# BUSINESS FINANCE AND ITS SOURCES (5.1 + 5.2)

*( Chapter 28 - AS level 5.1 )*

**Finance** is the money required in the business for a variety of reasons. Some needs will require long term sources of finance such as mortgages for buildings, other needs will require short term sources of finance like overdrafts when there is a temporary cash shortage.

**Start-up capital** is the initial capital used in the business to buy fixed and current assets before it can start trading. ( buildings, initial inventory and equipment etc. )

**Working capital** is finance needed by a business to pay its day-to-day running expenses (money to pay suppliers, bills, general operating costs etc.)

**Capital expenditure** is the money spent on fixed assets (assets that will last for more than a year). Eg: vehicles, machinery, research and development etc. The long-term capital needs.

**Revenue Expenditure**, similar to working capital, is the money spent on day-to-day expenses which does not involve the purchase of long-term assets. Eg: wages, rent. These are short-term capital needs.

**Liquidity** is the ability of a firm to be able to pay its short term debts. **Liquidation** is when a business is unable to pay back its debts and its assets are sold for cash to pay suppliers and other creditors.

## The significance of working capital :

**Working capital is the capital required by the business to pay its short-term day-to-day expenses.** Working capital is all of the liquid assets of the business– the assets that can be quickly converted to cash to pay off the business' debts. Working capital can be in the form of:

- cash needed to pay expenses
- cash due from debtors – debtors/credit customers can be asked to quickly pay off what they owe to the business in order for the business to raise cash
- cash in the form of inventory – Inventory of finished goods can be quickly sold off to build cash inflows. Too much inventory results in high costs, too low inventory may cause production to stop

Without sufficient working capital a business will be *illiquid* – unable to pay its immediate or short-term debts. If this happens, either the business raises finance quickly – such as a bank loan – or it may be forced into 'liquidation' by the firms it owes money to.

*( Still chapter 28 - AS level 5.2 )*

# Sources of finance

Businesses are able to raise finance from a wide range of sources, we can classify these types of finance into either being a source of **internal finance** or **external finance**.

**Internal finance** is obtained from within the business itself. Examples of internal finance include :

**1. Retained Profit** : profit kept in the business after owners have been given their share of the profit. Firms can invest this profit back in the businesses.

*Advantages :*

✔ Does not have to be repaid, unlike a loan.
✔ No interest has to be paid

*Disadvantages :*

✖ A new business will not have retained profit
✖ Profits may be too low to finance
✖ Keeping more profits to be used as capital will reduce owner's share of profit and they may resist the decision

**2. Sale of existing assets** : assets that the business doesn't need anymore, for example, unused buildings or spare equipment can be sold to raise finance

*Advantages :*

✔ Makes better use of capital tied up in the business ( selling spare equipment frees up space.)
✔ Does not become debt for the business, unlike a loan
✔ May be able to have the assets sold back / leased back when they have more money

*Disadvantages :*

✖ Unnecessary assets will not be available with new businesses
✖ Takes time to sell the asset and the expected amount may not be gained for the asset
✖ May be difficult to determine what's needed and what isn't

**3. Sale of inventories** : selling finished goods or unwanted components in inventory.

*Advantage :*

✔ Reduces costs of inventory holding, also frees up space for new inventory

*Disadvantage :*

✖ If not enough inventory is kept, unexpected demand from customers cannot be fulfilled

**4. Owner's savings**: For a sole trader and partnership, since they're unincorporated (owners and business are not separate), any finance the owner directly invests from his own savings will be internal finance.

*Advantages :*

✔ Will be available to the firm quickly

✔ No interest has to be paid.

*Disadvantages :*

✖ Increases the risk taken by the owners.

✖ Amount may be limited (not enough to finance activities)

**External finance** is obtained from sources outside of the business. Examples of external finance include :

**1. The selling of shares** : only for limited companies (big corporations). **Rights issues** are when existing shareholders are given the right to buy additional shares at a discount. **Equity finance** refers to the money made through the sale of shares.

*Advantage :*

✔ A permanent source of capital, no need to repay the money to shareholders, although they will expect dividends

*Disadvantages :*

✖ Dividends have to be paid to the shareholders

✖ If many shares are bought, the ownership of the business will change hands. (The ownership is decided by who has the highest percentage of shares in the company)

**2. Bank loans** : money borrowed from banks.

*Advantages :*

✔ Quick to arrange a loan

✔ Can be for varying lengths of time ( paid back over 2 months, 2 years, etc.)

✔ Large companies can get very low rates of interest on their loans ( small companies and sole traders may be seen as more risky to lend to.)

*Disadvantages :*

✖ Need to pay interest on the loan periodically

✖ It has to be repaid after a specified length of time

✖ Need to give the bank a **collateral security** (the bank will ask for some valued asset, usually some part of the business, as a security they can use if at all the business cannot repay the loan in the future. For a sole trader, his house might be collateral. So there is a risk of losing highly valuable assets)

**3. Debentures** : debentures are long-term loan certificates issued by companies. Like shares, debentures will be issued, people will buy them and the business can raise money. But this finance acts as a loan- it will have to be repaid after a specified period of time and interest will have to be paid for it as well.

*Advantage :*

✔ Can be used to raise very long-term finance, for example, 25 years

*Disadvantage :*

✖ Interest has to be paid and the money must be repaid

**4. Debt factoring** : a debtor is a person who owes the business money for the goods they have bought from the business. Debt factors are specialist agents that can collect all the business' debts from debtors.

*Advantages :*

✔ Immediate cash is available to the business (they can call in their debts)
✔ Business doesn't have to handle the debt collecting

*Disadvantages :*

✖ The debt factor will get a percent of the debts collected as reward. Thus, the business doesn't get all of their debts

**5. Grants and subsidies** : government agencies and other external sources can give the business a grant or subsidy ( i.e to encourage them to set up in low-employment areas.)

*Advantage :*

✔ Do not have to be repaid, is free

*Disadvantage :*

✖ There are usually certain conditions to fulfill to get a grant. Example, to locate in a particular under-developed area.
✖ Not widely available

**6. Micro-finance** : where special institutes are set up in poorly-developed countries where financially-lacking people looking to start or expand small businesses can get small sums of money. They provide all sorts of financial services.

**7. Crowdfunding** : raises capital by asking small funds from a large pool of people, e.g. via Kickstarter. These funds are voluntary 'donations' and don't have to be returned or paid a dividend.

Another way to classify finance is by dividing them into either **short-term methods** or **long-term methods.**

**Short-term finance** provides the working capital a business needs for its day-to-day operations. Examples of short-term finance include :

- **Overdrafts** - are similar to loans, the bank can arrange overdrafts by allowing businesses to spend more than what is in their bank account. It's **flexible**, interest only has to be paid on the amount borrowed and overdrafts tend to be **cheaper than loans** in the long run. However, **interest rates can vary**, unlike loans which have a fixed interest rate and a bank can sometimes ask to be repaid the **money on short-notice**, unlike regular loans which have a set time

- **Trade Credits** - this is when a business **delays paying suppliers** for some time, improving their cash situation. However, if the payments are not made quickly this can upset suppliers into refusing to supply next time

- **Debt factoring** - Debt factoring is when a business sells the debts that customers owe them to a third party at a discount, then this third party will be the ones that customers must pay. This way, the business is able to **get finance instantly**, although since they sell the debt at a discount they do **lose some money**

**Long term finance** is the finance that is used in a business for over a year. Examples of long-term finance include :

- **Long term loans** - that do not have to be repaid for at least one year

- **Debentures -** a type of long-term business debt not secured by any collateral. It is a funding option for companies with solid finances that want to avoid issuing shares

- **Issue of Shares** - no interest to be paid, only dividends. Risk of losing control.

- **Hire Purchase** - allows the business to buy a fixed asset and pay for it in monthly installments that include interest charges. This is not a method to raise capital but gives the business time to raise the capital. It requires a cash deposit and interest rates vary

- **Leasing** - this allows a business to use an asset without purchasing it. Monthly leasing payments are instead made to the owner of the asset. The business can decide to buy the asset at the end of the leasing period. Some firms sell their assets for cash and then lease them back from a leasing company. This is called sale and leaseback. The care and maintenance of the asset is done by the leasing company

- **Venture capital** - a type of financing that investors provide to startup companies and small businesses that are believed to have long-term growth potential

## Factors that influence the choice of finance :

- **Purpose**: if a fixed asset is to be bought, hire purchase or leasing will be appropriate, but if finance is needed to pay off rents and wages, debt factoring, overdrafts will be used.
- **Time-period**: for long-term uses of finance, loans, debenture and share issues are used, but for a short period, overdrafts are more suitable.
- **Amount needed**: for large amounts, loans and share issues can be used. For smaller amounts, overdrafts, sale of assets, debt factoring will be used.
- **Legal form and size**: only a limited company can issue shares and debentures, and only public limited companies can sell shares to the public. Small firms have limited sources of finances available to choose from ( loans from banks or friends investing.)
- **Control**: if limited companies issue too many shares, the current owners may lose control of the business. They need to decide whether they would risk losing control for business expansion.
- **Risk- gearing**: if a business has existing loans, borrowing more capital can increase gearing- risk of the business- as high interests have to be paid even when there is no profit, loans and debentures need to be repaid etc. Banks and shareholders will be reluctant to invest in risky businesses with a history of not paying back loans
- **Cost -** obtaining finance is never really ‘free’, even internal finance may come with an opportunity cost ( having to sell something valuable.)

## Finance from banks and shareholders

Chances of a bank willing to lend a business finance is higher when:

- A **cash flow forecast** is presented detailing why finance is needed and how it'll be used
- An **income statement** from the last trading year and the forecast income statement for the next year, to see how much profit the business makes and will make.
- Details of **existing loans** and sources of finance being used
- Evidence that a **security/collateral** is available with the business to reduce the bank’s risk of lending
- A **business plan** is presented to explain clearly what the business hopes to achieve in the future and why finance is important to these plans

Chances of a shareholder willing to invest in a business is higher when:

- **The company’s share prices are increasing**- this is a good indicator of improving performance
- **Dividends** and **profits are high**
- The company has a **good reputations** and **future growth plan**