Economic and legal advantages to business financing through the issuance of bonds

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Abstract

In this paper we treat economic and legal advantages to firms in business financing through the issuance of bonds. Besides theoretical analysis paper includes the empirical analysis, a survey conducted in 50 businesses, including individual businesses and corporations, about the types of financing they use. The objective was to obtain necessary information regarding the form of business financing in our country. The research shows that the majority of businesses surveyed stated that they started businesses with the bank loans due to lack of own capital. Most of the businesses surveyed feel the need for new sources of funding. The majority of surveyed businesses have no knowledge on how capital markets work in practice. The use of alternative financing methods in Kosovo hinders the lack of adequate markets for the trading of financial instruments. There is not yet a legal infrastructure that regulates the functioning of the capital market, especially the issue of bonds as funding conduit of great importance for large companies. Through hypotheses testing is proved that the development of the capital market would give the firms the opportunity of issuance of bonds as a funding source.

Key terms: Sources of funding; Bank loans; Bonds issuance; Capital market; Debt financing.

JEL Classification: G20, G21, G22, G30, G31, G32, G33

Introduction

In this paper we treat economic and legal advantages to business firms in financing through the issuance of bonds. The paper aims to make a modest contribution to argue that the issuance of bonds by business firms is an economically reasonable and legally safer move for both the issuer of the bond, and the buyer.

Internal sources of financing constitute the bulk of funding for business activity, usually between 50-70%. Although in certain periods the external financial resources increase significantly, they remain on a lesser importance compared with the internal financial resources (Brealey and Myers, 1984).

External sources are the focus of this paper, and they are divided into two main types: debt financing and equity financing. Large corporations often avoid using other methods to finance and achieve long-term needs by issuing bonds as long-term debt securities. Bonds are loans that issuers receive from investors through debt securities. Corporations can use these instruments to expand the businesses or for other needs (James and Wier, 1988).

Besides theoretical analysis paper includes the empirical analysis, a survey conducted in 50 businesses, including individual businesses and corporations, about the types of financing they use. The objective was to obtain necessary information regarding the form of business financing in our country.

During the study of this problem we encountered difficulties stemming from the lack of the securities markets in the country, and lack of experience in terms of transactions with debt financial instruments.

In this paper initially we treat the sources of financing, types of financing resources, internal and external resources of financing, business financing through the issuance of bonds, economic and legal advantages to business financing through the issuance of bonds, restrictions on the use of the bonds to finance the businesses, empirical analysis, and conclusions and recommendations.

At the end of the paper are given conclusions and suggestions. There is explained current state of the business funding in our country, the reasons for lack of capital markets and the need for improvements in the development of these markets. Given the lack of capital markets in our country, especially the lack of the financing through bonds issuance, the practical part this research is focused mainly on the overall level of funding of the businesses by including all types of business, and by presenting data collected as a result of our research survey.

Methodology

The practical part of the paper provides an overview of the findings and offers interpretation and analysis of the data from quantitative research conducted through structured questionnaires and conducted interviews. The research was conducted in 50 local businesses including various forms of organization (individual businesses and corporations).

The questionnaire is designed and crafted in such manner and form to enable the realization of the goals of this study. Analysis of the data presented are mainly quantitative and structured primarily regarding the form of business financing in our country and the challenges and obstacles faced by businesses to finance. The objective was to obtain information about the form of financing used by businesses.

1. The meaning and types of funding sources

A key decision of the business firm's financial management is the financing of its activity. If funding is not efficient, there will be influenced the firm's ability to accept the necessary projects, and this will affect the level of profit from its operations. The main objectives of efficient and effective financial policy are:

- To provide sufficient financial funds;
- in due time when funds are required; and
- at the lowest cost.

The capital structure of a business firm involves the firm's own capital and borrowed capital. In terms of business need for capital arise the following questions: What is the capital structure that maximizes the value of the business? What method to be used to finance working capital needs and what should be the proportion of the loan/capital registered? Key elements of this theorem are that (a) the total value of a business does not depend on its capital structure, and (b) the cost of equity of the business is an increasing linear function with its equity capital-debt capital proportion, by keeping constant the total cost of capital (Nichter & Goldmark, 2009).

In order to build efficient financial policies, business firms should be informed about possible funding sources (Rajan & Zingales, 1998). Business firms can raise funds from more financial resources and through various instruments. Financial policy of the business firm describes the combination of financial instruments used to finance the firm's activity.

The objective of financial resources is to fill the gap in the cash flows of the enterprise or the provision of sufficient resources available to the enterprise to balance incoming and outgoing financial flows, and its treasury. Financial resources cannot be allocated to the enterprise without counterparty. They immediately require some outflow from the enterprise, to compensate for funding. These allowances can be possible only when provided by positive flows originating from production or investment cycles. Investors, owners of financial resources, give their money only when manufacturers and industrialists promise them that they will benefit from surpluses they will provide from the manufacturing process.

Sources of financing business activity can be divided into two main groups (Pinegar & Wilbricht, 1989):

- Internal sources and
- External resources.

Very few businesses operate without the use of both, the debt financing and equity financing. Sources of funds are not free, creditors require payment of interest, and equity investors seek profits through dividends and stock price difference – capital gains. Equity consists of long-term funds provided by the business owners. Unlike the borrowed funds that should be paid on a certain date in the future, own equity stays in business firm for an indefinite period of time. Debt capital includes all long-term business loans. The cost of the debt is lower than the cost of the other forms of financing. That's because lenders face a lesser risk than long-term contributors (Pinegar & Wilbricht, 1989).

1.1. Internal sources of funding

Business firms provide financial capital from within the firm by keeping profits generated. These funds represent the positive difference between the spending of the organization (transaction costs, interest payments, tax payments, dividend payments or renewal of fixed assets), and of the income it generates.

Another source of internal financing that is often overlooked, are generated savings through more efficient management of working capital. This capital is melted in the short-term assets and liabilities. Efficient management of claims from buyers, obligations to suppliers, stocks of goods, and cash reserves, can reduce the overdraft from the bank account and interest burdens and increase cash reserves. And another source of internal financing of great importance is depreciation funds of fixed assets and equipment of the firm.

Firms prefer to use retained earnings as sources to financing investment projects because they appear as inexpensive resources, but the amount of the retained earnings is limited. However, these resources can be used depending on the financial situation of the business and its previous financial performance. Thus, if the business has accumulated reserves and has not distributed all profits, can utilize the internal resources to finance its needs (Fisman & Love, 2003).

1.2. External sources of funding

There are a variety of the external sources of funding, which can be divided into two main types:

- Financing through debt and
- Financing through equity capital.

External funding may also be classified in terms of maturity of funds (short, medium and long term financing), and institutional aspect (providing of funds through financial markets or through financial intermediaries). Short-term funding is done through short-term debt securities (with maturities of less than one year), medium-term financing is done by loans or debt securities with maturity up to 5 years, and long-term funding is realized by long-term loans and the issuance of long-term securities (with maturities longer than 5 years).

Bond financing is significantly different from the issuance of new shares by business firms (these differences do not belong to the procedural aspect). Usually, in the terms of the financing through borrowing, business is forced to pay interest (periodically) while financing through the issue of shares, business is forced to pay dividends when the certain conditions are met. If the amount of debt of a business grows, it creates more premises that business cannot meet the obligations it has undertaken and may go into bankruptcy, which in turn bears the costs in terms of paying lawyers, judges and others. Another theory suggests that the business firm prefers to issue bonds instead of shares only if the internal financial resources are insufficient. With internal resources of the business firm, we understand retained earnings, which are being held in order to meet the capital needs of business, and only when this becomes insufficient, then the business can address external financing sources (WB, 2011).

2. Business financing through bond issuance

The existence of internal capital market, active and efficient, especially of the bond market, would give to businesses a better funding alternative when banks cannot do this. Thus, correcting any potential negative effect it can have on the economy by the credit crunch of the banking system (Levine, 1997).

This method of financing implemented through the issuance of debt financial instruments (bonds). Normally the issue of debt securities is less costly than obtaining a loan. The reason why this is not as expensive as borrowing from banks, relates to the fact that there are avoided the costs of monitoring, such as reports on the financial situation of the borrower, required from lenders. Another advantage of financing through the bond issuance is the possibility of using a very wide range of entities from which borrowing can be carried out. Thus issued securities can be purchased by institutional investors, such as pension or investment funds, and from other companies and individuals. This wide group of entities guarantees funding which could not be guaranteed by a bank or a single funder. From the perspective of the issuing company, the presence of a large number of bonds buyers is seen as less disturbing than the authority of a single lender such as a bank. From an investor perspective, this is the preferred way of financing as debt instruments guarantee a fixed income and are marketable, which means that an investor (bond holder) can trade it at any time after they had purchased, without waiting the bond mature.

2.1. Issuance of bonds

Large corporations often avoid using other methods to finance and achieve long-term needs by issuing bonds as long-term debt securities. Bonds are loans that issuers receive from investors through debt securities. Corporations can use these instruments to expand their businesses or for other needs.

In countries where the bond market is functional, there can be achieved a number of benefits:

a) Diversification of funding sources of corporations, making it less vulnerable to crisis of bank lending;
b) Increased choice and flexibility of this method of financing, which increases the potential for providing corporate funds;
c) Strengthening the balance sheets of pension funds and insurance companies by guaranteeing institutional investors with instruments that meet the demand for fixed income assets with the long maturities, higher rates of return than government bonds and less risk than investing in stocks.

In relation to bank borrowing, issuing bonds may be preferred because it reduces funding costs to borrowers, as bank intermediation facilitates by allowing direct access to investors, thus avoiding the intermediation and costs associated to bank borrowing. From the perspective of lenders (buyers of corporations bonds) expansion of capital markets to bonds gives them more investment opportunities (Guiso et al. 2004).

> ***Despite the fact that bond is treated as a financial instrument, it essentially remains a contract between a lender and borrower, in which is realized what the parties have promised to each other. In this context, is established the liability relationship between the issuer (in the role of the borrower) and the bond buyers (lenders).***

Bonds are considered as an investment that guarantees periodical fixed payments of interest and the payment of principal in the maturity date. Periodical and fixed payments of interest are the main distinguishing criterion in relation to the securities which guarantee variable income (such as shares). Issuing bonds is a method used by companies to meet their capital needs as it is easy to calculate the borrowing costs for a fixed period of time. The calculation of costs is predictable because bonds are securities that guarantee a fixed income (here are excluded bonds with variable interest) and guarantee their holders, fixed interests in specified time periods and repayment of nominal value in the maturity date (except bonds that can be repaid before maturity date). In this way, corporate bonds give investors a secure income.

Large companies (public) listed on regulated markets can easily exploit the issue of debt securities. All the ways of borrowing are dictated by the fact that borrowing conditions are determined by the lender (Nichter & Goldmark, 2009). This situation forces the business in need of funds to look for alternative methods to financing that are more flexible and comfortable. However, the company cannot meet its own needs for capital if there are no investors willing to buy the securities issued. The Company may select the issuance of debt securities as a way of financing its needs by choosing the type of debt securities issues, by choosing between long or short term securities, securities with the regular payments (periodical) or securities with immediate payment, with the/or no other warranty.

Perhaps, this element may make corporate bonds more favorite securities compared to shares, for which there is no certain amount of annual income that will guarantee to their shareholders or to the worst case scenario may not generate income at all. However, it is an alternative method of financing businesses and for meeting their liquidity needs. In the end, we can conclude that there is no an optimal format of the business capital structure, but that structure should be determined depending on several factors such as the size of the company, its access to financial markets, its internal assets, et cetera.

3. Economic and legal advantages to business financing through bond issuance

The business firm must make a strategic choice by analyzing the advantages and disadvantages of each way to funding capital needs. From the company's' perspective, the long-term debt has a series of priorities and gaps.

The advantages of financing through the issuance of bonds:

1. The cost of debt (interest) is determined and does not change until the end of their maturity. Holders of bonds do not participate in the business profits (economic).

2. The expected percentage of the return is lower than that of ordinary or preferential shares (economic).
3. Shareholders do not lose any part of the control over the business if company uses debt financing. Interest payments on debt are deductible for fiscal purposes. It makes that a part of the cost of debt is transferred to the state (economic, legal).
4. The fact that the bond contracts contain the proviso of debt service prior to the maturity helps to create a flexible financial structure for the business (economic, legal).

The disadvantages of financing through the issuance of bonds:

1. The debt has a fixed cost that must be paid even when we have losses. This can lead to non-payment of interest, which in turn adds to fears of lenders, who may seek the return of principal amounts. Such a situation may lead to the bankruptcy of business (economic, legal).
2. A major risk contains higher percentage of profit share capitalization. So even if financial leverage is favorable and increases earnings per share, higher rates of capitalization which brings leverage can influence to lower the value of ordinary shares (economic).
3. The debt has a repayment term usually determined more accurately. For this reason, the financial manager should take precautions for its repayment. One such measure is known as the creation of a depreciation fund (economic, legal).
4. Because the long-term debt is a commitment for a long time, it carries a high risk. Forecasts and plans under which the debt has been issued may change. Debt can become a burden or can be an advantage. For instance, if the price and profit level lowers too much the decision of taking too much debt can be considered an incorrect financial policy (economic, legal).
5. In a contractual relationship, bond contract terms may be more stringent than the short-term loan deal. So, the corporation may be subject to greater obligations which disrupt and paralyze bond contract terms and make it worse than when short-term debt or ordinary shares are issued (legal).
6. Providing more funds through debt has a limit. Some financial policy rules, generally accepted, determine that the debt ratio should not exceed certain limits. These rules define the preventive financial limits to which funds can be provided through long-term debt (economic, legal).

Given these characteristics, bonds are considered as investment that legally guarantees periodical fixed payments and payment of principal at the maturity date. Periodical and fixed payments of interest are the main distinguishing criterion in relation to the securities which guarantee variable income (such as shares).

Investors that invest in bonds are excluded from decision-making and policy direction of the company (this is also a legal aspect). They are simply in the role of creditor that at certain moments provide the company with capital to meet its needs, but do not affect the political life of the company. However, their position is guaranteed (legally) as holders of bonds benefit from a fixed income (annually or periodicity agreed under loan program) despite profit from the company. In certain situations, during any financial year the dividend can also go for the payment of interest or for the payment of par value of the bonds issued by the business. Also, during the process of liquidation, the holders of the bonds are the first payable from the assets the business.

Another significant distinction between bonds and stocks is related to the ability of bond to ensure return on investment. There is no obligation of the company to guarantee the payment of dividend for the shares. While the situation is quite different with bonds. Bond being a loan contract can be guaranteed (legal precedence). This moment is provided in several provisions of the laws which regulate the legal regime of securities and bonds. The latter explicitly provides for the provision of principal, interest and bond costs by any means providing a guarantee of the issuer or third parties. In general, a large proportion between debt and equity of the company increases credit risk, giving a negative signal for banks, suppliers and other providers of debt.

4. Restrictions related to the use of bonds for business financing

In our country, in general there is a lack of capital. This lack of capital creates difficulties to business firms. While in developed countries there are many real choices of the financing sources, in our country there are only limited financial sources available. The bond market is an undeveloped market, which requires that the legal system and government policies encourage the emergence and development (Levine, 1997). This incentive is intended to guide local companies to experiment with the new ways of financing to provide funds for their capital needs. These techniques can positively influence the promotion of local companies in the region and beyond. In this context, the relevant legislation provides two important mechanisms in this regard: first, the exclusion of bond trading and transactions costs from taxation and other fees (other than income tax) and secondly, the creation of conditions that facilitate trading. These mechanisms aim to familiarize the issuers with the ability to exploit the issue of bonds and in turn to make financing more attractive and thus less costly. Exemption from taxation is a very good incentive used to bring local businesses to use such financing instruments.

5. Empirical analysis

5.1. Descriptive statistics

Part of this research has been 50 local businesses, which were different in terms of form and size of their organization.

Based on the research outcome we can conclude that most of the businesses surveyed stated that businesses are starting their activity with the bank loans due to lack of own capital. It's important to note that the vast majority of businesses surveyed feel the need for new sources of funding. While in terms of capital market most of the businesses in our country do not have any knowledge on how such market operates in practice. The use of alternative methods of financing hinder many factors such lack of adequate markets for trading financial instruments. In our country there is not still a legal infrastructure that regulates the functioning of the capital market, particularly the issue of bonds as a funding source, regardless of great importance that has this form of financing for large companies.

According to research we can say that it is too early to conclude as to whether it will operate capital market in a near future. Today the main source of business financing remains the banking system which has managed to win the confidence of individuals and businesses bearing in mind its development from the scratch. Commercial bank lending continues to represent one of the main sources of consumer financing and investments. The structure of total loans continues to be dominated by loans to enterprises, the share of which in 2012 was 67%. Much of the loans consist of loans for the services sector. In general, businesses are more focused on long-term loans.

5.2. Statistical analysis and the hypotheses testing

Hypotheses to be tested in this study are developed based on the key components affecting the needs of the business for funding in Kosovo. Null and alternative hypothesis are established as follows:

> Hypothesis 1 - Capital market development would fulfill the needs of the business for funding.
>
> Ho - The development of the capital market, would not affect the creation of additional sources of funding.

Table 1. Paired Samples Statistics

Paired Samples Statistics					
		Mean	N	Std. Deviation	Std. Error Mean
Pair 1	The need for new sources of funding	1.20	50	.404	.057
	Malfunction of the capital market	2.28	50	.784	.111

Table 1, named Paired Samples Statistics presents descriptive statistics (mean, number of data, standard deviation and standard error) for both variables. Table 2, named Paired Samples Correlations shows the correlation of the two samples, which shows the correlation coefficient between two variables and the significance level for two – fold test.

Table 2. Paired Samples Correlations

Paired Samples Correlations				
		N	Correlation	Sig.
Pair 1	The need for new sources of funding & Malfunction of the capital market	50	-.180	.210

Table 3. Paired Samples Test

Paired Samples Test									
		Paired Differences					t	df	Sig. (2-tailed)
		Mean	Std. Deviation	Std. Error Mean	95% Confidence Interval of the Difference				
					Lower	Upper			
Pair 1	The need for new sources of funding & Malfunction of the capital market	-1.080	.944	.134	-1.348	-.812	-8.088	49	.000

Table 3, named as Paired Samples Test presents the results of our analysis. Statistics provided under the column Paired Differences are calculated by calculating the difference between the compared values, in our case the variables: The need for new sources of financing, and The capital market recognition. Also there are shown the average, standard deviation and confidence interval for the difference between the averages in 95%. In addition there are presented results of T test. The test indicates results - 8088 on 49 degrees of freedom. Significance value is 0.000, which is less than 0.05, so rejects the zero hypotheses and accepts the alternative hypothesis, that is, it is proved that the development of the capital market would give firms the opportunity for new or alternative sources of funding.

Hypothesis 2 - Lack of information on capital markets will be an obstacle to the use of bonds as a funding source in the near future.

Ho - Lack of information on the capital market, will not hinder bond financing in the near future.

Table 4. Paired Samples Statistics

Paired Samples Statistics					
		Mean	N	Std. Deviation	Std. Error Mean
Pair 1	Ignorance of the capital market	2.48	50	.707	.100
	The use of bonds in the future	1.80	50	.881	.125

Table 4, named Paired Samples Statistics presents descriptive statistics (mean, number of data, standard deviation and standard error) for both variables.

Table 5. Paired Samples Correlations

Paired Samples Correlations				
		N	Correlation	Sig.
Pair 1	Ignorance of the capital market & The use of bonds in the future	50	.092	.526

Table 5, named Paired Samples Correlations shows the correlation of the two samples Paired Samples correlations, which shows the correlation coefficient between two variables and the significance level for two – fold test.

Table 6. Paired Samples Test

Paired Samples Test									
		Paired Differences					t	df	Sig. (2-tailed)
		Mean	Std. Deviation	Std. Error Mean	95% Confidence Interval of the Difference				
					Lower	Upper			
Pair 1	Ignorance of the capital market The use of bonds in the future	.680	1.077	.152	.374	.986	4.463	49	.000

Table 6, named as Paired Samples Test presents the results of our analysis. Statistics provided under the column Paired Differences are calculated by calculating the difference between the compared values, in our case the variables: Ignorance of the capital market and the use of bonds in the future. Also there are shown the average, standard deviation and confidence interval for the difference between the averages in 95%. In addition there are presented results of T test. The test indicates results 4.463 on 49 degrees of freedom. Significance value is 0.000, which is less than 0.05, so rejects the zero hypotheses and accepts the alternative hypothesis, that is, it is proved that the Ignorance of the capital market would be the main obstacle to not use of issuance of bonds as a funding source.

6. Conclusions and recommendation

1. This paper has discussed economic and legal advantages to business firms in financing through the issuance of bonds. The issuance of bonds is an economically reasonable and legally safer move for both the issuer of the bond, and the buyer.
2. Business firms can raise funds from more financial resources and through various instruments. Financial resources cannot be allocated to the enterprise without counterparty. They immediately require some outflow from the enterprise, to compensate for funding.
3. There are a variety of the external sources of funding, which can be divided into two main types: Financing through debt and financing through equity capital. Very few businesses operate without the use of both, the debt financing and equity financing.
4. The issuance of debt securities is less costly than obtaining a loan. In relation to bank borrowing, issuing bonds may be preferred because it reduces funding costs to borrowers.
5. Despite the fact that bond is treated as a financial instrument, it essentially remains a contract between a lender and borrower, in which is realized what the parties have promised to each other.
6. The business firm must make a strategic choice by analyzing the advantages and disadvantages of each way to funding capital needs. From the company perspective, the long-term debt has a series of priorities and gaps.
7. Bonds are considered as investment that legally guarantees periodical fixed payments and payment of principal at the maturity date.
8. There is not still a legal infrastructure that regulates the functioning of the capital market, particularly the issue of bonds as a funding source.
9. It is proved that the development of the capital market would give firms the opportunity for new or alternative sources of funding, and that the Ignorance of the capital market would be the main obstacle of not using of issuance of bonds as a funding source.

Recommendation

1. The issuance of bonds is an economically reasonable and legally safer move for both the issuer of the bond, and the buyer.

2. Business firms must raise funds from more financial resources and through various instruments.
3. Businesses should seek for both types of financing: the debt financing and equity financing.
4. Because the long-term debt has a series of priorities and gaps, the business firm must make strategic choices in funding their capital needs.
5. There is immediate need for a legal infrastructure that regulates the functioning of the capital market, particularly the issue of bonds as a funding source.
6. There must be developed proper capital market because it would give firms the opportunity for new or alternative sources of funding.
7. Ignorance of the capital market would be the main obstacle of not using of issuance of bonds as a funding source.

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