Business Finance: Needs and Sources

What do Finance Departments do?

- Recording all financial transactions, such as payments and sales revenue
- Preparing final accounts
- Producing accounting information for managers
- Forecasting cash flows
- Making important financial decisions

Why do businesses need finance?

- Revenue expenditure
- Start-up capital
- Capital to expand the business
- Capital expenditure
- Additional working capital

- Start-up capital is the needed finance by a new business to pay for essential fixed and current assets before it can begin trading

- Working capital is the finance needed by a business to pay its day-to-day costs

- Capital expenditure is money spent on fixed assets which will last for more than one year

- Revenue expenditure is money spent on day-to-day expenses which do not involve the purchase of a long term asset, for example on wages or rent

Sources of Finance

Sources of finance can be divided into two different groups:

i. Internal and external sources
ii. Short term and long term sources

- Internal finance is obtained from within the business itself
- External finance is obtained from sources outside the of the business and separate from the business

Internal finance

Retained profit

This is the profit kept in the business after the owners have taken their share of the profits, also referred to as ploughed back profit

- ✓ Retained profit does not have to be repaid
- ✓ There is no interest to pay
- × A new business will not have any retained profits
- × Many small firms' profits might be too low to finance the expansion needed
- × Keeping profits in the business reduces payments to owners, for example to dividends to shareholders

Sale of existing assets

Existing assets that could be sold are those items of value which are no longer required by the business, for example, redundant buildings or surplus equipment

- ✓ This makes better use of the capital tied up in the business
- ✓ It does not increase the debts of the business
- × It may take some time to sell these assets and the amount raised is never certain until the asset is sold
- × This source of finance is not available for new business as they have no surplus assets to sell

Sale of inventories to reduce inventory levels

- ✓ This reduces the opportunity cost of high inventory levels
- × It must be done carefully to avoid disappointing customers if not enough goods are kept as inventory

Owners' Savings

- ✓ It should be available to the firm quickly
- ✓ No interest is paid
- × Savings may be too lo
- × It increases the risk taken by owners

External Finance

Issue of shares

- ✓ This is a permanent source of capital which would not have to be repaid to shareholders
- ✓ No interest has to be paid
- × Dividends are paid after tax, whereas interest on loans is paid before tax is deducted
- × Dividends will be expected by the shareholders
- × The ownership of the company could change hands if many shares are sold

Bank loans

A bank loan is a sum of money obtained from a bank which must be repaid and on which interest is payable

- ✓ These are usually quick to arrange
- ✓ They can be for varying lengths of time
- ✓ Large companies are often offered low rates of interest if they borrow large sums
- × A bank loan will have to be repaid eventually and interest must be paid
- × Security or collateral is usually required

Selling debentures

These are long term loan certificates issued by limited companies

- ✓ Debentures can be used to raise very long term finance
- × As with loans, these must be repaid and interest must be paid

Factoring of debts

A debtor is a customer who owes a firm money for good brought. Debt factors are specialist agencies that buy the claims on debtors of firms for immediate cash.

- ✓ Immediate cash is made available to the business
- ✓ The risk of collecting the debt becomes the factor's and not the businesses'
- × The firm does not receive 100% of the value of its debt

Grants and subsidies from outside agencies

- ✓ These grants and subsidies usually do not have to be repaid
- × They are often given with strings attached

Micro-finance

Micro-finance is the providing of financial services including small loans, to poor people not served by traditional banks

Banks do not usually lend money to these people because:

i. The size of the loans means that the bank cannot make profit from the loans
ii. The people do not have assets to act as security for loans

Short term Finance

This provides the working capital needed by the business for the day-to-day operations, shortages of cash can be overcome by:

Overdrafts

- ✓ The banks gives the business the right to overdraw its account (that is spend more money than is currently in the account)
- ✓ The firm could use this finance to pay wages or suppliers but, obviously cannot do this indefinitely
- ✓ The overdraft will vary each month with the needs of the business, it is said to be a 'flexible' form of borrowing
- ✓ Interest will only be paid on the amount that is overdrawn
- ✓ Overdrafts can turn out to be cheaper than loans in the short term
- × Interests rates are variable, unlike most loans which have fixed interest rates
- × The bank can ask for the overdraft to be paid at very short notice

Trade Credit

This is when a business delays in paying its suppliers, which leaves the business in a better cash position

- ✓ It is almost an interest-free loan to the business for the length of time that payment is delayed for
- ✓ The supplier may refuse to give discounts or even refuse to supply any more goods if payment is not made quickly

Factoring of debts

Long term finance

This is finance which is available for more than a year, and sometimes for many years. Usually this money would be used to purchase long-term fixed assets to update or expand the business or finance a takeover of another firm.

Bank Loans

Hire Purchase

This allows a business to buy a fixed asset over a long period of time with monthly payments that include an interest charge

- ✓ The firm does not have to find a large cash sum to purchase the asset
- × A cash deposit is paid at the start of the period
- × Interest payments can be quite high

Leasing

Leasing an asset allows a firm to utilise an asset but does not have to purchase it. Monthly leasing payments are made. The business could decide to purchase the asset at the end of the leasing period. Some businesses decide to sell off some fixed assets for cash and lease them back from a leasing company. This is called sale and leaseback.

- ✓ The firm does not have to find a large cash sum to purchase the asset to start with
- ✓ The care and maintenance of the asset is carried out by the leasing company

× The total cost of leasing charges will be higher than purchasing the asset

Issue of Shares

- Shares ate often referred to as equities therefore the sale of shares is often called equity finance
- Public limited companies have the ability to sell a large number of shares to the general public
- These new issues can raise large sums, but are expensive to organise and advertise
- Gives current shareholders the opportunity to increase proportion of current shares, maintains balance of ownership

Long-term loans of debt finance

- Loan interest is paid before tax as an expense
- Loan interest must be paid every year, but dividends do not
- Loans must be repaid
- Secured against valuable assets

Debentures

How businesses choose their sources of finances

1. Purpose and time period:
   i. If the use is long term, for example, purchasing a fixed asset, then the source should be long term
   ii. If the use is short term, for example, the purchase of additional inventories, then the source should be short term
2. Amount needed: different sources depend on the amount of money needed
3. Legal form and size: certain sources of finances are available to public limited companies but unavailable to sole traders and partners. These business often depend on personal capital and have to pay higher interest rates, compared to larger, well-established businesses
4. Control: owners may loses control if they ask other people to invest in their firm
5. Risk and gearing: the gearing of a business measures the total proportion of capital raised from long term loans, if this proportion is high, the business is said to be highly geared. This is a risky way of financing business. Due to the fact that the loans have to be repaid irrespective of whether the business is making profits or not. When interest rates are high and profits low, businesses may be unable to pay all the interest. The future of the business will be at risk. Therefore banks are reluctant to lend to highly geared businesses which may have to use other sources of finance.

Will banks lend and shareholders invest?

The chances of obtaining a loan is increased if the following are available:

- A cash forecast is to show why the finance is needed and how it will be used
- An income statement
- Details of existing loans and sources of finances a
- Evidence that collateral
- A business plan showing clear objectives

Shareholders are likely to invest if:

- Share price is increasing
- Dividends are high
- Company has good reputation and has plans for future growth