# Financial Services Planning – Business

Warning: You MUST have a look at the Working Examples in the textbook.

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## Unit 1. Financial Services, Business Financial Planning & Financial Services Planning

### Learning Outcomes

After studying this unit and completing the activities within it, you should be able to:

* explain financial intermediation and relate it to retail financial services
* highlight the key elements of financial planning and relate these to accounting and financial control
* discuss the flow of finance within, and the financial needs of, a business operation
* demonstrate how financial services meet the financial needs of businesses
* discuss the main aspects of financial planning and risk with regard to micro/small businesses

### I. Difference between Accounting & Finance

|  |  |
| --- | --- |
| **Accounting** | **Finance** |
| Reporting:  Passive  Impartial  Standardised | Control:  Proactive  Involved  Customised |
| Backward looking:  Verifiable  Realised  Tangible | Forward Looking:  Judgemental  Potential  Intangible |
| Inward looking:  Objective  Costs  Capital maintenance | Outward looking:  Subjective  Values  Adequate |
| Static:  Discrete  Short-term  Profits/Assets | Dynamic:  Continuous  Long-term  Cash flows |

III. Definition: Financial Intermediation  
The term **financial intermediation** referring to the process of raising funds from one source and lending those funds to another party.

### IV. Business financial management is concerned with

* Sources of finance and financing decisions
* Uses of finance and investing decisions
* Management of sources and uses, and controlling finance resources

### V. Scope and relationship of financial planning

### VI. Long-term assets

Long-term assets comprise tangible assets such as land and buildings, plant and machinery, furniture and fittings, equipment and vehicles.

### VIII. Working capital

Working capital comprises four main elements:

* stocks
* debtors (including prepaid charges/accrues income)
* cash and cash equivalents (cash in ‘hand’, non-interest-bearing current account, short term investments, less short term money credit)
* creditors (including accrued charges/prepaid income)

Working Capital Formula:

Working Capital = stocks + debtors + cash and cash equivalents - creditors

### VIII. Flow of finance – continuation and expansion of business

### IX. Product/service life cycle

When a business introduces a product or service to the market, it has to work at consumer acceptance and satisfaction. The levels of sales growth and profit will, at first, be low. This is followed by a short period of high profits as the product or services takes off. But this success attracts new entrants to the market and there is then a slow down when profits may dip due to competition. Maturity is reached when the market becomes saturated, and sales and profits are static. Finally, there will be a decline as the product or service is replaces by improved products or services and substitutes. – Ref: P14

### Summary

In this unit, you have gained an insight into financial services planning in its fullest context, incorporating financial services and business financial planning. You should now be aware of the following points:

* Although accounting and finance share a common language and accounting statements may be used in financial decision-making, finance is dynamic and forward-looking. Finance is to the future while accounting is largely concerned with the past. Also finance and financial decision are largely based on liquidity whereas accounting focuses on profitability.
* Financial institutions seek to meet the financial needs of businesses. Banks provide savings/investment, borrowing/lending and money transmission services as well as other specialised services. Insurance companies provide cover for loss of assets, serious disruptions in activities, public liability claims, and so on.
* Financial planning is concerned with
* Capital funding planning – the process of selecting suitable funds to finance long-term assets and working capital
* Capital resource planning – the process of evaluating and selecting long-term assets to meet strategies
* Finance is necessary for the creation of business and for its continuation and expansion. Sources of finance are provided by the owners of the business and by outsiders such as banks and other financial institutions. The finance is initially invested in long-term assets and working capital to generate income and so provide growth of the business.
* Businesses would be unable to operate without financial services and, at the very least, they will use money transmission products and services, and operate a current account. Investment accounts are also required for efficient liquidity management, while borrowing facilities are frequently needed, both short and long-term. Insurance and life assurance are commonly required as a condition of medium to long-term borrowing.

## Unit 2. Finance Institution/Business Customer Relations

### Learning Outcomes

After studying this unit and completing the activities within it, you should be able to:

* highlight the main features of a sole proprietorship, partnership and limited liability partnership, and discuss the advantages and disadvantages of these types of business operation
* discuss the opening of accounts for these types of business from a financial institution perspective
* highlight credit card operations and discuss the relevant financial institution/small business relationships
* highlight the risks faced by a business and outline risk planning
* discuss business customer/insurance company relationships

### I. Sole proprietorship

A sole proprietorship is a one-owner business where the individual trades under his or her own name, or under a trading name. The narrower term 'sole trader' is often used.

In terms of numbers of businesses, sole proprietorships are by far the most common. They include small retailers such as grocers, newsagents, florists; trades such as plumbing, joinery and electrical work; service outlets such as restaurants; and professional services such as architectural services, interior design and accounting services.

While sole proprietors may recruit employees, full-time and part-time, it is the owners themselves who will drive their businesses and take on most or all of the management functions. Such type of ownership has its advantages and disadvantages.

#### **Advantages of sole proprietorship**

* Formalities are limited. There are no formal procedures necessary to establish the business except that in certain cases, such as restaurants and wine merchants, a local authority licence must be obtained before trading. Account details are required to be submitted to the tax authorities annually although the amount of detail for the smallest or micro businesses is very minimal.
* Self control of business and decision-making. A sole proprietor is independent and is not required to consult anyone else on business strategy or decision-making. This provides the owner with greater job satisfaction than under employment, and may result in a more effective and efficient business operation.
* In return for effort input and risks taken, the sole proprietor enjoys all of the profits. This entitlement can be a powerful motivating factor in ensuring the success of the business.

#### Disadvantages of sole proprietorship

* Unlimited liability for business debts. Just as the sole proprietor reaps all the rewards when the business is succeeding, he or she must bear all the losses if the business fails. The liability for business debts extends to the personal assets of the sole proprietor (such as private house) which may have to be sold off to meet the business obligations.
* Sole proprietorships need owners with energy and, drive. The demands on time can be onerous as so much has to be channelled through a single individual This may result in health problems which in turn may have an adverse effect on the functioning and/or profitability of the business. In the case of the death of the owner, the business may have to be sold to meet inheritance tax liabilities or there may be problems with succession should the beneficiaries of the deceased's estate not wish to continue the business.
* Limitations in raising finance. Sources of finance is often restricted to what the owner can invest personally and funding for expansion may only be possible by ploughing back wealth generated by the business in previous years. Bank funding may be available by way of loan and/or overdraft but institutions will not normally lend more than the sum of capital put in by the owner. Trade credit is particularly difficult to attract due to the unavailability of information concerning the sole proprietorship.
* Operating inefficiencies and management inadequacies. The former may arise through the lack of opportunity to benefit from economies of scale. Management inadequacy arises because sole ownership requires the individual to possess 0 the whole range of management skills: development, marketing, administration, 011 personnel, finance and so on. The owner may only possess one skill and is unlikely to have experience of all skills.

### II. Partnership

A partnership or firm is the relation which subsists between persons carrying on a business in common with a view of profit'. Typical examples are professional firms such as doctors, solicitors and accountants although it applies to all business types.

A firm is a legal person distinct from the partners of which it is comprised so can own property, hold rights and assume obligations. It can be a partner in another firm and can enter into contracts with its partners. Much of the law of partnership is an adaptation of the law of agency. Each partner is an agent for the firm, and any one partner can bind the firm and the other partners by transactions carried out in the normal course of business. For example, in a dental practice, one of the partners may purchase a replacement drill for his own use within the firm. Regardless of whether or not the other partners were agreeable, the cost of the drill would be met by the firm. As well as buying and selling goods, a partner has implied power to receive payments of debt and issue receipts for such payments, appoint and dismiss employees, and draw cheques in the normal course of business. In a trading partnership, the authority extends to borrowing money on the firm's credit and granting security. There are restrictions and a partner is not permitted to execute deeds on the firm's behalf or give a guarantee in the name of the firm.

The main advantages and disadvantages in forming a partnership business operation almost mirror the advantages and disadvantages of a sole proprietorship.

#### Advantages of partnership

* Sharing of effort, input, risks taken and expertise. Dividing the ownership/management workload reduces the problems arising from illnesses and holiday cover. Where the partners have similar skills, there is the opportunity of cross-fertilisation of ideas. If partners have varied management skills, they can be deployed more effectively. The downside of working in joint ownership is of course the problem of disagreement, and this is common.
* Enlarged ownership means an increase in capital funding and a larger business operation.

#### Disadvantages of partnership

* Partners are jointly and severally liable for the partnership debts, that is each partner is liable for the whole of the firm debt. This extends to the personal assets of the partner. A variation is a limited partnership where one or more partners (known as limited partners), but not all, limit their liability to the firm’s debts.
* Reduced independence in decision-making. Business strategy is determined by the partners as a whole and this may also apply to decision-making although a certain amount of delegation may be appropriate where the partners possess different skills.

### III. Business risks, risk planning and business customer/insurance company relationships

Risk, risk management and insurance are subjects in their own right which you may already have studied or opt to study in the future. In this module, therefore, we will confine our study to identifying the various types of risk faced by businesses, considering the risk management process and then looking at the business customer/insurance company relationship.

Risk is commonly considered to be about loss and is certainly viewed by insurers that way. But, in business, it is wider than that and includes unpredictability — the tendency that actual results differ from planned results. It is therefore possible that actual results may turn out better than projected. Since a business is more concerned about losses and that actual results may be lower than projected, we will focus on the possibility or uncertainty of loss.

The various risks which a business may face are many and varied. They are categorised as follows:

#### Physical risks

Loss or damage to the business's physical assets due to natural perils such as fire, storm, flood, earthquakes and so on. Loss or damage may also arise through human actions such as theft, terrorism or vandalism.

#### Interruption risks

Consequent upon the physical risk outlined, loss will include not only the cost of replacing the assets but the time involved in replacing them and returning to pre-loss levels of activity. During this time, the business's earnings will be affected and increased costs may be incurred.

#### Personnel risks

Death or injury of employees can involve the business in the costs of compensation payments, time lost due to an accident and possible fines if breaches of safety legislation are involved. There will also be indirect costs, including the time spent in investigation of an accident and the costs of recruiting and training a replacement employee. The latter can be considerable if a key employee is involved.

#### Labour risks

Apart from the risk of accident to employees, the business faces risks with regard to the quantity and quality of employees. It is dependent on the availability of suitable labour. Satisfaction and morale of the workforce is also important in maintaining productivity at target levels. Legal and liability risks All businesses can be faced with very large potential legal liabilities to other parties. In addition to employees as mentioned, there may be claims for compensation from customers, neighbours or members of the public generally who can be affected by their actions. For example, an incident involving physical harm to several individuals can result in compensation claims for millions of pounds, possibly considerably in excess of the net worth of the business.

#### Production risks

In both manufacturing and service industries, there is a risk that circumstances might occur which mean that the business is unable to maintain its normal output. Losses may occur as a result of machinery or computer breakdown, inadequate quality controls, bad weather, or faulty materials.

#### Technical risks

The pace of development of new technology increases risk for any business. The business faces the risk that technology may not produce the expected benefits, or may result in breakdowns or stoppages, or that competitors may gain an advantage from improved technology. On the other hand, there are potential gains from improved efficiency, and potential competitive advantage.

Marketing risks The business may misjudge the desires of consumers, both in the introduction of new products and the continuing market for existing products. This is a speculative risk. Losses may be incurred if demand is lower than anticipated, but there could be gains from higher than expected demand, provided the business has the productive capacity to meet such demand

#### Political and social risks

Government intervention, or changes in regulation, may affect the way in which the business carries out its activities, and may impose extra costs. On the other hand, legislation may provide opportunities for new product development. Social pressure may come from pressure groups, consumer organisations or public opinion generally.

#### Environmental risks

This is a special category of legal and social risks. Society is becoming more aware of the potential for pollution, and the legal consequences are increasing all the time. Again, there may be long-term risks as the effects of pollution may not become apparent until some time in the future. Additionally, the environmental lobby is a powerful force which can influence a business's activities.

#### Operating risks

All businesses face risks in connection with their operations and transactions. Sales turnover may slow down reducing cash flow, bad debts may be incurred, the cost of borrowing may increase, investments may fall in value or fraud may occur.

#### Funding and financial investment risks

These are the risks associated with the financing of the business and the investment of part of that funding in financial investments. Providers of the finance — owners and lenders — expect a return on their investment which the business may not be able to provide. The business risks not being able to pay its loan interest and the owners are probably reliant of receiving regular drawings. When the business invests outside, there are risks that it will not receive interest or dividends and may even lose the amount of the investment.

From the examples quoted above, you may well imagine the consequences for the business if things were to go wrong and losses were incurred. It could result in the closure of the business and the bankruptcy of the owner/s. For this reason, it is important that businesses give consideration as to how to manage risk. Risk management is the identification, analysis and control of risks which can threaten the assets or earnings potential of a business, and the risk management process can be shown diagrammatically as in figure 2.3.

### IV. Summary

In this unit, you have gained an appreciation of sole proprietorships and partnerships, and the important aspects financial Institution relationships with these business, You are aware of the following.

* Sole proprietorships are one owner businesses where the owner takes on most or all of the management functions. The advantages of this type of business are informality, self-control and full profit entitlement. In contrast, the owner has unlimited liability for the business debts, which liability extends to personal assets. Sole proprietorship operations need owners with energy and drive as well as management skills. Difficulties may be experienced in raising finance from a small base and this may lead to operating inefficiencies.
* The financial institution/sole proprietorship relationship is established with the opening of a separate business current account for managing the day-to-day financial operations of the business.
* Partnerships comprise two or more partners, each partners being an agent for the firm, and being able to bind the firm and the other partners by transactions carried out in the normal course of business. The advantages of partnerships, compared with sole proprietorships, are shared expertise and effort, and increased capital funding. Partners are, however, jointly and severally liable for the debts of the firm, that is each partner is liable for the whole of the firm debt.
* In opening a partnership bank account, the financial institution will obtain a mandate to be signed by all the partners. The mandate will identify those with cheque signing authority, incorporate joint and several liability and, should borrowing be anticipated, authority for the bank to permit overdrafts on the account.
* Limited liability partnerships operate largely as traditional partnerships except that the liability of the partners in limited. There are also more formalities involved in setting up the business.
* Solicitors, insurance brokers, investments advisers, estate agents, licensed dealers in securities and other financial intermediaries operate usually as partnerships or limited companies but they also handle money belonging to clients. Clients' funds may not be used to meet the debts or obligations of the solicitors' or other business and normally a separate 'clients' account' is required.
* A credit card is a form of money transmission and also a source of revolving credit for the cardholder. Unlike many of the other forms of money transfer, credit cards are not tied into current, deposit and other such accounts, and the relationship between the cardholder and the financial institution or credit card company differs from the traditional banker/customer relationship.
* Credit card services are dominated by two major international networks - Visa and MasterCard. All the main institutions offering retail banking facilities offer their own versions of each of these cards.
* A credit card is simply a plastic card enabling the cardholder to purchase goods and services to be paid at a later date. Each cardholder is given a limit. up to hundreds or even thousands of pounds, to which goods or services may be purchased on credit.
* The merchant, retailer, etc. is also given a limit but this is very much smaller as it pertains to individual transactions. If any single transaction breaches the limit, the merchant may phone the appropriate card centre to authenticate and approve the transaction.
* Cardholders are provided with monthly statements and have the option of :
* repaying the whole balance by the due date on the statement
* repaying 5% (or less) of the balance by the due date (or in full if the balance is £5 or less)

Interest, at a high rate, is charged monthly, from the statement date, on any outstanding balance not repaid in full. Credit cards can provide a period of up to 59 days (but usually 56 days) of interest-free credit and the limits tend to be generous.

* • A business is likely to be both a user of credit cards (cardholder) and an acceptor of cards in payment for its goods and/or services (card acceptor and merchant). In the latter role, the business presents the transaction data to the acquirer or merchant acquirer, being the financial institution which acquires transaction data from a card acceptor or merchant and enters such data into the appropriate payment system.
* For the business which accepts credit card payments by its customers (acting as merchant), there are a number of advantages:
* Payment is guaranteed and the business account is immediately credited with the cleared funds when the credit card vouchers are paid into the bank.
* The system permits the business to offer customers credit without the administration costs and risk of bad debts inherent in setting up one's own arrangements.
* By offering credit, more custom should be attracted and the security risk of handling cash will be diminished.
* The business has the support of an international credit network in advertising and promotional campaigns.
* The financial institution raises part of its credit card income from charging retailers and other merchants who accept the card in payment of goods and services. This merchant fee which is determined by the institution signing up the retailer - the merchant acquirer - is based on transaction value (ad valorem) and the rate varies between 1% and over 4%.
* Risk is commonly considered to be about loss and is certainly viewed by insurers that way. But, in business, it is wider than that and includes unpredictability — the tendency that actual results differ from planned results. It is therefore possible that actual results may turn out better than projected.
* The various risks which a business may face are many and varied. They include physical risks, interruption risks, personnel risks, labour risks, legal and liability risks, production risks, technical risks, marketing risks, political and social risks, environmental risks, operating risks, and funding and financial investment risks.
* Risk management is the identification, analysis and control of risks which can threaten the assets or earnings potential of a business.
* The extent to which a business customer engages with an insurance company will vary with the type of business, its risk management policy (risk retention or risk transfer), and legal and other requirements.
* The relationship between a business and an insurance company is based on the law of contract, businesses entering into contracts of insurance with insurance companies. The essential features of such contracts are:
* Agreement between the parties over detail
* Offer and acceptance Consideration
* Capacity and legality
* Errors, misrepresentation and fraud may invalidate the contract
* Agreements which one of the parties has entered into under duress or undue influence are unenforceable.
* Rather than purchasing individual insurance products, it is advantageous for the business to buy a 'package policy' as it offers the following benefits:
* The cover will be comprehensive enough to cover the main risks affecting the business whilst avoiding duplication and overlap of cover
* The insurance is easier to manage because there is a single set of documents, one point of contact and one renewal date
* The cost is often less as insurers offer a better total premium when they provider all the cover required by the business

## Unit 3. Current Account Operations: Rights & Obligations; Current Account Features; Cheque Operations

### Learning Outcomes

After studying this unit and completing the activities within it, you should be able to:

* assess the duties and responsibilities of bankers and businesses with regard to current account operations
* highlight and discuss the features of, and services associated with, current accounts
* discuss cheque negotiability, and the effects of endorsements and crossings
* compare the responsibilities of the paying and collecting banker

### I. Current account features

Current accounts have some of all of the following features and associated services:

* Cash card
* Cheque guarantee card
* Cheque book
* Standing orders
* Direct debits
* Debit card
* overdraft

### II. Cheque clearing process

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### III. Standing orders

standing order may be defined as - a signed authority by the customer, to their bank or other financial institution, instructing the bank or financial institution, to make regular payments from their account, to a named beneficiary, at stated times, for a stated period or until further notice.

### IV. Direct debits

Like standing orders, direct debits require the authority of the payer, payment is effected through the financial institutions, and they are used for regular payment, etc. However, the fundamental difference is that the payer authorises the payee to instigate the debit to the account by advising the financial institution of the amount.

### V. Exception clause for banker

The law is clear on such situations and protects the collecting banker who:

* credits the customer with the value of the cheque
* acts in good faith (i.e. honestly)
* acts without negligence

### VI. A banker (the paying banker) is required to honour cheques provided

* there are sufficient funds in the account;
* the cheque is technically and legally in order (i.e. signed, addressed, amount in figures agrees with amount in words, etc.);
* there is no legal impediment preventing the banker from making payment.

### VII. Summary

In this unit you have gained a good insight into current account operations, particularly cheque operations since the cheque is a very common form of business payment, and you now understand that:

* The acceptance of deposits on current account which the depositor might withdraw on demand by cheque is a major and traditional service of banks. Such a service provides the business with a safe and convenient means of saving funds, and receiving and effecting day-to-day money transfers.
* The account relationship between a banker and business places certain duties and responsibilities on each party. In particular, the banker must honour cheques issued by the business provided there are adequate funds/ facilities available, and there are no technical or legal irregularities. These duties mirror the business's responsibilities to ensure funds are available to meet cheques issued and not to facilitate cheque fraud and irregularities.
* A cheque is fundamentally a negotiable instrument, i.e. ownership of the cheque can be transferred, either by delivery or by endorsement and delivery.

Endorsement on the back of the cheque may be:

* simple (signature of the drawer only)
* specific (signature of the drawer with instruction to pay a named party)
* restrictive (signature of the drawer with instruction to pay a named party only)

Crossings effectively end negotiability. They may be:

* general (parallel lines, with or without 'not negotiable', 'account payee', etc.)
* special (incorporates the name of a bank)
* Collecting bankers examine cheques for compliance of technical details, act on the instructions of endorsements and crossings, and give value to cheque holders. Legal protection is available in the event that the rightful owners of the cheque do not receive value provided the banker gave value, acted in good faith and without negligence.
* Prior to paying cheques, the paying banker ascertains the sufficiency of funds of the customer, checks for compliance of technical details and whether or not there is any legal bar to payment. Protection is granted for payment on a forged or missing endorsement provided the banker had acted in good faith, in the ordinary course of business and without negligence. No legal protection is given if the banker pays on a forged drawer's signature.
* Apart from cheque facilities, current accounts offer features including: cash cards, standing orders, direct debits, debit cards and overdrafts. The overdraft is simply the negative balance on the account but is particularly useful to businesses which may have regular but temporary cash flow shortages.
* Cash, or notes and coin, is the most readily acceptable form of money and the most popular. It is convenient and quick to effect settlement, particularly for small payments. However, for businesses, cash transactions involve outlays in terms of collecting and handling costs, counting, storage, security, insurance, etc.
* Standing orders and direct debits are for regular payments, both being signed authorities of the customer to their banks or other financial institutions instructing the financial institution to debit their account in favour of a named beneficiary at stated times for a stated period or until further notice. The distinction between the two is that standing orders instruct the financial institution to make regular payments of regular amount to the beneficiary while the direct debit instruction to the financial institution is to accept debits to the account, instigated by the beneficiary. The latter is therefore more suitable for regular payments of irregular amount.
* Debit cards are plastic cards used to pay for goods and services at the point of sale. The debit card is a 'pay now' card, equivalent to an electronic cheque.

## Unit 4. Current Account Operations: Regular Operations; Terminating the Account

### Learning Outcomes

After studying this unit and completing the activities within it, you should be able to:

* highlight the assurances given to business customers in respect of interest and charges, and relate charging to money transmission services
* discuss why bank reconciliation is necessary and prepare bank reconciliation statements
* highlight the account review process and demonstrate the likely signs in the current account when a business is having cash flow problems
* apply the rule in Clayton's case and highlight its significance
* relate the circumstances for terminating a small business account
* interpret appropriation and set-off

### I. Back reconciliation

IMPORTANT: Example on Page 62~63

Both the business and the bank may maintain their own account records but it is very rarely the case that, on any one day, the two balances will agree. Differences are due to the following:

* Items not yet presented

These include cheques which have been written by the business but have not yet been presented to the banker, i.e. they are in the post to creditors, in the hands of creditors or are in the process of clearing.

Another instance is where the business has prepared a lodgement but has not presented the pay-in on time. This is common where the business banks at the end of the day, when the bank may still be open, although entries are treated as next day's postings because the end of the bank's day for transactions is earlier than the closing time.

* Errors and omissions

Errors can be made by the business in their own records or by the bank in the bank statement and these require to be corrected.

Omissions from the bank account are common. Regular items by way of standing order or direct debit may have been overlooked while bank charges and interest are often not known. Inter alia, the telebanking service is designed to avoid omissions as regular commitments can be checked while accrued interest and charges are advised.

### II. Appropriation and Set-off

#### Appropriation

Appropriation refers to the choice of applying particular deposits to particular accounts and debits. Where the business has more than one account, the owners have the right to appropriate funds lodged into whichever account they wish unless there is an agreement to the contrary in the account mandate. This applies even where one account is in credit and one in debit. Right of appropriation also extends to particular debits: for example, the business may specify that the amount lodged is to meet a particular cheque which may or may not have been issued at that time. The right should be exercised at the time of making the deposit.

#### Set-off

A banker has the right to combine or set-off the balances on two or more accounts even though they may be held at different branches. Normally this applies to current accounts but may also apply where the business has a current account and a deposit account.

### III. Summary

In this unit, you have gained a further insight into current account operations, looking at interest, charges and bank reconciliation in particular before account review and terminating the account. You are now aware of the following.

* The business receives payment in a variety of forms and may settle its own payments in different ways, all of which attract bank charges. These charges may influence the business's attitude to different forms of money transmission and the importance of ad valorem (according to value) or flat rate needs to be appreciated. Ad valorem charging is cheaper for those businesses dealing with low value products/services but costs rapidly escalate with the value of transactions.
* Bank reconciliation is the matching, at a certain date, of the balance on the bank account in a customer's records with the balance in the bank statement. Differences are due to error and omissions, which need to be corrected, and items not yet presented to the bank.
* In the normal course of business, there should be no particular problems regarding the running of the business account. Authority for dealings should be in accordance with the appropriate deed and payments should comply with the mandate.
* Nevertheless, current account operations may not proceed in a normal way and the bank will wish to protect its position. For this reason, transactions are monitored but reviewing the account can also reveal potential problems. Cash flow difficulties may emerge for the business but this can impact on the bank lending funds by way of overdraft.
* Change of ownership of a firm which has borrowing facilities will cause a financial institution to close the firm account and then open up an account for the new firm. This is to preserve their rights following the ruling in Clayton's case which was that account debits and credits are matched chronologically.
* The banker/business current account relationship may be terminated for various reasons, intended and unintended. Death, mental incapacity and bankruptcy of the sole owner will close the account. Change of ownership of a firm which has borrowing facilities will cause a bank to close the partnership account and then open up an account for the new firm if the remaining partners are to continue. This is to preserve the bank's rights following the ruling in Clayton's Case.
* The rule in Clayton's case was established in the English case of Devaynes v Noble, 1816. Examples of circumstances when it applies include the death of a joint account holder and the retiral of a partner. The resultant ruling was that, unless there is an agreement to specific appropriation, debit and credit transactions are matched chronologically: the earlier drawings are deducted from the earlier payments in.
* Appropriation refers to the choice of applying particular deposits to particular accounts and debits. Where the business has more than one account, the owners have the right to appropriate funds lodged into whichever account they wish unless there is an agreement to the contrary in the account mandate. This applies even where one account is in credit and one in debit. Right of appropriation also extends to particular debits and should be exercised at the time of making the deposit.
* Although it is the business which has the first right of appropriation, should the owner/s not do so, the bank may appropriate the funds and it would seek to do so in a way which is most advantageous to the institution. Should neither party appropriate, the default rule (Rule in Clayton's Case) applies.
* A banker has the right to combine or set-off the balances on two or more accounts even though they may be held at different branches. Normally this applies to current accounts but may also apply if the business has a current account and a deposit account. Loan accounts, which are for fixed periods and are set up by written agreement, normally cannot be combined with other accounts.

## Unit 5. Liquidity Management & Services

### Leaning Outcomes

After studying this unit and completing the activities within it, you should be able to:

* explain liquidity management, highlight the flow of liquid funds in a business, and discuss liquidity management objectives
* compare a cash flow statement or budget as prepared by the business and a bank pro-forma cash flow statement
* discuss the benefits of cash flow forecasting to a business and to a lender to a business
* appraise the financial services provided for business liquidity management
* discuss telebanking and demonstrate its benefits in the management of the liquid funds of a business

### I. Liquidity management

Liquidity management is simply the management of liquid funds, often narrowly referred to as cash and interpreted as bank current account. Liquid funds actually comprise cash, bank, short-term investments, less short-term money credit. These components were defined as net liquid funds', but the new term 'cash and cash equivalents' was substituted with the introduction of International Accounting Standard 7.

The following diagram illustrates the scope of liquidity management of a business and the inter-relationship of the elements. (P76)

In managing liquidity, business management should be mindful of the following

objectives:

* solvency

the ability of a business to meet its short-term obligations from its short-term sources

* risk

surplus funds have the expectation of high return for high risk, and low return for low risk: shortages should be identified so that funds can be arranged to cover such shortages

* return

maximise the return on surplus funds; minimise the cost of borrowed funds

* flexibility

the ability to react quickly to unexpected circumstances

### II. Five benefits of cash flow forecasting

The benefits of cash flow forecasting or budgeting may be summarised as follows:

* forecasting or budgeting shows an attempt to command the situation;
* cash shortfalls will be identified so arrangements may be made in advance for extra funding;
* surpluses will be identified so transfers may be made to higher return investments;
* attention will be drawn to occasional but major items of expenditure such as taxation, dividends, loan repayment, etc.;
* may assist in credit control and working capital management

### III. Worked example 5.1

P78 + P83

### IV. Bank giro credit

Of the forms of money transfer shown in Figure 5.2, only one has not yet been considered — bank giro credit. This is a credit transfer enabling anyone, whether an account-holder or not, to transfer funds to another party via their bank account.

Bank giro credits, therefore, differ from the other forms of money transfer in that payment is made directly to the bank account of the business.

### V. Short-term investments

The day-to-day activity on the current account will likely result in temporary surpluses

or temporary shortages. Bearing in mind the liquidity management objective of return, the business should maximise the return on surplus funds and minimise the cost of

borrowing. At this stage in the unit, we will concentrate on the former.

### VI. Deposit/savings accounts

Deposit or savings accounts are designed for very short-term surpluses, e.g. prior to investing elsewhere at a higher rate.

### VII. Term deposits/Accounts

For larger sums of money, a business may consider lodging money on deposit for a fixed term, ranging from one month to five years. Withdrawals are not normally permitted during the term of the deposit or, if they are, an interest penalty may apply.

### VIII. Investment accounts

Institutions offer a range of Investment' or higher interest accounts which attract money market rates. They are intended for large deposits for short periods but carry a period of notice of withdrawal; 7 days, 30 days or whatever.

### IX. Telebanking

Telebanking identifies a money transmission system which operates by direct relay of instructions via a telecommunication link. The service may be delivered through one or more distinct systems or channels, namely screen, automated voice response or person-to-person.

#### Telebanking systems provide the following facilities:

account details

statements/mini-statements

examination of regular payment

bill payments

inter-account transfers

service requests (e.g. cheque books and printed statement

cash management (business customers only)

### X. Summary

In this unit, you have gained a deep insight into liquidity management and you now understand that:

* Liquidity management is the management of liquid funds which comprises cash (notes and coins held on the premises), bank (non-interest-bearing current accounts), shod-term investments (short-term, interest-bearing accounts with financial institutions) less short-term money credit (credit card and other balances outstanding).
* The objectives of liquidity management are:
* solvency;
* risk;
* return;
* flexibility.
* Liquidity management is assisted by the preparation of Cash Flow Forecasts which should be fully detailed. The main benefits of such statements are:
* forecasting shows an attempt to command the situation;
* shortfalls are identified so arrangements may be made in advance for extra funding;
* surpluses will be identified so transfers may be made to higher return investments.
* Cash Flow Forecasts are also prepared to support proposals for borrowing and assist in determining the best funding arrangement for the parties involved.
* To assist their customers in organising and controlling liquid funds, the financial institutions provide the following relevant products and services:
* savings/investment services
* money transmission products and services
* borrowing by overdraft and credit card
* night safe facilities
* Cash is extremely popular with individuals and, provided the notes and coin are within legal tender limits, a business cannot refuse this form of settlement. From a business perspective, it is not safe to keep large amounts of cash on the premises and the common practice is to bank takings daily or more frequently. Notes and coin should only be retained for petty cash purposes (stamps, staff transport, etc.) and therefore, in terms of liquid funds, cash is normally of low value
* Typically, payments from customers for goods and services are made by cash, cheques, debit card, credit card and bank giro credit. These are lodged in or credited to the current account. Business payments from the current account are regular, in which case the appropriate vehicle is the standing order or direct debit, or spontaneous, where a cheque or debit card is more appropriate.
* Short-term investments comprise
* high interest cheque account
* deposit/savings account
* term deposit
* investment account
* Short-term money credit is primarily balances outstanding on credit cards which have a dual function of money transmission and source of borrowing.
* Telebanking combines savings/investment and money transmission services but, importantly for a business, offers real control over liquid funds through instant inter-account transfers and cash management facilities.

## Unit 6. Lending Principles and Practice

### Leaning Outcomes

After studying this unit, and completing the activities within it, you should be able to:

* describe the lending products appropriate for the small business
* demonstrate how interest is calculated, clearly distinguishing between nominal rate and true rate
* appraise the principles applied by lenders
* discuss the significance of cash flow forecasts in borrowing/lending
* appraise the suitability of various types of security

### I. Lending products

Lending to a small business may be over the short term (up to three years), medium term (three to ten years) and long term (over ten years). Advances are granted so that the business can meet obligations during temporary cash shortages, for the purchase of medium term assets such as equipment, to acquire commercial property and such like.

The very short-term sources of finance, overdrafts and credit cards, have already been considered (Units 3 and 2 respectively). Other lending products include:

* Loans/business loans
* bridging loans
* commercial mortgages

### II. Term Loans

Business terms loans are particularly designed to finance the purchase of tangible fixed assets, and are granted for amounts of hundreds of pounds upwards. The term is commonly medium, that is 3 tot 0 years, although loans can be arranged for 1 to 2 years and up to 20 years, or more. Repayment is phased monthly, quarterly, even annually, in equal instalments, either including interest if the rate is fixed, or with interest in addition if the rate is fluctuating. Flexibility is practised and it should be possible for both parties to come to an arrangement which fits in with reasonable business prospects.

### III. Bridging loans

Bridging loans are intended for situations where large-scale purchases precede major sales, creating large deficits for short periods. Commonly, the need for such borrowing arises when a business moves premises, for whatever reason, and the completion dates, for the sale of the old premises and the purchase of the new, don't coincide. Interest is charged on daily basis, and a fee payable.

### IV. Commercial mortgage/loans

A commercial mortgage is a specific type of secured loan to enable a business to purchase, or even lease, business premises. Although the term mortgage is commonly used to refer to the loan, it is, in fact, the security taken for the loan.

### V. Worked example 6.1

P102

### VI. Life policies

Life policies are a popular for of security due partly to the fact that the greater proportion of the population have life assurance rather than property or stocks and shares. Indeed, it would be prudent in business to take out life assurance in respect of the owners and other key persons. Popularity is also due to the fact that all the attributes of a good security will apply, disadvantages being more theoretical than practical.

### VII. Summary

In this unit, we have considered business borrowing from a lender's perspective so that business proposals can be presented in the best way to ensure acceptance. You should now appreciate the following points.

* The lending products which meet the needs of small businesses include:
* overdrafts
* credit cards
* business term loans
* bridging loans
* commercial mortgages
* On the granting of a loan, a separate loan account will be opened. The amount of the agreed advance is debited to the new loan account and credited to the business current account. The business will then be able to write a cheque to cover the cost of new assets. Interest is charged periodically and normally debited to the loan account. A standing order is arranged so that funds are regularly transferred from the current account to the loan account until such time as the loan is extinguished and interest has been met.
* Financial institutions set their own base rates of interest which will vary depending on market rates in general in the economy although the latter are subject to government intervention. Actual lending rates quoted to customers are at a margin above base rate while deposits pay below base, providing the institutions with their gross profit margins. interest may be fixed or variable, and front-end loaded (nominal) or payable as and when accrued.
* The lender is concerned with:
* personal aspects - to ensure the integrity of the borrower, their capability to operate efficiently and effectively, and their capital commitment
* purpose and amount - to ensure conformity with government, banking and business directives as well as adequacy and accuracy of projections
* repayment - to ensure repayment of borrowing and payment of interest
* safety - to safeguard against the ultimate risk of the borrower's bankruptcy or liquidation
* The terms of repayment of a loan is a matter of negotiation between business owners/partners and the lending banker but will be based on projections of cash flow. The banker will wish to see the pattern of all cash flows broken down on a monthly basis, certainly for the first twelve months and frequently for the first two years. The reason for the latter is that if the business is in its first year of operation or is to undertake a major expansion, the cash flow will hopefully show a growth pattern, but the normal pattern, which is required to judge the adequacy of funds, may not become evident until late in the first year, year two therefore being the first typical year. In such situations, the cash flow statement will be used to examine the extent to which facilities may be required in the early- stages of development.
* Items commonly taken in security include:
* Heritable property - land and buildings
* Stocks and shares
* Life assurance policies
* Guarantees
* The key characteristics of a good security are:
* simplicity of title
* stability of value
* realisability

## Unit 7. Financial Statement Analysis

### Learning Outcomes

After studying this unit, you should be able to:

* prepare financial statement analysis pro-formal
* highlight the main features and structure of financial statement analysis and appraise the items reported therein
* calculate financial ratios, interpreting the significance of each

### I. Financial ratios

A financial ratio is the relationship between one figure in a set of financial statements and another to which it is in some way connected. For example, as credit sales create debtors, sales and debtors are connected, although they will be reported by the business in different statements.

### II. Summary

In this unit, we have considered the compilation and content of financial statement analysis, from a lender's perspective a prime source of evidence concerning a business. You should now appreciate the following.

* Financial statement analysis is a pro-forma used by the lender and recording balance sheet data, selected profit and loss account data and selected financial ratios. It covers a five-year period so that the lender may review the performance of a business over time and thus gauge trends.
* In assessing the capability and means of the business, the lender will review the financial statement analysis to get some indication of the profitability/efficiency and liquidity of the business. Financial ratios assist in this process.
* Financial ratios may be categorised into:
* ratios of profitability/efficiency
* ratios of liquidity or solvency
* ratios of investment
* The ratios of profitability/efficiency calculated by the lender include:
* net profit before tax/net capital resources
* gross profit/turnover
* net profit before tax/turnover
* stock turnover
* credit allowed
* credit received
* The ratios of liquidity calculated by the lender comprise:
* current ratio
* liquid ratio
* Measures of investment calculated by the lender comprise:
* interest cover
* borrowing/net capital resources
* Financial statement analysis merely acts as a screening tool to highlight significant variances. Determining the reasons for these variances requires the lender to have knowledge of the borrower and the borrower's business.

## Unit 8. Financial Data & the Lending Decision

### Learning Outcomes

* interpret financial statement analysis to assess the profitability/efficiency of a business and demonstrate the relationships of profitability/efficiency ratios
* interpret financial statement analysis to assess the liquidity and discuss the value of the data to a lender to business
* interpret financial statement analysis to assess the means of a borrower and the risk to a lender
* discuss the importance of working capital management to a small business, stock holding policy and credit policy
* discuss and demonstrate overtrading, highlighting the signs, symptoms and consequences of overtrading

### Summary

In this unit, we have considered how financial data are interpreted and the quality of that data. You should now appreciate the following.

* In assessing the financial standing and means of the business, the lender will review previous financial statements to get some indication of the profitability/efficiency and liquidity of the business. Financial ratios assist in this process.
* An examination of the capital structure will indicate the financial risk of providing the advance.

Financial statement analysis merely acts as a screening tool to highlight significant variances. Determining the reasons for these variances requires the lender to have knowledge of the borrower and the borrower's business.

* Efficient management of working capital is essential for a business since:
* working capital is the lifeblood of the business, being the source of its growth
* it involves day-to-day-operations
* it takes up the largest proportion of financial management time investment in current assets tends to be large and volatile
* in small businesses in particular, investment in fixed assets is reduced by rental or leasing, but investment in working capital cannot be restricted
* Capital tie-up in stocks and debtors is necessary but these need to be convened into liquid funds in the short-term. A business should have proper stockholding and credit policies. With regard to debtors, there is the risk of bad debts and frequently the lender will require the business to regularly complete a debtors' analysis showing the age of debts.
* Factoring is a form of finance whereby cash is provided by the factoring company against each business invoice, normally 80% of the value of the invoice within 2 or 3 days of issue. Advances are charged at rates between 2,6 and 4 % above the factor's base rate with the remaining 20% being paid (less commission and interest) at an agreed future date, often 3 months hence. The service may extend to the factor offering a sales ledger management service by taking over the operation of the business's sales ledger and collecting the debts as they fall due. An administrative charge of 1-2% of invoice value will be levied. Even bad debts can be covered by the factor although this will involve further charging.
* Overtrading is 'trying to maintain a scale of operations with insufficient proprietorial stake so that the substantial circulating (current) assets necessary to support the operations are unduly reliant on outside finance'.
* Overtrading may result in:
* reduction in effective sales figure if custom/payment is to be attracted by extra discounts or low prices
* increased cost of purchases due to hand-to-mouth buying, loss of discounts, an inability to accept special orders, and making longer credit a more important criterion than quality, price and value
* interest charged for overdue payments
* sale of book debts
* damage to goodwill arising from pressure on debtors
* discontinuance of credit facilities from suppliers arising from delayed or non payment
* additional repairs and maintenance costs through delaying the replacement of fixed assets tangible
* depletion of tangible fixed assets due to sale and leaseback

## Unit 9. Capital funding planning

### Learning Outcomes

* demonstrate the matching of finance and highlight the principles of capital funding planning
* discuss capital structure and demonstrate the tax advantages of loans
* debate why projects should be evaluated at the weighted average cost capital rather than component cost
* review how internally-generated sources of finance impact on retained profits and distribution strategy

### I. Principles of capital funding planning

For each individual business, while there is probably an optional capital structure or mix of debt(loans) and owners' capital, it is certainly no easy matter to achieve it or, indeed, determine what it is. It is possible to list the factors which ought to receive consideration but assessing the weightings remains very largely a matter of judgement and experience. These considerations are examined briefly at this stage.

#### Cost

Current and future costs of each potential source of finance should be determined or estimated, and a comparison made. Sources are not necessarily independent of each other as, for example, an increase in debt now may require an increase in equity later to maintain the balance. Businesses will normally seek to minimise the weighted average cost of capital.

#### Acceptability

Finance can only be raised if investors are willing to invest. Capital structure must be acceptable to investing individuals and institutions.

#### Risk

There may be dangers in being unable to meet interest and/or other charges. Profit levels and gearing require consideration.

#### Control

Existing owners may wish to avoid funding which would have the effect of removing or diluting their control.

#### Transferability

Capital should be capable of being transferred easily on change in ownership or other circumstances concerning partners such as mental incapacity, bankruptcy or death.

### II. Summary

In this unit, you have examined the broad aspects of and issues raised in capital funding planning and its relationship with capital resource planning. You should now appreciate the following points.

* Sources of funds or finance should be matched with uses of that finance on a time basis, that is short-term sources for short-term uses, long-term sources for long-term uses.
* Owners' capital and loan capital have important, differing characteristics in terms of rights to return on investment and safety of investment.
* In particular, loan capital provides a tax advantage as loan interest is a recognised expense for tax purposes whereas drawings are paid out of taxed profits.
* When planning the capital structure of a business, the owners should consider:
* Cost
* Acceptability
* Risk
* Control
* Transferability
* If a business wishes to invest money in a capital project it will have to find a source of that money and there will be a cost attaching to it. There are two prime sources of capital funding, the owners of the business and the outsiders such as financial institutions.
* Banks and other lenders take a risk in advancing money to businesses but there is a limit to the level of risk they are prepared to take, hence many business applications are refused.
* Capital funding for projects should be regarded as a total entity rather than being made up of the two main components mentioned above. This equally applies to the cost of capital which should be considered on a weighted average basis rather than a component cost basis.
* The cost of capital is a marginal cost of a weighted average of components. Component costs need to reflect tax implications and future costs.
* Internally generated sources comprise reserves, provisions and deferments. Although nominal and intangible by nature, transfers to reserves have the effect of restricting the amount of drawings and therefore drawings distributions, preserving the size and growth of the business.