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The Nature of Debt Finance and the Factors to Consider when Choosing the Source of Debt Finance

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Abstract

Debt finance is part of the capital structure of an entity that is used to finance its assets. Being an essential part of an entity's financial structure it has been deemed necessary to discuss the nature of debt finance and the factors to consider when choosing the source of debt finance in this paper. Therefore the title of this article is "The nature of debt finance and the factors to consider when choosing the source of debt finance".

The details in this article are entirely collected through secondary research due to the specialised nature of the article. Information is specifically obtained from scholarly articles in accounting and finance, various text books in accounting and finance and journals from professional bodies such as ACCA, CIMA, ZICA and AAT.

Keywords: Debt finance, financial risk, Cost, Availability, Maturity, financial obligations, Security, Legal restrictions on borrowing.

Introduction

This article details the discussions on the nature of debt finance and the factors to consider when choosing the source of debt finance. Initially the nature of debt finance is discussed detailing background information about debt finance mostly in comparison to equity finance and finally the factors to consider when choosing the source of debt finance are discussed.

Debt Finance

Apart from equity debt finance is another source of capital. In this article features of debt finance are discussed both from the investor's perspective and the company's perspective. From research suggests that from the investor's perspective the holders' debt instruments have priority in interest payments and on liquidation compares to other forms securities such as shares. The holders of debt finance receive a fixed rate of return on their investments. The return debt holders' investment is in form of interest on the debt funding provided. This implies the holder of debt instruments receives the same returns on the debt funding provided whatever the earnings of the company. Furthermore debt has a definite maturity. The holders of debt finance do not possess the powers to participate in the financial and operating policy matter of an entity through voting at the general meeting and annual general meeting either by show of hands or through the ballot box. Debt holders can only possibly take control of an entity if interest on the loan and principal loan amount is not paid in this entails entity ceases to be a going concern when the extent of default is very severe. It is on the basis that the holders of debt finance have the rights to approach the courts of law to initiate the liquidation or winding up of the company if the loan and interest on the loan is not repaid "F.K. Musweu, 2018, Page 2". Research in accounting and finance emphasis that debt repayments are an obligation by the borrower and are not negotiable by law.

On the other hand from the company's perspective research indicates that debt finance is generally a cheaper form finding for the company due to the fact that the holders of debt finance usually accept a lower rate of return than shareholders and it is less risky than equity for an investor. One essential factor that makes debt finance a cheaper source of funding compared to share capital is due the tax shield effects of the interest on debt finance. This happens because interest on loans is tax allowable expense for tax purposes and the dividends on share capital are not tax allowable expenses for tax purposes there by reducing the cost of capital for debt finance compared to share capital. The other essential feature is that the cost of debt finance for the company is limited to the stipulated interest payment. Furthermore the issue of finance does not entitle the investors in debt security to ownership in the company. This implies that when debt finance is used as a method of funding by the entity its ownership structure is maintained. In other words there is no dilution of control in the entity when debt is issued.

Debt is generally useful if it is utilized to finance activities or projects that have signals of yielding positive cash flows "F.K. Musweu, 2018, Page 5". If not debt finance may not be the ideal source of funding as lack of possible future cashflows may lead to the company to fail to honour its obligations of repaying the loans and paying the interest on the loan in accordance with the terms of the loan agreement.

Factors to consider when choosing a source of debt finance

The following are the factors that a company should consider when choosing a suitable source of debt finance. Matching the features of the company's debt instruments with its corporate needs is essential when choosing the source of debt finance.

Cost

The cost constitutes the interest rate to be charged on the borrowed funds as well as the issue costs incurred in order to obtain debt finance. Furthermore the repayment terms of debt finance should also be considered for instance for a bank loan there may be capital payment in addition to the interest payment.

Financial risk

The gearing of the company increases with an increase in debt finance and an increase in the company's gearing leads to what is referred to financial risk. Financial risk is the concerns the uncertainty of the company ability repay the debts and payment of interest on the debt finance from its future cashflows. Thus the company should consider changes in its gearing over the life of the debt funding chosen and how the company will be viewed from a risk point of view by future investors.

Availability

The kind debt instrument available to an entity is dependent on the relative size of an entity as well as its relationship with its lenders e.g. banks and capital markets that provides funding. It is known fact that few small and medium scale enterprises issue traded bonds as a way of raising funding because of this small and medium scale enterprises for instance are likely to rely on bank loan as way of raising funding compared to traded bonds.

Maturity

The time it takes for the debt to mature is also an important consideration. The period it take for the debt to mature needs to be matched against the period over which an entity will be needing funding and entity's ability to meet the financial commitments that associated with the selected debt funding. According to research in accounting and finance another factor to consider is the flexibility of short term funding over long term funding. Additionally entities taking on long-term debt finance also take on long-term commitment where they get to have contractual obligations.

Risk and the ability to meet financial obligations

Providers of debt funding will determine the entity's ability to meet its future financial obligations and the risk the entity is exposed to when considering the amount to lend out and the terms of the funding to make available to the entity. The management of funds by the board directors responsibly and effectively can be determined by assessing the previous records which can be used as a guide to that effect. The business plan stating the kind of business activities for which funding is needed needs to carefully scrutinized to make sure that it rests it rests on reasonable assumptions and that the cash flow forecasts are achievable. This is an aid to the reduction in the uncertainty associated with the proposed business activities to be funded.

Security

The amount of debt funding to be offered to an entity will be dependent on assets available to be offered as collateral or security. Expectation of security by the debt investors will have the effect of reducing on the risk of the investment from their perspective. To compensate for the higher level of risk higher rate of interest may have to be paid if security is not available or is limited.

Legal restrictions on borrowing

Legal restrictions on the amount of debt that the company can take on is another factor to consider if any, for instance existing debt agreements may have restrictive covenants, or in the entity's memorandum or articles of association may contain such restrictions.

Conclusion

Debt finance has been increasingly been an essential source of for most organizations. The fact that debt finance has been a safer mode of accessing funding due to the financial infrastructure and other factors in put in place builds the case for debt finance as an essential source of funding. For instance evaluation of the credit worthiness of borrowers using vehicles such as credit rating and credit reporting have made debt safer mode of finding by reducing on the risk of default. One important fact to notice is that even organizations with sound financial performance still have debt finance as a significant portion in its financial structure. Therefore it is vital for various persons who have an interest in debt finance to understand the factors to consider when choosing a source of debt finance.

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