JOURNAL OF GLOBAL ACCOUNTING
9 (3) September, 2023.
ISSN: 1118 – 6828
https://journals.unizik.edu.ng/joga

SOURCES OF FINANCE AND FINANCIAL PERFORMANCE OF FIRMS IN NIGERIA

Paper Type: *Original Research Paper.*
Correspondence *felix.emovon@iuokada.edu.ng*

Key words: *Borrowing, Finance, Internal Funding, Issuing Equity, Sources of Finance,*

CITATION: Emovon, F.O., Josiah, M. & Ozele, C. (2023). Sources of finance and financial performance of firms in Nigeria, *Journal of Global Accounting*, 9(3), 314 – 321.

Available:https://journals.unizik.edu.ng/joga

Felix O. Emovon[1] Mary Josiah[2] Clement Ozele[3]

[1]Postgraduate student, Department of Accounting, Igbinedion University, Okada, Edo State, Nigeria.
[2]Associate Professor, Department of Accounting, Igbinedion University, Okada, Edo State, Nigeria.
[3]Lecturer, Department of Accounting, Igbinedion University, Okada, Edo State, Nigeria.

1. Email: felix.emovon@iuokada.edu.ng
2. Email: josiah.mary@iuokada.edu.ng
3. Email: ozele.clement@iuokada.edu.ng

ABSTRACT:

Financing of business operations is a critical requirement for the success of any business venture and thus is fundamental to the achievement of the corporate objectives of any establishments. Finance is the management of the flows of money through an organization. Such flows include outflows and inflows of financial resources. In order to implement an investment decision, the necessary finance (capital) must be acquired. There are three methods of financing business operations and they are: borrowing (debt), issuing equity (stock ownership), and internal funding. To make decisions on the financing of the organization, the manager needs to know the cost of the various sources of finance at his disposal in order that he may select the most efficient funding package. The study aimed to identify the various sources of finance to an organization. The objective of this study is to review extant literature on the various sources of finance to an organization in Nigeria. The methodology adopted for this study is library approach which focuses on content review of extant literature. We concluded that firms depend more on formal banking sources for investment and that management and Board of Directors should pay attention to the utilization of these sources particularly short-term finance to avoid mismatch. We recommended that managers should know the cost of various sources of finance and use fund, which will reduce cost of capital. Also, companies should use more of debt financing because it is less risky and costly compared to capital market source.

1. INTRODUCTION

Sources of finance mean the ways for mobilizing various terms of finance to the industrial concern. Sources of finance state that, how the companies are mobilizing finance for their requirement. Financing is an important tool for any firm growth and required throughout the firm's lifecycle (Ou & Haynes, 2006). To finance means to engage in money business. Besides labour, land and

entrepreneurial skill. Finance is one of the well-known productive input in any organizational setting. Conceptually, finance is a word that takes on different characteristics. This implies that its definition depends on its usage. One way of looking at the subject matter therefore is to credit Anao & Osazee (1990) who defined finance in relation to money or near money are referred here. Cash, debt certificates, equity certificates are implied. The subject matter, finance, can be defined as the management of the flows of money through an organization. Such flows include outflows and inflows of financial resources (Ofanson, 2002). In order to implement an investment decision, the necessary finance (capital) must be acquired, such as internal sources and external sources. Companies whether public or private, obtain long-term funds from a variety of sources, such as: new issues of equity shares, preference shares, loan stock or bonds, retained profit bank borrowing (medium term). It is an indisputable fact that one of the ultimate goals of every firm is to maximize the wealth of overall value of the business. More specifically, maximizing the wealth of a firm means making the highest possible profit at the least risk. Also, to minimize the cost of capital thereby increasing the value of the firm. Therefore, the financial manager has a task of obtaining fund for the use of the organization at the most favorable terms like cost, and the utilization of such funds for the maximum benefit of the firm (Pandey, 1987).

Assuch, capital plays an enormous role in nearly all activities carried out by mortal for his continued survival in business, funds must be readily available in order to accomplish their investment project. Due to lack of capital finance, projects and their financial involvement in firms that lead to the role being performed by individuals or the public and institutional investors in project financing in the course of providing equity, debt financing to firms for such proposes. If the firm fail to earn the minimum rate of return to cover the cost of the fund being generated to finance investment, otherwise, no one will be willing to buy its bond, preference shares and the ordinary shares (Brockington, 1978). The insufficiency, lack of money, and costs of domestic and external capital to these enterprises are significant performance barriers. The study investigates the various sources of finance to an organization in Nigeria and review extant literature on sources of financing and equity financing.

1.1 Objective of the Study

The objective of this conceptual paper is to review extant literature on sources of finance and financial performance of firms in Nigeria identify the various sources of capital, how companies use different sources of finance to boost their investment efficiencies and measurement of the cost of capital.

2. LITERATURE REVIEW

2.1 Conceptual review

2.1.1 Sources of Finance

There are three methods of financing business operations and they are: Borrowing (debt), Issuing equity (stock ownership), and internal funding. Debt financing is when a business sells debt securities to retail and institutional investors in order to raise funds for working capital. The people or organizations receiving the funds become creditors and are given the assurance that the principal and interest on the loan will be paid back. In 1958, Modigliani and Miller pioneered the issue of debt financing in determining a company's value and future performance. Myers et al. (2001), opined the clarity of the combination of securities and financing sources used by companies to fund assets. Generally, debt financing (capital structure) is designed to serve equity investors interest. Debt financing has pros and cons. Debt can be a useful strategy for a business if it can be used to boost expansion. The other method of raising money in the debt markets is by issuing stock in a public offering; this process is known as equity financing. By selling shares, a company effectively selling ownership in their company in return for cash. The most important benefit of equity financing is that the money does not need to be repaid. However, equity financing does have some drawbacks. For a firm to keep its stock price at a healthy level and be able to distribute dividends to its shareholders, it must consistently produce profits. The cost of equity is frequently higher than the cost of debt since equity financing benefits the lender. Managers must learn to overcome the financial obstacles that are inherent in global expansion and make significant decisions for the firm (Duran & Stephen, 2020). On the other hand, internal funding (reserves) is the process of a firm using its profits or assets as a source of capital to fund a new project or investment. However, internal financing is not ideal for long-term projects or accelerated growth. Internal financing limits a company's ability to borrow funds and therefore their growth is limited by the rate at which they can generate profits. It is also important that managers should know the relative merits and demerits of different sources so that the choice of an appropriate source can be made (Dalisto & Peter, 2000).

2.1.2 Definitions of Sources of Finance and Finance

The term "sources of finance" refers to the methods for obtaining different types of financing for an industrial business. Financial sources indicate how the companies are securing funding for their needs. Myers et al. (2001) opined the clarity of the combination of securities and financing sources

by companies to fund assets. Generally, debt financing (capital structure) is designed to serve equity investors interest. Included in this are equity, preferential capital, retained earnings, and borrowed money in the form of bank loans, debentures, and bonds. The primary financing class of every organization is debt equity (Joshua, 2017). The capital structure is characterized as a mixture of fund used by the firm in its operation and a mixture of various securities as opined by Abor (2005). Finance plays an improvement role in the smooth running of a business organization. This is because not having adequate sources to fund its operations hampers the growth of such business venture. Financing is an important tool for any firm growth and required throughout the firm's lifecycle. Finance therefore can be defined as the management of the flows of money through an organization. Such flows include outflows and inflows of financial resources (Ofanson, 2002). To finance means to engage in money business. Besides land, labour and entrepreneurial skill, finance is one of the well-known productive inputs in any organizational setting. Anao & Osazee (1990) defined finance in relation to money or money affairs. All forms of money or near money are referred here as cash, debt certificates, equity certificates are implied.

Again, according to Ofanson (2002), finance uses the information provided by the accounting system to make decisions to help organizations achieve their objectives. Stated briefly, accounting is a collection process while finance is a managerial or decision making process. To make decisions on the financing of the organization, the manager needs to know the cost of the various sources of finance at his disposal in order that he may select the most efficient funding package.

2.1.3 Different Sources of Business Finance

In order to implement an investment decision the necessary finance (capital) must be acquired. Sources of finance can be categorized into two – internal and external (Ofanson, 2002).

a. **Internal Sources**: Internal sources of business finance include retained profit, the reallocation of existing finance from other projects especially those whose marginal productivity in their present use zero. By disposing of such assets, funds are made available.
b. **External Sources:** The major sources of external finance are financial markets. The term "financial markets" is used here to embrace both money and capital markets.
c. **Short-Term External Sources:** Short-term external sources include trade credit, term loans, advances and overdraft.
d. **Long-Term External Sources:** Long-term external sources include mortgage finance, equity finance, debentures, preference shares warrants and government grants.

e. **Debt Financing:** Debt financing occurs when a company raises money by selling debt instruments to investors.

Furthermore, debt and equity financing are the two major sources of financing. Myers et al. (2001), opined the clarity of the combination of securities and financing sources used by companies to fund asset. The primary financing class of every organization is debt financing (Joshua, 2017). Debt financing is less risky and costly than equity financing. The use of debt capital enhances the productivity of capital invested. This is because the use of borrowed funds enables firms to effectively monitor the investment behaviours of managers and the threats caused by the managements' failure to settle debt financing requirements are also effective motivating forces to make organizations more efficient.

2.1.4 The Cost of Different Components of Funds

i. **The Present Cost of Ordinary Share Capital**: What rate should be paid in order to maintain the present value of equity? The payment on equity has two parts: The first part is cash dividend and the second part is that which is meant for capital appreciations. It has often been assumed that equity has no cost since the decision to pay dividend depends on the availability of profits and the option of the directors of the company to pay dividends. According to Pandey (1987) individual securities have different degree of risk. Shares are generally riskier than bonds or debentures for risky securities, investors require a higher rate of return of a security is given by the following:

$\text{Expected return} = \text{risk free rate} + \text{risk premium}$, that is expected return must exceed the risk free rate for compensating the investor for taking risk. The amount of risk premium depends on the riskiness of the security. Ofanson (2002) explained that the expected return from a portfolio will be the weighted average of the expected return from each investment in the portfolio and the higher the risk the higher the return.

a. **Cost of Debt:** According to Okafor (1983), cost of debt is the rate of return expected by the lenders of the fund and has both short-term, (mostly bank borrowing) and long-term debt. Generally, this rate is the interest rate specified at the time of debt issue. Veit & Madura (1988) also defined cost of debenture (debt) as the rate which investments should yield to need the outflows to the debenture holders. According to Pandey (1981), cost of debt represents the minimum rate which should be earned by debt to keep the earnings per share unchanged.

b. **New Issue of Shares:** The issue of new share has costs associated with it. Such cost may be in the form of the following: Floatation cost, advertising cost, cost of printing the prospectus, underwriting commission, financial and legal advise cost, clerical costs and commission to brokers.

c. **Cost of Retained Earnings:** The retention of profits is equivalent to the issue of fresh equity to existing shareholders collectively, they are expected to make a further investment in their company.

2.2 Empirical Review

Dube (2013) discovered that debt financing improved SMEs' productivity, finding that companies who received enough bank financing improved their output. Small and Medium sized companies (SMEs) are considered to have more trouble accessing external funding than large corporations. Dube (2013) had several limitations, including mechanical correlations in its baseline model due to measurement issues, a limited scope, a weak regression analysis.

Prior studies conducted by Berger and Patti (2006) that examined the relationship between debt financing and corporate efficiency found both positive and negative associations between the two variables. These disparate results may be due to the fact that using debt can affect a firm's performance in both positive and bad ways.

Mallick and Yang (2011) used firm level data covering over 11,000 firms from 47 countries over a period of 1997-2007 to examine the effect of different sources of financing on corporate performance. The results showed that firms with high debt-to-equity ratio tend to have lower returns to shareholders (profitability) and lower internal efficiency (productivity). The study found that retained earnings and equity financing improve profitability, while debt financing by firms particularly in the form of bank loans lead to lower performance, although not so in the case of debt raised through issuing bonds.

Memba et al. (2012) examined the impact of venture capital on growth of SMEs in Kenya. Data collection before and after the usage of venture capital was the methodology used. The study's conclusions showed that venture capital has an effect on the expansion of the SMEs it finances. Saeed (2009) investigated the impact of financial sources on firm growth in Brazil. The empirical results revealed that internal finance maintains positive relation with firm growth.

An empirical study that uses firm-level data from the World Bank Enterprises Survey data (WBES) of around 71,000 firms from 100 countries, present the result for sources of finance and all four indicators of innovation. The coefficient of bank finance and informal finance is consistently

positive across all the models. The coefficient is although small but statistically significant, whereas the coefficient of capital market is insignificant for all the models (Ayyagari et al., 2011).

CONCLUSION AND RECOMMENDATIONS

This study theoretically investigates the sources of finance and financial performance of firms in Nigeria. The extant literature reviewed shows that equity financing and debt financing have a positive and negative significant effect on companies profitability or growth in Nigeria. To this need, the study concludes that firms depend more on formal banking source for investment and this is found to be significant in explaining innovation, growth and sustainable development of organizations. Therefore, in as much as long-term finance and short-term finance had significant effects on profitability then, the sources of finance significantly affected financial performance of companies in Nigeria. The management and Board of Directors should pay attention to the utilization of these sources, particularly short-term finance so as to avoid mismatch.

Based on the above findings, the study therefore recommends that:

1. The financial institutions and capital markets from which long-term finance can be obtained should regulate the interest rates which made the source to have inverse relationship with the performance. Also, managers should know the cost of the various sources of finance and use funds, which will reduce cost of capital. But care should be taken so that the owner's investment interest is not diluted. They should also compare the expected return on their investment with their market price.
2. Companies should use more of debt financing because it is less risky and costly compared to capital market source. Also, the threats caused by the managements' failure to settle debt financing requirements are also effective motivating forces to make organizations more efficient.

REFERENCES

Abor, J. (2005). The effects of capital structure on profitability: An empirical analysis of listed firms in Ghana. *The Journal of Risk Finance*, 6, 438-445.

Anao, R. & Osaze, B. (1990). Managerial finance, Benin City, Uniben Press.

Ayyagari, M., Demirgue-kunt, A., & Maksimovi, V. (2011). Firm innovation in emerging markets: The roles of finance, governance and competition. *The Journal of Financial and qualitative analysis*, 46(6), 1545-1580.

Berger, A. N., & Patti, E. B. D. (2006). Capital structure and firm performance: A new approach to testing agency theory and an application to the banking industry. *Journal of banking and finance*, 30(4), 1065-1102.

Brockington, B. (1978). Financial management, Great Britain, Billings and sons Limited.

Dalisto, K., & Peter, O. (2000). The policy environment for promoting small and medium-sized enterprises in Ghana and Malawi. University of Manchester.

Dube, H. (2013). The impact of debt financing on productivity of small and medium scale enterprises (SMEs). A case study of SMEs in Masvingo Urban. *International Journal of Economics, Business and Finance*, 1(10), 371-381.

Duran, M.M. & Stephen, S. (2020). Internationalization and the capital structure of firms in emerging markets: Evidence from Latin America before and after the crisis. *Research in International Business and Finance*, 54.

Joshua, Y.A., (2017). Entrepreneurial finance for MSMEs. A managerial approach for developing markets. Doi.10.1007/978-3-31934021-0.

Mallick, S. & Yang, Y. (2011). Sources of financing, profitability and productivity: first evidence from matched firms. *Financial markets institutions and instruments*, 20(5), 221-252.

Memba, S. F., Gakure, W. R., & Karanja, K. (2012). Venture capital (VC): its impact on growth of small and medium enterprises in Kenya. *Interbank Journal of Business and Social Science*, 3(6), 32-38.

Modigliani, F. & Miller, M. H. (1958). The Cost of capital, corporation finance and the theory of investment. *The America Economic Review*. 48(3), 261-297.

Myers, S. C., & Majiluf, N. S. (2001). Corporate financing and investment decisions when firms have information that investors do not have. *Journal of financial economics*, 13(2), 187-221.

Ofanson, E. J. (2002). Corporate Finance, Vol. 1, Benin City, Imprint Services.

Okafor, O. F. (1983). Investment decisions, evaluation of projects securities, Cassel Ltd, London.

Ou, C. & Haynes, G.W. (2006) Acquisition of additional equity capital by small firms-findings from the National survey of small business finance. *Small Business Economics* 27(2), 157-168.

Pandey, I. M. (1987). Financial management, Vikas Publishing House Pvt Ltd, New Delhi.

Pandey, I. M. (1981). Finance Management. 2nd revised edition, Rashtravani Printers, New Delhi. .

Veit, S. & Madura, I. (1988). Introduction to financial management, West Publishing Company, New York.

Saeed, A., (2009). Formality of financial sources and firm growth: Empirical evidence from Brazillian SMEs. *Journal of Academic Research in Economics*, 1(2), 129-140.

JOURNAL OF GLOBAL ACCOUNTING
9 (3) September, 2023.
ISSN: 1118 – 6828
https://journals.unizik.edu.ng/joga