Learning Media, Page 329, 2007".

CONCLUSION

Debt is generally useful if it is utilized to finance activities or projects that have signals of yielding positive cashflows; to the contrary if the activities or projects being financed do not give any signal of positive cashflows being yielded then debt should not be obtained. From the information given in the article in the past both providers of debt finance and borrowers had challenges. Nowadays these challenges have been alleviated. For instance financial intermediaries utilize credit reporting and credit rating of borrowers and potential borrowers to reduce on the credit risk on the loans they lend out and this has been discussed at length in this article. On the other hand information and knowledge on how to manage finances and investments well are offered to the borrowers of finding with the motive of yielding higher returns on their investment and ultimately gain sufficient cash flows to repay their debts and enhance their wealth. All these issues have been discussed in this article.

Debt provides an important means of access to funding which is essential to wealth maximization of individuals and institutions, including government, thus the use of debt finance can be encouraged as means of financing projects and activities so long it will lead to positive cashflows being yielded. Depending on the way debt is utilized by the borrowers it either increases or

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reducestheir cashflows. Fortunately nowadays the use of debt finance has been made safer to both the providers of finding and borrowers as described above, hence building a stronger case to support debt finance as a means of finding projects and activities. Furthermore even the wealthiest institutions have significant liabilities in their statements of financial position, an indication of how debt is being used to generate the wealth of most institutions.

Therefore the decision whether to obtain debt finance to fund organisation's activities will be dependent on the various factors that relate to such organisations. However this article offers both the negative side and the positive side of debt finance and has categorically spelt out the recent changes that add to debt finance being a safer source of funding as compared to the past years.

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