

12.1: Comparison Between Equity and Debt Financing

Brief Comparison between Equity and Debt Financing

Debt financing means borrowing money that will be repaid on a specific date in the future. Many companies have started by incurring debt. To decide whether this is a viable option, the owners need to determine whether they can afford the monthly payments to repay the debt. One positive to this scenario is that interest paid on the debt is tax-deductible and can lower the company's tax liability. On the other hand, businesses can struggle to make these payments every month, especially as they are starting out.

With **equity financing**, a business owner sells part of the business to obtain money to finance business operations. With this type of financing, the original owner gives up some portion of ownership in the company in return for cash. Each partner's share is based on their financial or other contributions.

If a business owner forms a corporation, each owner will receive shares of stock. Typically, those making the largest financial investment have the largest say in decisions about business operations. The issuance of dividends should also be considered in this set-up. Paying dividends to shareholders is not tax-deductible, but dividend payments are also not required. Additionally, a company does not have to buy back any stock it sells.

ETHICAL CONSIDERATIONS

Debt versus Equity Financing

Many start-ups and small companies with just one or two owners struggle to obtain the cash to run their operations. Owners may want to use lending, or debt financing, to obtain the money to run operations, but have to turn to investors, or equity financing. Ethical and legal obligations to investors are typically greater than ethical and legal obligations to lenders. This is because a company's owners have an ethical and legal responsibility to take investors' interests into account when making business decisions, even if the decision is not in the founding owners' best interest. The primary obligation to lenders, however, is only to pay back the money borrowed with interest. When determining which type of financing is appropriate for a business operation, the different ethical and legal obligations between having lenders or investors need to be considered.⁹

Equity Financing

For a corporation, equity financing involves trading or selling shares of stock in the business to raise funds to run the business. For a sole proprietorship, selling part of the business means it is no longer a sole proprietorship: the subsequent transaction could create either a corporation or partnership. The owners would choose which of the two to create. Equity means ownership. However, business owners can be creative in selling interest in their venture.

The main benefit of financing with equity is that the business owner is not required to pay back the invested funds, so revenue can be re-invested in the company's growth. Companies funded this way are also more likely to succeed through their initial years. The Small Business Administration suggests a new business should have access to enough cash to operate for six months without having to borrow. The disadvantages of this funding method are that someone else owns part of the business and, depending on the arrangement, may have ideas that conflict with the original owner's ideas but that cannot be disregarded.

The following characteristics are specific to equity financing:

1. No required payment to owners or shareholders; dividends or other distributions are optional. Stock owners typically invest in stocks for two reasons: the dividends that many stocks pay or the appreciation in the market value of the stocks. For example, a stock holder might buy Walmart stock for \$100 per share with the expectation of selling it for much more than \$100 per share at some point in the future.
2. Ownership interest held by the original or current owners can be diluted by issuing additional new shares of common stock.
3. Unlike bonds that mature, common stocks do not have a definite life. To convert the stock to cash, some of the shares must be sold.
4. In the past, common stocks were typically sold in even 100-share lots at a given market price per share. However, with Internet brokerages today, investors can buy any particular quantity they want.

Debt Financing

As you have learned, debt is an obligation to pay back an amount of money at some point in the future. Generally, a term of less than one year is considered short-term, and a term of one year or longer is considered long-term. Borrowing money for college or a car with a promise to pay back the amount to the lender generates debt. Formal debt involves a signed written document with a due date, an interest rate, and the amount of the loan. A student loan is an example of a formal debt.

The following characteristics are specific to debt financing:

1. The company is required to make timely interest payments to the holders of the bonds or notes payable.
2. The interest in cash that is to be paid by the company is generally locked in at the agreed-upon rate, and thus the same dollar payments will be made over the life of the bond. Virtually all bonds will have a maturity point. When the bond matures, the maturity value, which was the same as the contract or issuance value, is paid to whoever owns the bond.
3. The interest paid is deductible on the company's income tax return.
4. Bonds or notes payable do not dilute the company's ownership interest. The holders of the long-term liabilities do not have an ownership interest.
5. Bonds are typically sold in \$1,000 increments.

Footnotes

- [9](https://www.forbes.com/2007/01/05/eq...l#bd27de55819f) Nolo. "Financing a Small Business: Equity or Debt?" *Forbes*. January 5, 2007.
<https://www.forbes.com/2007/01/05/eq...l#bd27de55819f>

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