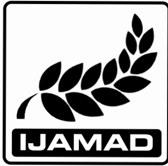

International Journal of Agricultural Management and Development (IJAMAD)
Available online on: www.ijamad.iaurasht.ac.ir
ISSN: 2159-5852 (Print)
ISSN:2159-5860 (Online)
Mini review

External Financing Method: Financing through Debt and Stock Issuance

Reza Aghajan Nashtaei, Ebrahim Chirani * and Mehrdad Goudarzvand Chegini

Received: 12 August 2016,
Accepted: 16 October 2017

Keywords:
financial markets, financing through debt, stock issuance

Abstract

Countries need short, medium, and long-term investment plans for production growth and development. Different sources for these investments can be supplied through retained profit, stock issuance, and bank loans, or a combination them. Institutions and firms need huge amount of capitals for their survival, production, and also development of activities. In addition, these institutions and firms rely heavily on financial markets for self-financing. The role of financial markets is to provide the required capitals for institutions and firms. Financing strategy is considered as one of the main areas of financial management decisions in companies seeking to increase shareholders' wealth. Therefore, the aim of this paper was to discuss conventional methods of external financing through debt and stock issuance and explain their associated advantages and disadvantages.

Department of Business Management, Rasht Branch, Islamic Azad University, Rasht, Iran
* Corresponding author's email: chirani@iaurasht.ac.ir

INTRODUCTION

Financing is one of the most important issues facing every company. Decisions regarding financing and investment in companies are made with foresight. In financing decisions, the company uses the given funds to be able to fulfill its obligations to the suppliers of financial resources in the future. In investment decisions, company ignores some of current profits, hoping to receive more profits in the future. Investment in machinery and equipment can be an example of foresight in gaining profit and returning it on investment. The production cycle and the development of joint stock companies are driven by appropriate financial resources. Financial resources are necessary to implement and complete industrial and administrative projects. Appropriate capital resources should be provided and this is why the method of financing is really important (Sheikh et al., 2013).

It is the duty of a manager to determine the sources of financing and how to use them. Financing decisions, optimum combination of capital, creating cash flows, optimal use of obtained financial resources, and the ability to repay debt are important issues for management decisions (Talebnia et al., 2015). There are several methods and approaches that exist in the area of financing in firms. It gives several choices and decisions to entrepreneurs and managers which can make this process more complicated (Chowdhury & Maung, 2013).

Among the most important methods of financing for joint stock companies that are active in the stock exchange are long-term bank loans and common stock issuance. Given that for co-financing in companies, both aforementioned sources are used and that the stock market reaction to insert any type of basic information is manifested as the symbol of price and output changes, resources used by companies for funding are very important. Accordingly, in this article, the researchers outline the theoretical foundations of external financing methods.

Financing in financial markets

Common framework for analyzing different financing methods is usually based on the following factors: Flexibility, risk, profit, timing and other factors include collateral value, floatation cost, pace, and future consequences. The relative importance of each of the above-mentioned factors depends on the specific condition of the business unit, but financial managers should ensure that they accommodate all the relevant factors (Babaei, 2014).

Flexibility factor refers to the impact of current financing decisions on different available financing methods in future periods. Using a financing method at the moment can possibly limit financing methods that can be used in the future. For example, using a financing facility at the moment can impose some restrictions on the business unit in terms of borrowing again in the next year and forcing it to use stock issuance method in an attempt to raise the required funds. Risk and profit are closely connected and have great importance. Controlling the business unit is also a concern of stakeholders. If the majority of stocks are currently owned by a small number of shareholders that control the business unit in question, maintaining this control will be of particular interest in decisions concerning the choice to be made from among different ways of financing and the impact of each of these methods. Yet, in large companies with a vast number of shareholders, controlling factor will have little effect on financing decisions. Timing is also a very important factor in the analysis of financing methods. The importance of timing depends on fluctuations in stock and bond market such that the more the fluctuations, the greater the importance of timing. Of course, other factors in addition to those just outlined should also be taken into consideration; factors like collateral value and available assets, which can be used as a guarantee. Floatation cost represents expenses that cover issuing and selling of securities. The speed of accessing to funds represents the fastest time during which the needed funds become available. Future outcomes represent the opportunities created by current issuance of securities and buyers' familiarity with the business unit (Abdi Tabrizi, 2015).

Thus, one of the decisions that the business unit managers should take to maximize share-

holders' wealth is the decision regarding financing. These decisions are related to the capital structure as well as to determination and selection of the best financing method and its composition. Accordingly, a financial manager can affect shareholder's wealth through changes in items such as earnings per share, dividend policy, the timing and risk of profitability, and choosing financing method. Financial resources for each economic unit consist of internal and external resources. Financing methods are usually studied in two groups of short-term and long-term financing (Sheikh et al., 2013).

Financing decisions are originally very important for two groups of economic unit subsets: The first group is the company or its managers and directors. Financial structure of joint stock companies is composed of two parts: The first part shows company's assets or investment results such as investments in machinery, buildings, and so on, and it is shown on the right side of the balance sheet (or company's financial statement). The second part consists of financial sector in companies, long-term and short-term debts, common and preferred stocks, as well as bonds and retained profit. Through these financial resources, companies collect the necessary funds, capital, as well as investment in properties and machinery. Therefore, accessing low-cost, long-term and low-risk capital resources is crucial for companies, because every funding has a minimum cost that the company should pay by the returns generated from investments and, it is believed, failure to pay it could have serious consequences. The second group involved in the issue includes the suppliers of funds or shareholders. Financing decisions are more important for the second group since shareholders are looking for more profits and less risk. They want financing decisions to be organized in such a way that their stock prices and, generally, their yield increase (Ahmadi, 2013).

Theories of capital structure

Financing methods are under the influence of internal and external factors such as company's growth opportunities, retained profit, company size, debit ratio, and intangible assets. Nobody has ever been able to provide an optimal capital structure. At the same time, the tax savings of interest expense encourage companies to finance through debt.

Several theories have been presented regarding the capital structure and each considers some factors in determining the debt ratio (the optimal capital structure):

- Traditional Theory: Based on this theory by using leverage, the value of the company can be increased.
- Modigliani–Miller Theory: According to this theory, there is no optimal capital structure. Although the cost of financing through debt is less than the cost of financing it through stocks, increasing debts can increase the financial risk of company which in turn increases the return shareholders.
- Static Equilibrium Theory: This theory assumes that there is an optimal capital structure which determines the balance between the costs and the different profits derived from stock issuance and debt in capital structure. Companies have a target capital structure which is determined by the benefits resulting from debt (tax benefits of debt) and the costs of debt (bankruptcy costs and agency costs). They adjust the target capital structure in response to transitory shocks that results in the diversion of company's financial leverage from the target leverage.
- Market Timing Theory: This theory states that the capital structure is the accumulated outcome of past attempts at market timing (Kordestani & Pirdavar, 2012).
- The Hierarchical Theory: According to the hierarchical theory, which is caused by information asymmetry, companies raise their own needed funds through internal resources first and then through borrowing, and finally, by stock issuance. In this theory, Market value to book value (MTB) is a criterion for investment opportunities. Based on the hierarchical theory, companies with a high ratio MTB, which reflects the growth or investment opportunities, use their internal resources and after making full use of their debt capacity, try to finance through stock issuance (Kordestani & Pirdavar, 2012).

Investment increase strategy in the processing industry

One of the requirements for the growth of any sector of economy is investment due to the extent of agricultural activities and capital intensity of new technology, greater investment is required. Increase in investment as well as increase in production and farmers 'income leads to the improvement of productivity in production factors. The sources of investment supplies comes from private and state sectors. Investing in integration, rural roads and the projects on water resources are directly done by the government. In cases where investment meets higher efficiency, in comparison with those with lower efficiency, financing is done by state banks with the subsidy interest rate like mechanization, conversation and soil fertility.

The private sector will be willing to invest in other cases with possibility of efficiency. To put it into practice, government plays a great role in identifying, introducing, promotion and particularly, reducing risk. Activities like construction of greenhouses and industrial animal farming meet these features. Moreover, the government should cause the development of investing by discounting or removal of taxes for the investors in agriculture and related industries. Process industry such as Yekoyek, Sanich, Tabarrok, Bozorgmehr, Chin-Chin companies.

The theory of hierarchical financing patterns was firstly presented by Myers as follows:

• Companies prefer internal financing resources.

• A target dividend ratio is chosen according to investment opportunities, and sudden changes in the dividend are to be avoided.

• Establishing a fixed dividend policy along with unexpected changes in profitability and investment opportunities means that sometimes internal cash flows are more and sometimes are less than the capital costs. If cash flows are more than the capital costs, the company will pay back its debts. If cash flows are less than the capital costs, company uses its bank account balance or sells its marketable securities (short-term).

• If external financing is required, companies issue the safest securities first. Accordingly, companies initially use debt, and only then and if possible, use convertible securities or common stocks for financing (Carbonara et al., 2014).

Types of financing methods

In order to attract appropriate financial resources, companies' management should specify the cost of multiple financing resources and determine the effects of these financing resources on company's return and operational risk. The term "appropriate" in the above sentence suggests implementing programs by which shareholders' wealth can be maximized. What makes it difficult is that there are myriad types of securities that a company's management can use. Notwithstanding, there is still no specific financial program by which the value of the company can be maximized (Babaei, 2014).

Various methods for financing have been suggested which are classified as follows in Figure 1: (Modares & Abdollahzadeh, 2007)

A) Short-term financing (current): defined as obligations and liabilities that will be paid during one-year maturity. The main resources of funds

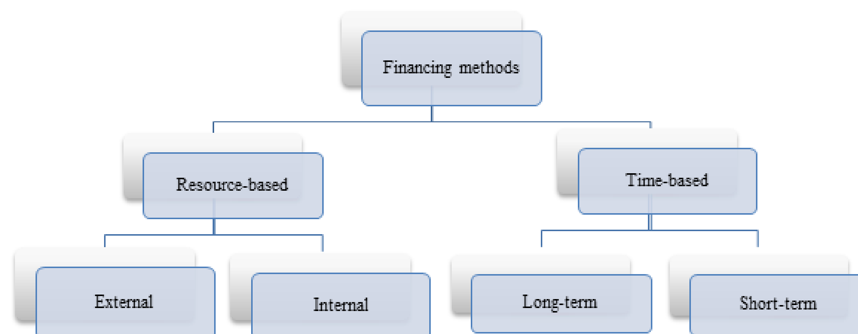

Figure 1. Different financing methods

in short-term financing in the order of importance for companies and institutions include:

- Floating credits between companies and institutions
- Getting loans from banks and other credit institutions
- Commercial paper, including promissory notes and bills of exchange that are generally sold to other institutions.

B) Long-term financing: defined as obligations and liabilities that will be paid during more than one-year maturity. The main resources of long-term financing include:

- Long-term loans
- Issuance of common and preferred stocks

C) Financing from internal resources that includes the following:

- A decrease in current assets
- Selling surplus fixed assets
- Depreciation allowances
- Undivided reserves and profits

D) Financing from external resources that includes the following:

- Getting loans from banks and credit institutions
- Credit or installment purchases
- Postponing (increase) liabilities
- Issuance of bonds, common, and preferred stocks

Managers decide how to provide the needed funds and how to use the available financial resources. (Shahid Ebrahim et al., 2014). Conventional methods of external financing companies are two: (a) financing through stocks, and (b) financing through debts. The advantages and disadvantages of these two methods of financing are as follows.

Financing through stocks:

Capital stock is money prepared by transferring the ownership of the company. Stock investor receives a percent of company's ownership which is ideally priced according to the company's growth. Investors may also obtain part of its annual profits, which is called dividend, and is determined based on the percentage of ownership. The advantages and disadvantages of this type of financing include:

Advantages:

- No personal guarantee is needed.
- No collateral is required.
- No regular cash payments are needed.
- Such investors may be investors with added value.
- Stock investors cannot force the company into bankruptcy.
- On average, the companies that invest through stocks are growing faster.

Disadvantages:

- Dividends cannot be reduced.
- The owner finds a new partner.
- This method is too expensive.
- The entrepreneur may lose his/her power (Deh Haft, 2015).

Financing through debt

Methods of financing through debt include funds that owners of small businesses have borrowed and should repay with interest. Although, the borrowed funds allow the company to retain full ownership, it will be obliged to the liabilities created in the balance sheet and repay it with its interest in the future. In addition, due to more risks associated with small businesses, they should also pay higher rate of interest. However, the cost of financing through debt is often lower than financing through stock. The company seeking financing through debt will be quickly faced with a wide range of credit options (loan). Financing resources through debt is divided into brokerage firms, insurance companies, credit unions, bonds, private bonds, government assistance, savings and loan associations, asset-backed lenders (mortgage), commercial credit, equipment suppliers, commercial finance companies, accounts payable and commercial banks (Aqajani et al., 2013).

During medium periods, companies usually finance through loans which means that the period for this type of loans is between one and a maximum of ten years. The period for some rental agreements is almost twenty years old. Thus, it can be said that for medium and long periods of time, loans and leasing contracts are used as a means of financing. The medium-term loan agreements are made directly between the lender and the borrower, and therefore, the

provisions in different agreements can vary. Since the company that usually needs money goes directly to the bank and lending institution and tries to reach an agreement with the agency, they do not interfere in determining the provisions and conditions of the loan agreement with regulatory agencies and the government (such as stock exchange commission). The medium-term loans have common features in terms of lending institutions, loan repayment table, interest rate, collateral type, and other contractual conditions. The advantages of long-term loans can be regarded as follows:

• Since the interest of mid-term loans is nearly constant, the borrower company will gain a large benefit from these loans if the profit from these loans is more than the cost of interest.

• The borrower company can typically negotiate about the conditions of the loan with the bank or lender; therefore, the repayment terms can be complied with the financial position.

• Companies that are eligible for issuing commercial papers due to improvement in their financial position can negotiate with the bank without giving collateral for long-term lending with low rates.

The disadvantages of long-term loans can be regarded as follows:

• Financial leverage resulting from medium-term loan can lead to a decline in the profits of the company, as the interest rate is relatively constant.

• Negative terms included in this type of loan agreements reduce the company's maneuverability and investment in the financing projects.

• Where companies have put some of the items of their assets as collateral, they cannot put it back as collateral again without the consent of the creditor.

• Paying annual installments may exert great pressure on the company's liquidity, because the company shall pay a large amount of money in each installment as the principle and interest of loan.

Financing through debt, due to tax savings and lower rates compared with the expected return of shareholders, is a more favorable solution for financing (Amiri & Mohammadi Khorzoghi, 2012).

The main resources for this type of financing include personal savings, family and friends, business angels, charities, government, banks, brokerages, financing through customer, financing through providers, and financing through purchase order and credit cards (Rogers , 2009).

Terms of financing through debt

The only criterion for the creation of debt as leverage for a company is comparing company's return on capital with payable average rate of interest. There are three cases in comparing them:

1. Return on capital more than interest rate: If return on capital is more than interest rate, it means that the company was able to increase earnings per share through loans. Getting a loan in this situation is a sensible way to continue company’s activities and ensure that the company has good financial leverage.

2. Return on capital equal to interest rate: In this case, company’s income is exactly equal to the interest it pays to use the funds. In this case, getting a loan is not sensible unless in some certain conditions.

3. Return on capital less than interest rate: In this case, company will be damaged by getting loans and using financial resources, accordingly, getting loan cannot be justified. Since the profit from company’s activities is less than the cost of interest on loans, it is called inappropriate financial leverage.

Capital structure of a company is the relationship between debt and equity, which solves the financial need for the preparation of assets (Hampton, 2006).

The advantages of financing through debt

• The cost of the interest on the debt is the acceptable cost of the tax.

• The debt repayment will be cheaper in times of inflation.

• Planning and controlling the company by financing through long-term debt is more suitable.

• By applying the terms of redemption in the contract, company’s financing will be more flexible. Such a provision allows the company to pay off its debts before the maturity of bonds.

• Long-term debt can maintain the company's future financial stability, especially at a time when money markets have stagnated and getting short-term loans is not possible.

The disadvantages of financing through debt

• Regardless of the profit or loss from operations under the contract, the interest cost on debt will be paid.

• The debt should be usually paid on the maturity date.

• The conditions of the loan agreement may impose extreme limitations on companies.

• The company's risk may be increased due to forecast errors in operations under the financing contract (Hampton et al., 2011).

Financing through borrowing is related to the balance between costs and benefits, and there is a total debt level beyond which the costs will be higher than the benefits related to tax immunity. Achieving a satisfactory level of debt or borrowing is not only essential, because of the need to achieve profitability and company value, but also important for the ability of an organization to deal with its competitive environment (Yazdanfar & Ohman, 2015).

CONCLUSION

Foreign financial resources are of great importance in terms of their impact on the company's financial risk and control. The most common external resources among joint stock companies that are active in the Tehran Stock Exchange include long-term bank loans and common stock issuance. Since both of these resources have the ability to absorb large amounts of cash and are long-term in terms of financial maturity and repayment obligations, joint stock companies have welcomed them in recent decades. Stock market's reaction to the events is in the form of price changes and stock returns. The impact of increased capital or long-term loan on prices and stock returns can help investors to take appropriate decisions.

REFERENCES

Ahmadi, M. (2013). *Studying the impact of financing methods on the value of companies listed in Tehran Stock Exchange.* Unpublished thesis, Faculty Management and Accounting, Centeral Tahran Branch, Islamic Azad University, Iran.

Amiri, H., & Mohammadi Khorzoghi, H. (2012). Analyzing the relationship between financing through debt and the quality of earnings in companies listed on Tehran Stock Exchange. *Journal of Financial Accounting, 4*(16), 61-81.

Aqajani, H. A., Abasgholi Pour, M., & Fahimi Raad, M. (2013). Explaining the methods of financing in case study entrepreneurial projects in Mazandaran Province: The development of technology. *Journal of Parks and Incubators, 9*, (36), 36-29.

Babaei Fasamy, M. (2014). *The relationship between methods of financing (retained profit, stock issuance and debt) and stock returns in companies listed in Tehran Stock Exchange in terms of the type of industry and company size.* Unpublished thesis, Faculty Management and Accounting, Rasht Branch, Islamic Azad University, Iran.

Carbonara, N., Costantino, N., & Pellegrino, R. (2014). Concession Period for PPPs: A win-win model for a fair risk sharing. *International Journal of Project Management, 32*, 1223-1232

Chowdhury , R. H., & Maung, M. (2013). Corporate entrepreneurship and debt financing: Evidence from the GCC countries. *International Journal of Managerial Finance, 9*(4), 294-313.

Deh Haft, M. (2015). The relationship between entrepreneurship and financing through debt in companies listed in Tehran Stock Exchange. Unpublished thesis, Faculty Management and Accounting, Rasht Branch, Islamic Azad University, Iran.

Hampton, J. (2006). *Financial management* (Masoud Vakilifard, Trans.). Tehran: Samareh Publications.

Hampton, J., Hurt, B., Stewart, F., & Vance, P. (2011). *Decisions on financial issues* (Hamid Reza Vakilifard, Trans.).Tehran: Jangal Publications.

Kordestani, G.R., & Pirdavary, T. (2012). Capitcal structure of empirical test of market timing theory. *Journal of Accounting, 9*, 142-123.

Shahid Ebrahim, M. Sourafel Girma, M., Shahc, E., & Williams, J. (2014). Dynamic capital structure and political patronage: The case of Malaysia. *International Review of Financial*

Analysis, 31, 117-128.

Sheikh, M. J., Dehghani, J., & Raiee Ezabadi, M. I. (2013). The Effect of Inflation Rate on Financing of Company listed in Tehran Security Exchange (Debt Financing and Equity Financing). *Journal of Asset Management and Financing, 1* (2), 68-51.

Talebnia, G., Desineh, M., & Moridi, F. (1394). The impact of financing decisions on the management of cash flows. *Researches in Financial Accounting and Auditing, 7*(26), 106-87.

Yazdanfar, D., & Öhman, P. (2015). Debt financing and firm performance: An empirical study based on Swedish data. *The Journal of Risk Finance, 16*(1), 102-118.

How to cite this article:

Aghajan Nashtaei, R., Chirani, E., & Goudarzvand Chegini, M. (2017). External financing method: financing through debt and stock issuance. *International Journal of Agricultural Management and Development, 7(4), 517-524.*

URL: