UNIT 4

ECONOMIC-ADMINISTRATIVE FUNCTION IN A COMPANY

PART II: FUNDING AND INVESTMENT

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1. FUNDING OF THE COMPANY

Funding consists of providing money and resources for the acquisition of goods and /or services that the company needs to carry out its business activity (either for its maintenance or enrichment).

Source of funding is understood as the ways or mechanisms by which the company obtains funding.

Funding sources are a fundamental element for the favorable economic development of any company. In fact, the success or failure of a business model depends largely on the choice of funding.

According to its origin, the **funding** is classified as:

- Own funding
- External funding

The difference between them is the obligation to return (or not) the money.

A. OWN FUNDING (Financiación Propia)

Self-funding is made up of those financial resources that reach the company in different ways and that it is not obliged to return.

There are two types: internal and external funding

A.1. Internal Financing

a) Contributions from the employer or partners.

a.1. Initial contributions to create the capital stock of the company. It is the first step in order to set up the company: determining how much money the partner (s) is going to contribute to the project.

a.2. Expansion of share capital. If the company plans to grow with new investments and projects, it may be necessary to increase the resources available. These resources can be increased by following the option of new contributions by the partners of the company to the company's capital stock.

b) Company contributions: self-funding.

Self-funding is made up of the resources generated by the company itself, that have its origin in the commercial activity of de company.

b.1. Reserves. Reserves are profits obtained by the company, that have not been distributed among their owners.

b.2. Amortization. Any permanent asset, tangible or intangible, that becomes part of the structure of the activity of a company suffers as a result of the passage of time, a depreciation or loss of value. This loss of value can occur for two reasons:

- The good deteriorates due to its use.

- The asset suffers a technological obsolescence as a result of the appearance of new equipment or procedures that leave our asset obsolete.

This loss of value of the permanente assets of the company is reflected in accounting and taxation by applying a series of adjustments in their value: these are called **amortizations.**

These amortizations, as we have seen in the Balance Sheet, reduce the tax base of the Corporation Tax or Direct Estimate of the Personal Income Tax, producing significant tax savings. For these reasons, when an asset or a good is incorporated into the equity of the company, we must decide the amortization system that we are going to use. It is an important decision since the repayment installments (cuotas de amortización) vary and, therefore, the tax savings also vary.

Amortization systems: we have to assign a percentage of the amortizable value to the total of the useful life of the asset. To calculate the amount we assign to each year, different methods can be used, depending on the amortization process that you want to obtain:

o ***Linear or fixed-fee method.*** This method consists of amortizing the same amount each year of useful life. This system has the advantage of being very simple, although it assumes that the good is always used with the same intensity.

o ***Functional amortization method.*** This method calculates the depreciation in proportion to the intensity of the good's use (hours of use, in the case of machines; distance traveled for transport elements;….).

b.3. Provisions. They are used to cover possible obligations or losses, of which it is not known exactly if they will materialize or not, and / or in what amount (for example, payment of taxes, future rehabilitation of a premises, etc.).

A.2. External financing within Own Funding. Investment contributions

External funding is obtained from other sources that do not belong to the company: **contributions from investors**

a) Family and friends.

Many of the entrepreneurs when they begin their business career turn to the help of family and friends. It is also known as the 3 F's (Family - Friends - Fools: Familiares - Amigos - Locos). These contributions are considered external own financing if the money obtained does not have to be returned, but if, on the contrary, it must be returned, then we will be talking about external financing (short or long term).

b) Venture Capital Companies (Sociedades de Capital Riesgo, SCR).

Venture capital companies are public limited companies whose main corporate purpose consists of taking temporary shares in the capital of non-financial and non-real estate companies that, at the time of taking the share, are not listed on the first market of Stock and have a high growth potential.

The business of this type of company consists of the investment achieving rapid success and then selling its participation and thus obtaining profits.

c) Business Angels

They are individuals who have experience in business management and are also willing to deliver financial resources (capital, reserves, participating loans, etc.) to companies that have an investment project. This double circumstance means that the Business Angels can contribute, to the company, not only financial resources, but also knowledge or contacts related to management. The double objective that BAs seek when entering a company is to live an experience, by collaborating in the management of a young company with the aim of consolidating it, and earn money especially from the sale of their participation when leaving the company (capital gain, plusvalía), since their collaboration in the company is usually limited in time.

d) Crowdfunding

Crowdfunding can be defined as the funding of a project collectively through the internet. That is, it is a funding mechanism by which a promoter requests help or financing for their project publicly over the internet and in which people who wish can make their financial contribution through a specialized crowdfunding platform. When the person who contributes the funds does so altruistically, it is called micro-sponsor (micro-mecenas) and if it has an economic interest it is called a microinvestor (and in this case we would be talking about short or long-term external funding).

e) Subsidies.

A subsidy is considered to be any free patrimonial attribution (without there being an obligation to reimburse it) in favor of natural or legal persons intended to promote a certain activity or behavior of public or social interest (for example, the set-up of a company).

B. EXTERNAL FUNDING

The sources of external funding of a company are resources that **have to be returned**. They can be classified into two large groups: short-term financial sources and long-term sources. The distinction between the two is important, since the procedure for obtaining them, the entities that grant them and even their destination are very different.

In principle, **short-term financial resources** should be used to finance the typical or ordinary activity of the business activity (purchase of raw materials, payment of supplies, etc.), while **long-term resources** should finance the permanent structure of the company (elements of permanent assets, such as the acquisition of a transport element or computer equipment). It is very convenient that part of the company's long-term resources finance part of that typical activity of the company. This is what is usually known as the **working capital** (Fondo de Maniobra)

B.1.- Long-term funding

a) Loan

They are contracts that formalize the delivery of money by a financial company. The company agrees to return the amount loaned plus accrued expenses (gastos devengaddos, i.e., interests or commissions) over a specified period. Depending on the return period, they can be short or long term, so that they could be included in one or another classification.

b) Leasing and Renting

They are similar to rent a asset. Both of them allow access to an important asset for the business (vehicles, computer equipment, etc.) without having to buy it or assume its depreciation. The provider is paid a monthly fee during the agreed term. They are favorable modalities because the asset is used during the best period of its useful life and they have tax advantages.

Renting	Leasing
Only on movable property	On movable and inmovable property
The maintenace falls on the landlord	The maintenance falls on the tenant
There is no purchase option	Offer option to purchase

c) Reciprocal Guarantee Companies (Sociedades de Garantía Recíproca)

Small and medium-sized companies often run into a lot of obstacles when applying (solicitar) for a loan. Likewise, entrepreneurs generally arrange and design large projects, but when applying for financing, they do not receive any type of support. Reciprocal guarantee companies are non-profit making entities (sociedades sin ánimo de lucro). The have a mutual structure and they are directly controlled by the Bank of Spain.

The objective is to facilitate access to credit for SMEs and the self-employed. This task is done in two ways:

- Being as a guarantor (avalista) of operations before banks and administrations.

- They are able to get better financial conditions thanks to the agreements they usually sign with certain financial institutions.

d) Loans (Empréstito)

A bond (bono, obligación) is a kind of an obligation. It is a document issued by an entity that recognizes its holder as creditor of the same for the amount indicated in the document at the maturity agreed upon (vencimiento acordado), at the time of issue (cuando se emitió). Usually, it recognizes the right to receive periodic interest (coupons), issue premium (primas de emisión), redemption premium (primas de reembolso), convertible bonds, etc. A disadvantage that can be underline is that it is used by companies with a high initial launch cost.

e) Public aid (Ayudas públicas)

In this case, it is a question of public aid that must be returned (unlike subsidies). For example, the credit of the public commercial entity of the Official Credit Institute (ICO). It is a public bank with the legal form of a public business entity (Entidad Pública Empresarial), attached to the Ministry of Economy and Business through the Secretary of State for the Economy and Business Support

B.2. Short-Term Funding

a) Credit

The financial institution makes a limited amount of money available to its client for a specific period. The company only returns and pays interest on the capital it has used. It is usually returned in the short term, and is included in this section, but it must be borne in mind (debe tenerse en cuenta) that there are also lines of credit whose repayment is long-term.

b) Payment to suppliers (pago a proveedores)

Negotiating with suppliers represents a type of non-bank financing. We can distinguish two types of financing by providers: when the payment term is extended and when a discount is obtained for prompt payment (pronto pago). Regarding the first, the company can negotiate with its suppliers the extension (prórroga) in the term of their payments (30, 60 or 90 days). Another way of financing by providers is discounts for prompt payment: the possibility of paying less if payment is made just after receipt of the order (recepción del pedido). The possibilities of obtaining funding for these procedures will depend on the market situation, and on the company's management capacity.

c) Factoring

The company delivers to the factoring entity the credits originated by the sales (payment of the invoices of its clients) and the factoring company anticipates the amount of said credits, discounting a commission and the remaining interests (intereses que restan por cobrar) until maturity (hasta el vencimiento).

d) Confirming

It is the inverse mode of factoring. What companies offer their customers is the management of the payment of their purchases, seeking the highest possible credit. In return, they offer creditors a discount line to advance payment, but under the conditions set by the financial institution.

e) Commercial discount

It consists in that a bank advances the amount that it has to receive from a client. The supporting document is made through receipts, Bills of Exchange (letras de cambio) and promissory notes (pagarés).

2. INVESTMENTS

Sometimes the words "investment" and "expense" are confused.

An "**expense**" reduces capital to the company and that capital is not recovered. The "investment" also reduces capital, but it is expected that this amount will be returned and increased, reporting a benefit to the business.

Investments are goods that a company buys (for example, machinery) that are necessary to obtain the product (good or service) that it manufactures or offers. Investments are used and not sold; so that they will remain in the company for the long term (more than a year) in the company. An expense is the purchase of a good, a service or a right that the company is going to consume (to "spend") imminently, so that its use is less than one year (short term).

Example of investments: premises, facilities, furniture, machinery, tools, supplies, vehicles, computer equipment, computer programs, patents, trademarks, etc.

Example of expenses: initial expenses of constitution and start-up, rent of a premises, workers' salaries, supplies, stocks, office supplies, etc.

3. THE BREAK-EVEN POINT (PUNTO MUERTO) OR PROFITABILITY THRESHOLD (UMBRAL DE RENTABILIDAD)

An important concept in business management is the **Break-even point** or Profitability Threshold.

To get there we are going to remember some concepts that we have studied into Accounting.

If you remember the company, as a result of its activity, it obtains income from the sales of its products. We can call them as **revenues** (ingresos).

If the company makes these products, it has borne **costs** (ha soportado unos costes). The cost indicates the amount of money that a company dedicates to the creation or production of goods or services.

The cost is part of the value of the product and it could be **classified i**n different ways.

Thus, it is posssible to distinguish between **fixed costs and variable costs.** Fixed costs are maintained over time (for example, the payment of the rent of a premises). Variable costs vary depending on the level of production (for example, labor or raw materials).

Likewise, and depending on time, there are **long-term costs** (more than a year) and **short-term costs** (less than a year)

Finally, we have to consider **direct costs** (which are directly related to the manufacture of the product, such as raw materials); or **indirect costs** (when they do not have that direct relationship, such as the cost of electricity)

The **profitability threshold** or **break-even point** is the amount of goods or services that a company has to sell in order to cover its costs (zero profit). Since this amount of goods or services the profit is positive (profit)

Revenues and Costs are equal at break-even point. From this one, everything that is sold above will mean profits for the company. If, on the other hand, sales fall below the break even point, the result will be losses.

Let's express these ideas numerically:

At the **Profitability threshold**, it is fulfilled that:

Total Revenues = Total Costs

IT = CT

Total Revenues = Price * Quantity of product

IT = P * Q

The Total Costs are obtained by adding the Fixed Costs and the Variable Costs

CT = CF + CV

Variable costs come from multiplying the variable cost of a single unit (which is called unit variable cost) by the number of units produced (Q):

CV = CVu x Q

Taking into account the above

CT = CF + CVu x Q

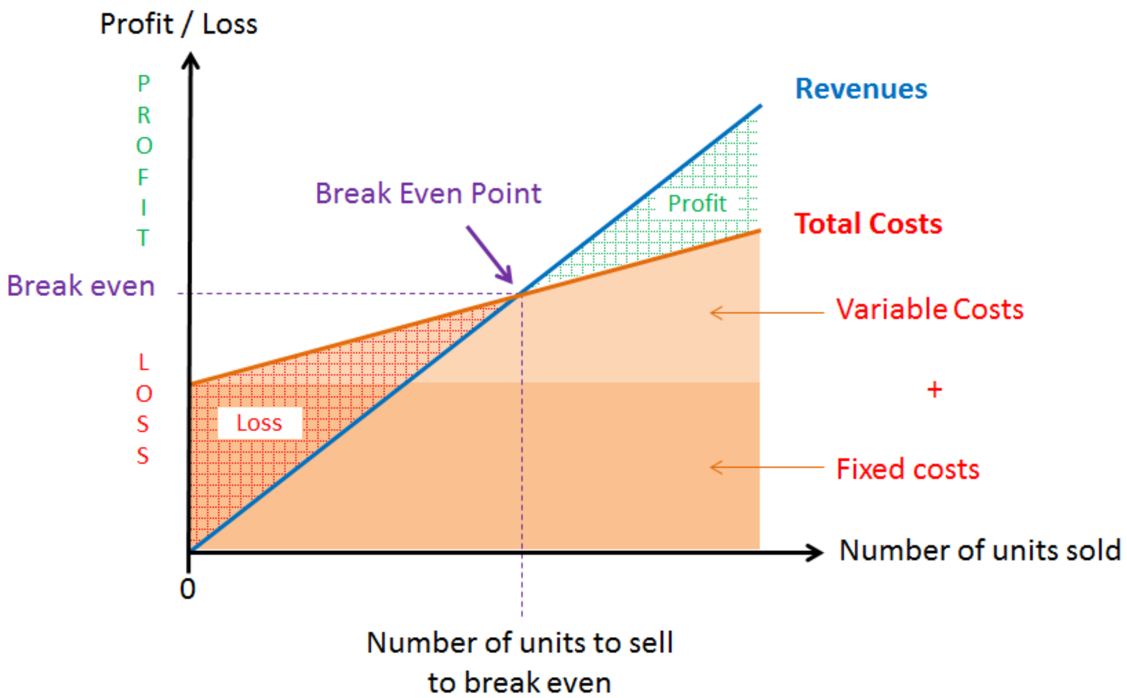
As we know, Total Income is equal to Total Costs, so:

P X Q = CF + CVu x Q

Solving for Q we obtain the formula to find the Profitability Threshold or Break-even point in product units:

Q (Break-even point) product units = CF / (P - Cvu).

This would be its graphic representation:



The profitability threshold is the break-even point at which a business becomes profitable (rentable). This threshold is reached when the total cost to run (desarrollar o gestionar) your business is equal to its total revenues. Above this threshold, the business is deemed to have reached the profit zone. Below this threshold, the business will struggle (tendrá problemas) to generate a profit, or survive over the long term or haul (largo plazo). The value of this threshold can be expressed in the number of units of a product sold, in revenue received or in periods of time (months or years, for example).

If we calculate it in **Monetary Units** we would use this formula:

Break-even point = Fixed Costs / (1 - Total Variable Costs / Sales Amount)

Example:

Mauro Products distributes a single product, a woven basket whose selling price is €15 and whose variable expense is € 12 per unit. The company's monthly fixed expense is € 4,200

The equation method yields the break-even point in unit sales,Q, as follows:

Break-even point = 4200 / (15 – 12) = 1400 baskets.