

Week 8 – Long Term Sources of Finance

1] Ordinary shareholders

Investment:

Since they are the owners of the company, they are able to vote suitable members to seat in board of directors to lead and manage the company to another victory. The investment made is not refundable once it is paid.

Return on investments:

They receive dividend out of accumulated profits (retained earnings). The *dividends* are not fixed and are determined by board of directors.

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2] Preference shareholders

Investment:

Since they are not the owners of the company (do not carry the voting right), their investment is refundable or convertible to ordinary share.



Return on investment:

They can only receive fixed rate of *dividend* out of its nominal value of the preference share.

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3] Debenture holders

Investment:

They purchase fixed interest debenture issued by the company. Once the investment is made, they will be informed that the company will repay their investment at a future pre-determined date.

Return on investment:

Debenture holders will receive semi-annual fixed *interest* on certain date in every financial year until the debenture is called back.

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4] Retained earnings

Retained earnings are referred to as accumulated profits from commencement of business until now. These are the profits plus depreciation retained within the company after the payment of dividends. In fact, it is the most significant source of new funds for companies in UK.

Raising new shares is costly, the companies will think of it only when financing the takeover of other companies (vendor placing). However, it is wrong to think retained earnings are free.

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4] Retained earnings (cont')

Retained earnings are not free capital. Shareholders, by allowing the company to keep profits within the business, are making a significant sacrifice. They are forgoing dividends which could be invested in other financial instruments.

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5] Bank loan (revolving credit)

An alternative to going to the capital markets to raise money is to borrow directly from a bank. In this case, bank loan is not traded.



It should be noted that interest rate above can be either fixed or floating. If it floating, interest rates charged by commercial bank, increased or decreased is linked to the Bank's base rate or **LIBOR – London Inter-Bank Offered Rate**. LIBOR is the rate at which a bank can borrow money on the inter-bank market.

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6] Leasing (capital lease)

Leasing is legal arrangement in that an equipment owner (lessor) conveys the right to use the equipment in return for regular payments by the equipment user (lessee) over an agreed period of time. The leasing company retains legal title. Equipment has lower purchase price such as computers, photocopier, motor vehicle, truck and aircraft.

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7] Hire purchase

Hire purchase (HP) is a form of instalment credit. An industrial or commercial business can use hire purchase as one alternative source of finance. It includes vehicles, plant, machinery, and office equipment. Hire purchase arrangements for car manufacturers are quite common.

Hire purchase is similar to leasing, with the exception that ownership of the goods passes to the hire purchase customers on payment of the final credit installment, whereas a lessee never becomes the legal owner of the goods. HP payments consist partly of capital payment and partly of interest charges.