South Tuen Mun Government Secondary School
Business, Accounting and Financial Studies
Source of financing WS

Name:________________________________ Class: ________No(_________)

1. Explain why a firm should raise long-term capital for its investment in fixed assets.

____

____

____

____

____

____

____

____

2. Explain TWO reasons why stockholders of a firm are usually reluctant to raise capital through issuing stock.

____

____

____

____

____

____

____

____

3. Explain why some firms prefer debt financing although it is riskier than equity financing.

4. Suppose a firm can purchase a machine using either internal or external financing. Which type of financing would you recommend? Explain.

5. Suggest THREE major long-term sources of capital for small enterprises.

1 A firm should raise long-term capital for its investment in fixed assets because it is less risky to do so. The firm is unlikely to generate sufficient cash flows in the short-term to pay for the fixed assets. By using long-term financing, the firm would not need to refinance frequently. If the firm uses short-term financing instead, it may face financial difficulties if it could not find refinancing opportunities or the cost of financing increases sharply.

2 Stockholders of a firm are usually reluctant to raise capital through issuing stock because:

- New common stockholders can affect the firm’s decisions (as they have voting rights). Thus, issuing new stock may <u>undermine existing stockholders’ control over</u> the firm.
- By issuing stock, the firm’s profits will have to be shared by more stockholders. This may lead to a <u>decrease in the existing stockholders’ return on their investment</u>.
- In general, <u>equity financing is more costly than debt financing.</u> As stock investment is riskier than bond investment, investors often demand a higher rate of return from stocks. Moreover, dividends are not tax deductible (while interest is tax deductible).

3 Some firms prefer debt financing because:

- debt financing does not affect existing stockholders’ control over the firms.
- if the firm earns a huge profit, existing stockholders can earn a higher rate of return.
- debt financing is less costly (as a lower rate of return is required by investors and interest expense is tax deductible).

4 If both types of financing are available, internal financing is recommended. This is because internal financing has the following advantages:

- It is more flexible (as no approval is needed to use retained profits).
- It is less costly as it does not involve transaction costs or interest expense.
- It does not result in additional owners.
- It allows greater freedom in decision making (as the firm does not have to disclose information or get approval from new owners).

5. Issuing stock to existing stockholders; long-term bank loans; retained profits; hire purchase or leasing