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**CORPORATE BONDS  
AS A SOURCE OF FUNDS**

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*The topic of this article is the corporate bonds as a source of funds. The corporate bonds represent external long-term source of funds. The corporate bonds become more and more significant and create a part of long-term debt instruments. This growth is related to rapid business expansion and inadequate funds generated from the internal operations of business firms.*

To manage business, companies need real assets, for example machinery, factories, offices, trademarks, and patents. All of them need to be paid for. To obtain the necessary money, the company must find available sources of funds.

**Short-Term and Long-Term Sources of Funds**

Financial manager must solve a time problem, but he also needs to select the right type of financing. Financial manager must ask himself: Should the financing be long-term or short-term, debt or equity?

Figure 1 presents a diagram which shows many of the sources that can be used by a Czech corporation. In most cases a corporation will use a combination of these financing methods. At all times the financial manager will balance short-term versus long-term considerations against the composition of the firm's assets and the firm's willingness to accept risk.

### External and Internal Long-Term Sources of Funds

When corporations seek long-term funds (for example 1 million crowns for a new plant), quite a few choices are open to their financial managers. Corporations could raise funds externally through long-term financing, using bonds, common stock, and preferred stock. As an alternative, instead of issuing securities the firm could negotiate a term loan with a bank.

Other extremely important sources of funds to the corporations are internally generated funds as represented by retained earnings and cash flow added back from depreciation.

### Corporate Bonds

A corporate bond is a long-term promissory note issued by a business unit. A bond is a long term contract under which a borrower agrees to make payments of interest and principal on specific dates to the holder of the bond. [1]

The financial manager must take features of corporate bonds into consideration. Literature [2,3,5] mentions features of corporate bonds. They are summarized in Table I.

Tab I Features of bonds

	Bonds
Main characteristic	Bonds represent external long-term source of funds.
Ownership and control of the firm	Belongs to common stockholders through voting right and residual claim to income, bondholders have got limited rights.
Obligation to provide return	Bondholders must receive payment before preferred and common stockholders.
Claim to assets in bankruptcy	Bondholders have got the highest claim. Bondholders and creditors must be satisfied first.
Risk and return	Bonds provide the lowest risk and moderate return.
Tax status of payment by corporation	Interest payments are tax deductible.

## Advantages and Disadvantages of Corporate Bonds

The financial manager must also take into consideration benefits and drawbacks of bonds. Advantages and disadvantages of corporate bonds are set out in literature [3,4,6]. They can be summarized:

### *Advantages of Bonds:*

1. The corporate bonds provide higher flexibility in capital structure.
2. The financial obligation is fixed (with the exception of floating rate bonds).
3. Interest payments are tax deductible. Because corporate tax rate is 35 percent in the Czech Republic, the effective after tax cost of interest is approximately two thirds of the nominal amount expended.
4. Stockholders do not lose control over the firm.

### *Disadvantages of Bonds:*

1. Interest and principal payment obligations are set by contract and must be paid, regardless of the economic position of the firm.
2. Although bondholders do not have the right to vote, they may take control of the firm, for example they may agree upon some restrictions on the firm, such as limits on future debt, and guidelines for dividend policy.
3. Issuing of bonds leads to higher financial risk.
4. The corporate bonds provide higher interest payment than short-term debts.

## Corporate Bonds in the Czech Republic

In the Czech Republic bonds can be issued not only by corporations but also by banks and government. In Table II it can be seen that a number of issues and volume of capital are rising.

Tab. II Situation on Capital Market in the Czech Republic from 1994 to 1998

	1994	1995	1996	1997	1998
No. of issues of bonds	27	48	80	92	93
Market capitalization of bonds (billion CZK)	50.0	87.8	136.9	176.1	x
Market capitalization of shares and units (billion CZK)	353.1	478.6	539.2	495.7	x

Source: Internet pages of Prague Stock Exchange

Altogether 22 bank bonds, 25 government bonds and 46 corporate bonds are now marketed on the Czech capital market. The corporate bonds are issued by firms working in different branches, especially in power system, metallurgy and mechanical engineering.

Only one chemical firm issued corporate bonds. MCHZ issued 5,000 pieces of the bonds. The par value of these bonds is 100,000 crowns. The interest rate is fixed at 12.4%.

The interest rate with the corporate bonds is generally fixed although in recent time there has been an increase in the use of floating rate bonds. The Czech corporations offer bonds with fix coupon rate from 8.5 to 18%.

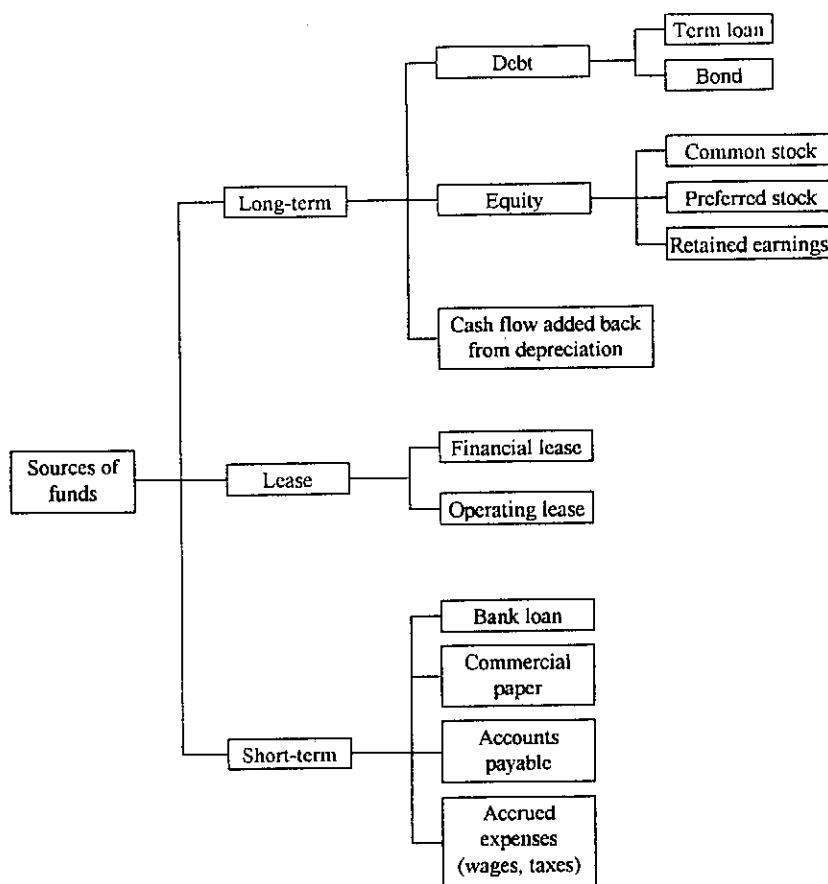


Fig. 1 Sources of funds

## How to Rise Issuing of Corporate Bonds?

The corporate bonds represent a new financing method in the Czech Republic, so the amount of capital following from this source is small in comparison with other countries.

Some reasons which cause this situation are:

1. Legislature in the Czech Republic is insufficient. It is necessary to create strict legislature in accounting, taxing and capital market area.
2. Tax rate imposed on interest payments from bonds is 25%. Tax rate imposed on interest payments from deposits is 15%. The government should harmonize the tax rate or reduce it.
3. The firms suffer from lack of information about the new method. It is necessary to provide more information about this problem.

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