Corporate Finance and Credit Options in a Global Age

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Abstract: In the context of globalization, finance often seems to be all number but it is fundamentally social rather than mathematical. It is a product of society. Modern finance consists of promises that are accepted. The Latin root of “Credit” illustrates this aspect - *credere* is to believe or entrust. In the same way that language facilitates expression and understanding finance gives promises power in commerce, over the allocation of goods and services to consumers and over the uses of land, labour and capital in production. This study upholds the view that finance cannot be separated from risk. The opposite of risk is confidence. Finance harmonizes these opposites when risk is sufficiently offset by confidence, transactions occur and value is created. Finance therefore cannot exist without confidence. The relationship between value risk and confidence is triangular.

Key words: Capital, credit, finance, globalization

INTRODUCTION

Credit enables. It gives borrowers purchasing power that can be used to obtain assets that are expected to yield a return. This is the simple development model that underlies funds, government intervention in financial markets and other efforts to promote loans for small business, farmers, women or other groups. The model is valid, but its application if sometimes native and its progression not fully appreciated.

In fact, credit is debt. It earns no return for borrowers. A loan is a liability of the borrower, a source of expense in the form of interest and transaction costs. When a borrower receives a loan in the form of cash, the cash also has no earning power until it is invested. If a farmer who borrows invest in seeds, they may contribute to a successful harvest that can be sold at a remunerative price.

The intermediate steps between credit access and income generated that are often neglected are receipt of the loan and the purchase and utilization of assets that are capable of yielding a return, of course, these steps are not entirely, ignored in practice. Credit programmes and loans from Donor agencies for example, generally have specific purposes often supported by technical assistance designed to make loan use more efficient. Misinterpretation occurs when the returns to the use of funds are attributed to the loan rather than to the activities “Financed by the loan” or associated with the borrower’s use of funds.

TERM STRUCTURE OF CREDIT

The quest for larger returns leads financial market participants to seek greater value from their activities. This is seen in the bargaining and bidding processes from which financial transactions evolve. A more subtle expression of this force is the introduction of new types of financial arrangement, which consist financial institution. Innovation provides a dynamic means of creating value where none existed before. Financial innovation, which increases wealth by creating value, is natural in competitive financial markets.

In an expanding economy borrowers seek larger loans and lenders have more funds at their disposal, corporations and their shareholders want a laughter price for their stock, and intermediaries seek more funds and transactions. Under term structure, discounting incorporates a time horizon. Term structure is financial terminology that denotes a time horizon and movement towards it by decision makers operating in markets for debt.

Term structure is created in exchanges of cash in the present for expected future value. Without term structure there would be no credit and no equity markets because promises would not command any value. It is essential for creation of value and of course has two dimensions, maturities and interest rates. The maturities of financial contracts define the term structure of the markets in which they trade. The term structure of interest rates is the relationship between maturity and yield on promises differing only in maturity.
COST AND VALUE OF FINANCE

Risk, the possibility of loss pervades finance. This is because finance trades the future against the present and the present against the future. Because the future is uncertain, risk is always present. Financial behaviour responding to risk is seen even where money is not used.

Allan (1965) described how clan groups practicing slash and burn agriculture accommodates risk. Cost and value of credit is a function risk. Risk management centers on the sacrifice and preservation of liquidity. The most over formal lender is the comprehensive information they accumulate about their clients through day to day contact. Timberg and Alyar (1984) found an extreme example of this when they asked an Asian money lender how he decided to take on additional clients. Understandably, the proprietary nature of this information cause money lenders as well as other informal lenders who reply heavily on inside information, to be decry about candid information about their operations with researchers (Chandavarkar, 1986).

The malicious money lender myth holds that exploration through credit terms in pervasive and highly oppressive. One flaw in the myth is that extreme cases are often interpreted as common practice. The attack of the myth of pervasive high levels of abuse by informal, private lenders begins with several arguments. In the 1950s Martin Welmington suggested that informal finance is not necessarily exploitative. Critics also appear to overlook many lenders relatively restricted opportunity to diversity their loan portfolios. Bottomley (1975) and others have posed persistent challenges to malicious information finance myth. Evidence from India with reference to the ALL-India Rural credit survey and survey results from Philippines with reference to the Technical Board for Agricultural credit are clear indications.

Critics often cite exorbitant interest rates as the main justification for condemning informal finance. They also ignore inflation. At least three questions must be answered to establish whether lenders are taking undue advantage of borrowers:

1. What are lenders opportunity costs of funds and the risks involved in lending?
2. Are more informal lenders in a position to extract monopoly profits?
3. Are credit transactions linked with marketing and production to enhance exploration?

Studies by Singh (1968) of informal fiancé in India, show that informal finance’s interest rates are high because the opportunity cost of funds, together with lending risks, are high. The high interest rests in informal markets largely indicate that funds are scarce and that at least some people realize high rates of return from using borrowed funds.

Christen (1988) makes the same point from the perspective of borrowers in Latin America. He argues that many managers of micro-entreprises borrow from informal finance at high rates of interest because of the low transaction costs involved and the high quality and dependability of the informal financial services and also because high rates of return result from the use of borrowed funds. Many of these high return activities are also available to lenders and are further indications of high opportunity costs of lending if traces of monopoly power exist in informal financial markets, they can be moderated by expanding formal lending. And if monopoly power lies in other markets linked to informal finance, that power will not be directly affected by finance persists and often flourishes because it resolves important problems that are handled poorly or not at all on most formal financial systems.

SHORT TERM SOURCES OF CAPITAL

The primary source of all capital is savings or postponed consumption. Savings set aside as a means of increasing future production are known as capital. Besides savings for own production are known as capital. Besides savings for own production, there is another feature of the developed economy that the saving (surplus) of the producer may be invested in another producers business rather than his own. There are considerable differences of opinion on the limits for the various terms of capitals. Most classifications observe arbitrary time span. Although the sources of all capital are savings, people motives for savings vary widely as do their motives for investing their savings. Consequently, it is apparent that a particular investment opportunity will appeal to some people and not to others.

Short term source of capital can be defined as funds made available for short periods of time though there is no agreed definition of the word, short term it is probably fair to say that money borrowed for period up to one year is short term borrowing. Short term needs are usually to buy raw materials, pay salaries and to meet seasonal fluctuations in inventories. The cost of short term borrowing is usually less than that of long term borrowing.

The cost of managing current liabilities is like that of managing any other area of a business. Management wants to balance their costs against their benefits to increase shareholders wealth.

If the company uses short term financing, then using sources that are least costly improves earnings and cash flow. It must be emphasized that short term financing
exposes borrowers to interest rate risk. It reduces the average maturity of liabilities forcing the company to roll over its debt more often. If interest rates rise then the company must roll over debt in a higher interest rate environment. That leads to lower earnings. Lenders unwillingly or unable to provide funds may force borrowers into bankruptcy and liquidation.

**TRADE CREDIT BETWEEN FIRMS**

The granting and taking of trade credit is an important aspect of business. In ordinary course of events, a firm buys its supplies and materials on credit from other firms, recording the debt as trade creditors. Trade credit is the largest single category of short term finance and its represents about 6.0% of the current liabilities of non-financial companies. This percentage is somewhat larger for small firms because small companies may not qualify for financing from other sources; they rely rather heavily on trade credit.

A company received trade credit when it buys goods without paying cash on or before delivery. Trade credit is a spontaneous source of financing because it increases with business activity. The company’s financial manager does not need to negotiate for trade credit convenience explain its widespread use. Writing a cheque once a month is easier than using cash. Companies enjoy the convenience for writing few checks even though they may make hundreds of small and large purchases each month.

In addition to convenience, trade credit enables companies to use else where the cash they would have used to pay for goods on delivery (C.O.D.) interest on a bank loan appears for shareholders and lenders to see. Unlike bank loans, using trade credit rarely entails an explicit interest expense. Trade credit looks like the proverbial free lunch. Its cost does not appear on the income statement. However, prices of goods purchased may be larger because of trade credits. Competition among sellers largely controls the credit terms a customer receives. Industry standards which depend on the product also play roles. Perishable goods requires a fast payoff to reduce the risk of customers defaulting different turnover of products provide difference in credit terms. Generally speaking, trade credits vary among customers even within the same industry.

A customer with a good payment record and sound financial position received more credit than weaker counterparts. Sellers ordinarily grant more liberal credit terms to customers with financial liquidity, high profit and low deb-equity rations. These customers have low default risk.

**BORROWING FROM COMMERCIAL BANKS**

Commercial Bank borrowing for short term is usually of two types: Overdraft and term loans. Bank lend on overdrafts by permitting a business to overdraw its accounts up to a specific limit. This faculty is very flexible and ideally showed be used for temporary situations often being kept in reserves for unusual events. Overdrafts are payable on demands but in practice they are allowed to continue. If the account is conducted satisfactorily. The business advantage to the borrower is its flexibility that all interest is charged to the daily overdraft balance.

Banks offer companies unsecured and secured loans. Historically, bankers preferred to make secured loans called short term self-liquidating. Theses were loans repaid out of cash flows from the asset financed. A typical short term, self liquidating loan is a loan to finance inventory and generates cash to repay the loan. Bankers view such loans as exposing them to little default risk. Today, deregulation of the banking system and increased competition force banks to make several different types of loans and to be aggressive lenders.

Companies use unsecured short term bank loans for a specific purpose example to finance temporary or seasonal increases in current asset. The borrower does not pledge assets to secure them; sometimes companies apply for direct loans, one time loans for a specific purpose. The financial manager negotiates each loan, tailoring it to company needs. Bank loan officers analyze the application and decide whether or not to extend the load.

Banks through line of credit provide finance for companies. This defines the maximum loan balance during a year subject to renewal and cleans up.

**FACTORING AS A SOURCE OF FINANCE**

Factoring involves raising funds on the security of the company’s debts. So that cash is received rather than if the company has waited for the debtor to pay. Basically, most factors offer three services to their customers (Osubor, 1984):

- Sales ledger accounting that is sending out invoices and making sure bills are paid
- Credit insurance, guarantee against bad debts
- Provision of finance

The company needs to use all the services offered by factor who may be a lawyer, an accounting firm, a debt collecting firm a finance firm etc. The company may decide to just use one or two of the above listed services. In acting as a sales ledger accounting the factor mails out
involves to the company’s customers and also receives payments on behalf of the company. A dept collection commission of sum collected is usually charged for such services and in acting as credit insurance, the factor pays all un-collectible debts to the company. A reasonable premium to cover such risks is usually charged by the factor.

Unlike pledging for a loan, factoring is the outright sale of receivables. When a company pledges receivables, it retains title them. With factoring, the company transfers title to the facto, the financial institution buying the receivables. Factors include subsidiaries of bank holding companies and institutions specializing in factoring.

The cost of factoring appears more expensive than unsecured bank borrowing. However, bank loan fulfill only the lending function factors check credit and bear risk as well as loan money. Factoring ends bad debt expense and the need for a credit department.

**Borrowing on the Security of Debtors**

Bills of exchange are used mainly by large firms and sold primarily to the discount house. A bill is defined in section 3 of the Bills of Exchange Act 1982 (U.K.) as an “Unconditional order in writing addressed by one person to another signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time a sum certain in money to or to the order of a specified person or to bearer.

A post dated cheque is a simple example of a bill of exchange. Bills of Exchange are today being used for a lot of overseas trade; the cost of funds provided by the bill of exchange depends upon the rate at which the bill is discounted. The discount rate fluctuates from day to day and is influenced by bank rate, the state of the money market and the credit worthines’ of the bill owner.

This form of financing which was considered by the Radcliffe committee in 1959 to have irreversibly shrunk’ has been growing rapidly in recent years. Although several factors have contributed to this resurgence the most dominant factor has been the existence of credit squeezers which have led business firms faced with shrinking availability of banks finance to resort to other means of short term finance.

**Other Sources of Short Term Capital**

The use of hire purchase for the acquisition of assets is quite common and follows the pattern of domestic hire purchase. The property belongs to the hire company until the final installment is paid, the asset then becoming the hirer’s. the legal framework of hire purchase agreement is that the hire purchase company hires the equipment to the intended purchaser who is given an option to purchase the equipment does not rest in the hire until the completion of the agreement. The significance of the hire purchase in the finance structure of the economy is that it is a convenient source of credit in fixed terms for the purchase of equipment where the equipment can provide adequate security for the loan and the loan can be paid off by regular installments.

Leasing is a form of short term finance. The distinguishing feature agreement is that the company leasing obtains the use of an asset for a period of time, whereas the legal ownership of the asset remains with the company (Lessor). Leasing does not bring in new money to the company but it obviates finding the capital sum and introduces additional earning capacity. Where a technological change is rapid the lessee runs less risk of getting stuck with an obsolete asset. Leasing is a financial service whose main benefit is to preserve a firm’s liquidity and reduce its risk from obsolete equipment. The extensive use of this source of finance may prejudice existing loans through reducing the asset backing.

Loans from non-bank lenders are another good source of short term funds for companies. Non bank lenders consist of finance companies, insurance firms’ credit unions and savings and loan banks. These institutions are specialized financial intermediaries and sometime act as agents of the companies before the commercial banks. The costs of short term from these sources are usually higher than those of the commercial banks.

Some well managed companies raise short term funds by selling large domination commercial paper which man or may not be negotiable. Since commercial papers mature at per, they are usually sold at a discount. Unlike the bank loan market the commercial paper market is impersonal. Companies that issue commercial paper have high credit ratings. Corporations, money market mutual funds, insurance companies, pension funds and banks are major investors in commercial paper.

**Perspectives on long term financing**

Financing on long term sources of funds such as: bonds, preferred stock, shares, debentures and others are widely common in developed markets of the world. Recently, business concerns and government bodies in Africa have shown interest in this avenue of raising needed long term capital for their project.

Debt financing has grown wide in developing countries where the urge to come developed is very high because of many reasons:
Companies growth rate in sales and assets have increased that is has become very difficult to finance them entirely from retained earnings. The present day double and triple digit inflation has encouraged firm to use more long term debt. The cost of debt capital is usually lower than that of equity capital. Moreover, the absences of developed stock market have made firms in these countries to rely very much on debt capital. Finally, interest expense on bond is tax deductable in some countries which makes the overall cost of debt smaller than that of equity.

**BONDS AS SOURCE OF CAPITAL**

A bond is a promise to pay, issued by a firm corporation or government bodies to borrow long term fund. It pays stated interest and repays its face value at maturity. There are about eight major types of bond. Mortgaged bonds, collateral bonds, income bonds, revenue bonds, general obligation bonds, debentures and subordinated debentures.

The cost of debt is the rate of return required by the contributors of debt capital to the company. The cost represents the minimum rate of return that must be earned on investments financed with debt on order to maintain the market value of the company’s. Shareholders equity infact. All bonds have three yields a coupon yield, a current yield and a yield to maturity.

Debenture is a bond given in exchange for a loan by which the company agrees to pay a stated rate of interest for its use through out an agreed term. Rearly a company may issue irredeemable debenture which cannot be paid off although they are sold on the stock exchange.

**SHARES AS SOURCE OF FUNDS**

Ordinary shares constitute the first sources of funds to a new business. Ordinary shareholders have residual right in the company whose divided depend very much on the earnings and dividend determinants of the company.

Preference share has claims ahead of ordinary share but behind all bonds. The preference may be a prior claim on earnings; it may take the form of a prior claim on assets in the event of liquidation of both. Preferred share is often viewed as both equity and both. When an ordinary shareholder is considering the earning fluctuations induced by fixed change securities, preference share would be treated as debt. Preference share provide an additional equity base.

**SUMMARY AND CONCLUSION**

Financial transactions monetize promise, exchanging cash in the present for a promise of future reciprocity. Credit markets create value in the form of loans in the present that are exchanged for promises to pay in the future. These promises are often supplemented by undertaking regarding the rights and behaviour of parties to credit transactions. Equity markets create value when a corporation issues shares of stock, promising rights of control and allocations of expected earnings that are traded for cash in the present. Value is created in markets for guarantees when one party pays another for a promise to assume a financial obligation related to occurrence of a future event. The Value of a contract equals its prince.

Borrowers are originators of promises that help them obtain funds that enable them to demonstrate their abilities to define their place in the future lenders are buyers of promises who support and participate in the activities of those offering promises. There are many sources and forms of short term financing. The best is a function of many variables. Generally, speaking, transactions among buyers and sellers of promises (credit) spread risks and returns, both actual and expected, over a larger number of economic units.

**REFERENCES**


