ASSIGNMENT

BUSINESS FINANCE.

1.FACTORS TO CONSIDER WHILE CHOOSING A SOURCE OF FINANCE

1) RISK

Risk is an important element to consider. We must consider what will happen if we are unable to meet the financial commitments relating to that particular source of finance. If we borrow from friends and family, for example, we will need to take into account what would happen to our relationship with them should the business fail and we are unable to repay them.

What will happen if we are unable to meet the financial commitments of a bank loan if our business succumbs to financial difficulty? When it comes to choosing suitable funding, we must strive to minimize the overall risk.

2) COST

The cost of finance and its effect on income will play a fundamental role in our financing decision. Our overall aim is to minimize the cost of finance and maximize owners’ wealth. Therefore, it is essential to consider the implications of choosing one source of funding over another.

If they consider that the additional borrowing increases the risk of bankruptcy then they may require an additional return as compensation for this risk. Therefore, this compensation will represent an increase in the cost of equity. We also need to consider the other costs of borrowing which include interest rates, origination fees, and brokers’ fees.

3) CONTROL

Control is another factor that plays an important role when choosing a source of finance. Issuing additional shares (equity) will result in a dilution of control among existing shareholders/owners. You are effectively giving each investor a piece of ownership in your business and thereby are accountable to those shareholders.

Investors will require input into the operations such as sitting on the board of directors and receiving performance and operation reports. You will have to provide them with information that you may have wished to keep hidden from your competition, as well as detailed explanations for your business decisions.

Owners who do not want to lose control of their business, preferring to keep major decision-making in their own hands, will only consider equity financing up to a certain level or may prefer loan capital.

Once the loan is paid back, your relationship with the lender ceases, whereas investors continue to have a say in the company until they are bought out, the company is sold or goes public. As a result, how we choose to finance our company will have an impact on our independence as management.

4) LONG TERM VERSUS SHORT TERM BORROWING

When sourcing finance, we also need to consider whether we should obtain long term or short-term funding. In many cases, it may be appropriate to match the type of funding to the nature of the asset.

If we are obtaining a noncurrent asset, for example, a piece of machinery that will form a permanent part of our operating base, then we would consider using a long-term source of finance to fund this asset.

Long term finance will be repaid over a longer period and include bank loans, hire purchase, debentures and retained profits for example.

On the other hand, if we were obtaining an asset that was more flexible in

seasonal demand or money to cover the day-to-day operations of our business, then we would finance this using a short-term source of finance.

This kind of finance is intended to be paid back in a matter of months rather than years. As a result, there is less risk involved for the lender. Overdrafts and supplier credit would be an example of short-term finance.

1. CONCEIPT OF AGENCY RELATIONSHIP IN FINANCE.

An agency relationship arises when the principal hires an agent to perform some services or the decision-making authority is delegated to the agent. However, the agent is not fully responsible for the decision that is made. Since the agent and the principal may have different goals, the agency relationship creates a potential conflict of interest.

CONFLICT BETWEEN MANAGERS AND SHAREHOLDERS AND THEIR POSSIBLE SOLUTIONS.

The conflicts between stockholders and the managers of a business include the following:

* The more money that managers make in wages and benefits, the less stockholders see in bottom-line net income. Stockholders obviously want the best managers for the job, but they don’t want to pay any more than they have to. In many corporations, top-level managers, for all practical purposes, set their own salaries and compensation packages.

A public business corporation establishes a compensation committee consisting of *outside* directors that sets the salaries, incentive bonuses, and other forms of compensation of the top-level executives of the organization. An outside director is one who has no management position in the business and who, therefore, should be more objective and should not be beholden to the chief executive of the business.

This is good in theory, but it doesn’t work out that well in practice — mainly because the top-level executive of a large public business typically has the dominant voice in selecting the persons to serve on its board of directors. Being a director of a large public corporation is a prestigious position, to say nothing of the annual fees that are substantial at most corporations.

* The question of who should control the business — managers, who are hired for their competence and are intimately familiar with the business, or stockholders, who may have no experience relevant to running this business but whose money makes the business tick — can be tough to answer.

In ideal situations, the two sides respect each other’s contributions to the business and use this tension constructively. Of course, the real world is far from ideal, and in some companies, managers control the board of directors rather than the other way around.