Cambridge

AS - Level

Business studies

CODE: (9609)

Unit 05- Chapter 28

Business finance

Introduction

Business activity cannot take place without fi nance – or the means of purchasing the materials and assets before the production of a good or service can take place. Finance decisions are some of the most important that managers have to take. Inadequate or inappropriate fi nance can lead to business failure – in fact, shortage of liquid funds is the main reason for businesses failing.

Why business activity requires finance

Finance is required for many business activities. Here is a list of just some of the main situations in which businesses will require finance:

■ Setting up a business will require cash injections from the owner(s) to purchase essential capital equipment and, possibly, premises. This is called start-up capital.

■ All businesses need to finance their working capital – the day-to-day finance needed to pay bills and expenses and to build up stocks

■ When businesses expand, further finance will be needed to increase the capital assets held by the firm – and, often, expansion will involve higher working capital needs.

■ Expansion can be achieved by taking over other businesses. Finance is then needed to buy out the owners of the other firm.

■ Special situations will often lead to a need for greater finance.

■ Apart from purchasing fixed assets, finance is often used to pay for research and development into new products or to invest in new marketing strategies, such as opening up overseas markets.

Capital and revenue expenditure

T h ese two types of spending will almost certainly be financed in different ways and the length of time that the money is 'tied up' will be a major factor influencing the final finance choice.

KEY TERMS

Capital expenditure: the purchase of assets that are expected to last for more than one year, such as building and machinery.

Revenue expenditure: spending on all costs and assets other than fixed assets and includes wages and salaries and materials bought for stock.

Working capital – meaning and significance

Working capital is often described as the 'lifeblood' of a business. Finance is needed by every business to pay for everyday expenses, such as the payment of wages and buying of stock

Without sufficient working capital a business will be illiquid – unable to pay its immediate or short-term debts. What happens in cases such as this? Either the business raises finance quickly – such as a bank loan – or it may be forced into '**liquidation'** by its creditors, the fi rms it owes money to.

How much working capital is needed?

Sufficient working capital is crucial for a business to avoid illiquidity and debt payments. Too much capital tied up in inventories, accounts receivable, and idle cash can lead to opportunity cost and potential return on investment. The working capital requirement depends on the business's 'working capital cycle', with longer periods requiring more or less credit. Effective management of working capital is vital for all businesses, as discussed in Chapter 31.

Where does finance come from?

T h is section deals initially with sources of fi nance for limited companies – and then considers sole traders and partnerships. Companies are able to raise fi nance from a wide range of sources. It is useful to classify these into:

■ internal money raised from the business's own assets or from profits left in the business (ploughed-back or retained earnings)

■ external money raised from sources outside the business.

Internal sources of finance

Profits retained in the business

If a company is trading profitably, some of these profits will be taken in tax by the government (corporation tax) and some is nearly always paid out to the owners or shareholders (dividends). If any profit remains, this is kept (retained) in the business and becomes a source of fi nance for future activities. Clearly, a newly formed company or one trading at a loss will not have access to this source of fi nance.

Sale of assets

Established companies often find that they have assets that are no longer fully employed. Th ese could be sold to raise cash. In addition, some businesses will sell assets that they still intend to use, but which they do not need to own.

In these cases, the assets might be sold to a leasing specialist and leased back by the company. This will raise capital – but there will be an additional fixed cost in the leasing and rental payment.

In 2014 the struggling cell phone manufacturer BlackBerry considered the sale of property assets to raise finance to help the business over a difficult trading period caused by its loss of market share to iPhones and Android phones.

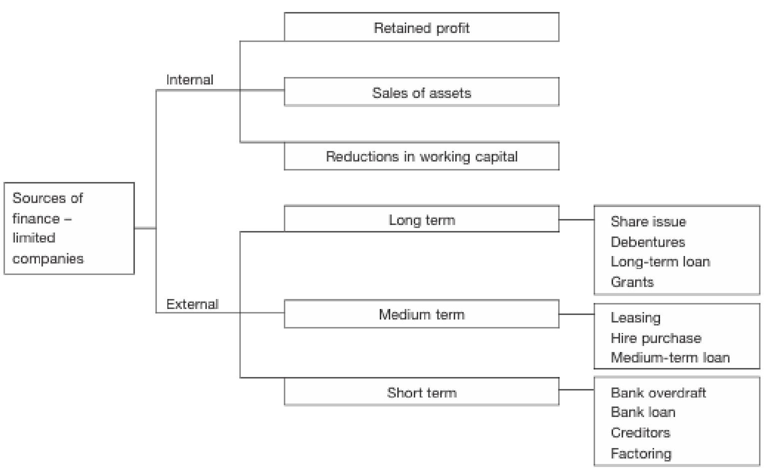

Figure 28.2 Sources of finance for limited companies

Reductions in working capital

When businesses increase stock levels or sell goods on credit to customers (trade receivables), they use a source of fi nance. When companies reduce these assets – by reducing their working capital – capital is released, which acts as a source of fi nance for other uses

The Coca-Cola Company and its bottling partner, COFCO Coca-Cola Beverages Ltd, have continued their expansion in China with the opening of two bottling facilities in less-developed central and western China – Coca-Cola finances most of its expansion from retained earnings

Internal sources of finance – an evaluation

T h is type of capital has no direct cost to the business, although if assets are leased back once sold there will be leasing charges. Internal fi nance does not increase the liabilities or debts of the business, and there is no risk of loss of control by the original owners as no shares are sold. However, it is not available for all companies

External sources of finance

KEY TERMS

Overdraft: bank agrees to a business borrowing up to an agreed limit as and when required.

Factoring: selling of claims over trade receivables to a debt factor in exchange for immediate liquidity – only a proportion of the value of the debts will be received as cash.

Short-term sources

T h ere are three main sources of short-term external fi nance:

■ bank overdraft s ■ trade credit ■ debt factoring

Bank overdrafts

Bank overdrafts are flexible financial options for businesses, allowing them to withdraw money from their account at the bank. However, these overdrawn amounts must be agreed in advance and have a limit. Businesses may need to increase the overdraft for short periods due to slow payments or large stock deliveries. High interest charges may apply, and banks can call in overdrafts for customer stability.

Trade credit

By delaying the payment of bills for goods or services received, a business is, in effect, obtaining fi nance. Its suppliers, or creditors, are providing goods and services without receiving immediate payment and this is as good as 'lending money'

Debt factoring

A business selling goods on credit creates trade receivables, which require more finance to continue trading. If cash payments are unwise, businesses can sell these claims to a debt factor for immediate cash, but not for the full amount of the debt. Smaller firms often sell debt to credit-loan firms, ensuring the credit agreement is with a specialist provider.

Sources of medium-term finance

There are two main sources of medium-term external finance:

■ hire purchase and leasing ■ medium-term bank loan. Hire purchase and leasing

Hire purchase and leasing

Hire purchase is a form of credit for purchasing an asset over a period of time. Th is avoids making a large initial cash payment to buy the asset.

Leasing involves a contract with a leasing or fi nance company to acquire, but not necessarily to purchase, assets over the medium term

KEY TERMS

Hire purchase: an asset is sold to a company that agrees to pay fixed repayments over an agreed time period – the asset belongs to the company.

Leasing: obtaining the use of equipment or vehicles and paying a rental or leasing charge over a fixed period, this avoids the need for the business to raise long-term capital to buy the asset; ownership remains with the leasing company.

Long-term finance

T h e two main choices here are debt or equity fi nance. Debt fi nance increases the liabilities of a company. Debt finance can be raised in two main ways:

■ long-term loans from banks ■ debentures (also known as loan stock or corporate bonds).

Long-term loans from banks

T h ese may be offered at either a variable or a fixed interest rate. Fixed rates provide more certainty, but they can turn out to be expensive if the loan is agreed at a time of high interest rates. Companies borrowing from banks will often have to provide security or collateral for the loan; this means the right to sell an asset is given to the bank if the company cannot repay the debt. Businesses with few assets to act as security may find it difficult to obtain loans – or may be asked to pay higher rates of interest.

Long-term bonds or debentures

Long-term bonds or debentures are a form of financing used by companies to raise funds. They are usually not secured on an asset but can be converted into shares if the borrower requests it. These bonds can be resold to other investors if they don't want to wait until maturity. In recent accounts, BT's total loan stock was £3,000 million.

Sale of shares – equity finance

Limited companies issue shares when formed, raising capital to purchase essential assets. Private and public limited companies can sell further shares to raise additional finance, with no repayment required unless the company is completely wound up. Private limited companies can sell shares to existing shareholders, maintaining control and ownership. Owners can also go public, raising more capital but potentially losing control to new shareholders.

In the UK, this can be done in two ways and these are quite typical for many countries:

1 Obtain a listing on the Alternative Investment Market (AIM), which is that part of the Stock Exchange concerned with smaller companies that want to raise only limited amounts of additional capital. The strict requirements for a full Stock Exchange listing are relaxed.

2 Apply for a full listing on the Stock Exchange by satisfying the criteria of (a) selling at least £50,000 worth of shares and (b) having a satisfactory trading record to give investors some confidence in the security of their investment. This sale of shares can be undertaken in two main ways:

■ Public issue by prospectus: This advertises the company and its share sale to the public and invites them to apply for the new shares. This is expensive, as the prospectus has to be prepared and issued. The share issue is often underwritten or guaranteed by a merchant bank, which charges for its services.

■ Arranging a placing of shares with institutional investors without the expense of a full public issue: Once a company has gained plc status, it is still possible for it to raise further capital by selling additional shares. This is often done by means of a rights issue of shares.

Debt or equity capital – an evaluation

Which method of long-term fi nance should a company choose? Th ere is no easy answer to this question. And, as seen above, some businesses will use both debt and equity finance for very large projects. Debt fi nance has the following advantages:

■ As no shares are sold, the ownership of the company does not change or is not 'diluted' by the issue of additional shares.

■ Loans will be repaid eventually (apart from convertible debentures), so there is no permanent increase in the liabilities of the business.

■ Lenders have no voting rights at the annual general meetings.

■ Interest charges are an expense of the business and are paid out before corporation tax is deducted, while dividends on shares have to be paid from profits aft er tax.

■ The gearing of the company increases and this gives shareholders the chance of higher returns in the future. This point is dealt with more fully in Chapter 35. Equity capital has the following advantages:

■ It never has to be repaid; it is permanent capital.

■ Dividends do not have to be paid every year; in contrast, interest on loans must be paid when demanded by the lender

Other sources of long-term finance

Grants

T h ere are many agencies that are prepared, under certain circumstances, to grant funds to businesses. Th e two major sources in most European countries are the central government and the European Union. Usually grants from these two bodies are given to small businesses or those expanding in developing regions of the country. Grants often come with conditions attached.

Venture capital

Venture capitalists, specialist organizations or wealthy individuals, can provide long-term investment funds to unquoted companies, which may struggle to raise capital from other sources due to risks in new technology or complex research. These investors take great risks and may lose all their money, but the rewards can be significant. High-tech businesses have seen rapid growth, with many financed by venture capitalists.

Finance for unincorporated businesses

Chapter 2 discusses the distinction between company finance and unincorporated business finance. Unincorporated businesses, such as sole traders and partnerships, cannot raise finance through shares or debentures. Owners can access bank overdrafts, loans, and credit from suppliers. However, they face the risk of losing all property if the business fails. Lenders are often reluctant to lend to smaller businesses, and grants are available for small and newly formed businesses.

Microfinance

The Grameen Bank, founded by economist Muhammad Yunus in 1983, provides small capital sums to entrepreneurs in developing countries. Since its foundation, it has lent $6 billion to over six million Asian people, many of whom have started small enterprises with the capital. Yunus' success led to his Nobel Peace Prize.

KEY TERMS

Equity finance: permanent finance raised by companies through the sale of shares.

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

KEY TERM

Long-term bonds or debentures: bonds issued by companies to raise debt finance, often with a fixed rate of interest.

KEY TERM

Rights issue: existing shareholders are given the right to buy additional shares at a discounted price.

KEY TERM

Microfinance: providing financial services for poor and low-income customers who do not have access to banking services, such as loans and overdrafts offered by traditional commercial banks.

KEY TERM

Venture capital: risk capital invested in business start-ups or expanding small businesses that have good profit potential but do not find it easy to gain finance from other sources.

KEY TERM

Crowd funding: the use of small amounts of capital from a large number of individuals to finance a new business venture.

Crowd funding

This is becoming an increasingly significant source of finance for new business start-ups. Th e basic idea behind it is that entrepreneurs rarely have sufficient finance to set up their own business

Crowd funding websites like Kickstarter and Crowdcube allow entrepreneurs to promote their new business ideas to thousands of potential investors. These websites allow entrepreneurs to explain their business, objectives, and financial need, and investors can commit small amounts until the target sum is reached.

In business ventures that are successful, the crowd funding investors will receive either:

■ their initial capital back plus interest – this is sometimes known as peer-to-peer lending, or

■ an equity stake in the business and a share in profits – when these are eventually made

Finance and stakeholders

Providing fi nance to a business creates a stakeholder relationship with that business. All stakeholders have certain rights, responsibilities and objectives, but these will diff er between the various sources of fi nance. Th is is made clear in Table 28.1, which looks at the three main providers of company fi nance.

Raising external finance – the importance of a business plan

Without some evidence that the business managers have thought about and planned for the future it is most unlikely that bankers, venture capitalists or potential shareholders will invest money in the business. Th e main content sections of a typical business plan are explained in Chapter 40.

Business plans do not guarantee the success of a new business proposal, but they are likely to increase the chances of avoiding failure. Th e business-planning process not only provides essential evidence to investors and lenders and makes the fi nance application more likely to be successful, but it also:

■ forces the owners to think long and hard about the proposal, its strengths and potential weaknesses – it might actually dissuade some people from progressing with their proposal, thus avoiding a near-certain business flop

■ gives the owners and managers a clear plan of action to guide their actions and decisions, at least in the early months and years of the business.

KEY TERM

Business plan: a detailed document giving evidence about a new or existing business, and that aims to convince external lenders and investors to extend finance to the business.

Factor influencing finance choice	Why significant
Use to which finance is to be put – which affects the time period for which finance is required	■ It is very risky to borrow long-term finance to pay for short-term needs. Businesses should match the sources of finance to the need for it. ■ Permanent capital may be needed for long-term business expansion. ■ Short-term finance would be advisable to finance a short-term need to increase stocks or pay creditors.
Cost	■ Obtaining finance is never free – even internal finance may have an opportunity cost. ■ Loans may become very expensive during a period of rising interest rates. ■ A Stock Exchange flotation can cost millions of dollars in fees and promotion of the share sale.
Amount required	■ Share issues and sales of debentures, because of the administration and other costs, would generally be used only for large capital sums. ■ Small bank loans or reducing trade receivables' payment period could be used to raise small sums.
Legal structure and desire to retain control	■ Share issues can only be used by limited companies – and only public limited companies can sell shares directly to the public. Doing this runs the risk of the current owners losing some control – except if a rights issue is used. ■ If the owners want to retain control of the business at all costs, then a sale of shares might be unwise.
Size of existing borrowing	■ This is a key issue – the higher the existing debts of a business (compared with its size), the greater the risk of lending more. Banks and other lenders will become anxious about lending more finance. ■ This concept is referred to as gearing and is fully covered in Chapter 35.
Flexibility	■ When a firm has a variable need for finance – for example, it has a seasonal pattern of sales and cash receipts – a flexible form of finance is better than a long-term and inflexible source.

Table 28.2 Factors to be considered in making the 'source of finance' decision

Revision questions

Q1: Case Study 6: (Lasting Memories) 9707/02M/J/04/Q2 (d)
Explain the following term: capital expenditure. [3]

Q2: Case Study 103: Lovell's Jeweler (LJ) 9609/21/F/M/16/Q1 (b)
Briefly explain the term 'start- up capital' (line 2-3). [3]

Q3: Case Study 113: Pampered Pets (PP).9609/22/O/N/16/Q1 (b) (ii)
Briefly explain the term 'working capital' (line 9). [3]

Q4: Case Study 12: (The Sun Hotel Ltd) 9707/02/O/N/05/Q2 (a) (i)
Explain two ways in which pad man might improve the management of working capital. [4]

Q5: Case Study 72: Cando enables (CeC) 9707/23/M/J/13/Q2 (a) (i)
Discuss possible solutions to CeC's working capital problem. [10]