A/S Level Business Studies Research Assignment

By Sharjeel Tahir

Basic Information: -

You have just completed your B.A (Honours) Degree in accounting and have secured your first job as a junior accountant, working for the prestigious accounting firm, Coopers and Lybrand.

Assignment: -

Your assignment involves investigating the possible sources of finance available to your client company.

Sources of finance

All businesses need money invested in them. Sources of finance are the origins of that money. They are where the money in the business comes from. Another definition is that they create the money that is used to start-up and finance a business. Sources of finance are split into two main categories internal and external sources of

Internal sources of finance: -

Internal sources of finance are finance gained inside the business. Another definition is the generation of cash from within the company's resources/accounts. Internally generated finance is usually owner's equity and this is usually permanent. There are three main sources of internal finance.

Trading Profits: -

It can be calculated by: Gross Profit - Overheads

a) *Retained profits:*

Once the business starts to generate sales it will hopefully make some profit. A firm's profit, after tax, is an important and inexpensive source of finance. This provides a return on the investment in the business. Research shows that over 60% of business investment come from reinvested, retained profit.

The advantages of retained profit is –

1. Firm has more control over the money
2. It reduces gearing.

The disadvantages of retained profit is –

1. It is only effective when profits are good.
2. Refusal to use loans in addition to profits can lead to overtrading.

Retained profit represents an important source of long-term finance. It adds to a balance sheet's reserves and this is found at the bottom of the sheet. Its overall job is to finance assets and long-term development.

b) *Operating Profit:*

This is the measure of profit, which an organisation earns on its normal operations and excluding any extraordinary or exceptional items, which might distort a true appreciation of its usual business. Therefore, clear comparisons with previous years or with similar firms may be made.

Sale of Assets: -

An established business has assets. These can be sold to raise cash. The business loses the asset but has the use of cash. It makes good business sense for business to dispose of redundant assets. Occasionally a company may be forced to sell assets because it is not able to raise finance from other sources. The sale of business assets such as an associated company or a subsidiary of a business is called divestment.

They can finance development without extra borrowing. If the asset is needed, it may be possible to sell it, but immediately lease it back. In this way the business has use of the money and the asset. This is known as sale and leaseback. It was the method chosen by Sainsbury's and Tesco to finance their rapid growth in the 1980's and 1990's. An advantage of asset sales is that you get quick cash and low gearing. A disadvantage is you get a high rate of tax. Assets on a balance sheet are the ones, which can be given a monetary value, usually because they have been bought and a value thus obtained.

Working Capital: -

Can be calculated by: Current Assets -   Current Liabilities

Working capital (sometimes called circulating capital) is the amount of money available to pay for the day to day trading and financing of a business. A business needs working capital to pay expenses such as wages, electricity and gas charges, and to buy components to make products. If a firm has too little working capital available, it may struggle to finance increased production without straining its liquidity position. Yet if a firm has too much capital tied up in the short term, it may not be able to afford the new machinery that could boost efficiency. The working capital of a business is the amount lefts over after all current debts have been paid.

It is:

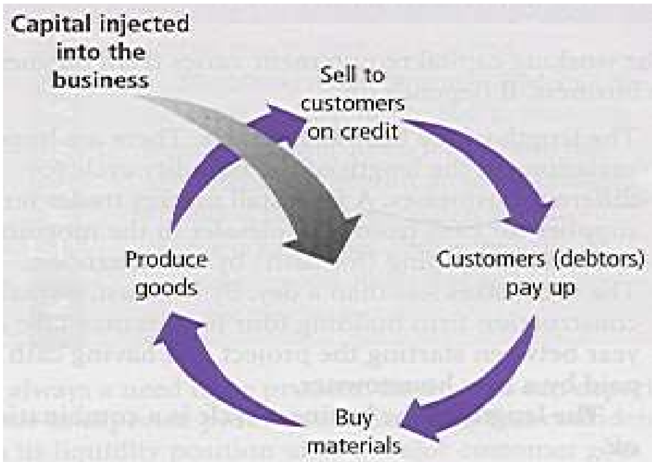
- the relatively liquid assets of a business that can easily be turned into cash (cash itself, stocks, the money owing from debtors who have bought goods or services);

Minus

- the money owed by a business which needs to be paid in short term (to the bank, to creditors who have supplied goods or services, to government in the form of tax or shareholder's dividends payable within the year).

Managing working capital is about ensuring that cash available is sufficient to meet the cash requirements at any one time. This is also known as having enough liquidity. Managing working capital is a continuous process. This process is known as the liquidity cycle.

Diagram of Liquidity cycle:



Working capital can be used as a source of finance. This is done by cutting working capital usage. This can be done by cutting stocks, chasing up debtors or delaying payments to creditors, cash can be generated from a firm's working capital.

The advantages of cutting working capital usage –

1. Maximises usage of your own assets.

2. Encourages (and relies upon) greater efficiency.

The disadvantages of cutting working capital usage –

1. However, when cash is taken from working capital for a purpose such as buying fixed assets, the liquidity position worsens.

2. Risk of overtrading.

3. Risk upsetting customers and/or suppliers.

On a balance sheet of a company working capital is calculated by subtracting current liabilities from current assets.

External sources of finance: -

This is finance gained from outside the business. Another definition is by obtaining capital resources from outside the firm's resources from outside the firm's resources or accounts. External finance can be split into two sections short-term finance and long-term finance.

External short-term sources of finance: -

Trade Credit: -

It is common for businesses to buy raw materials, components and fuel and pay for them at a later date, usually between 30 – 90 days. It is a short to medium term source of finance. Paying for goods and services using trade credit seems to be an interest free way of raising finance, which helps the customer's cash flow at the cost of suppliers. It is particularly profitable during periods of inflation. It does not pay for anything immediately. However, many companies encourage early payment by offering discounts. The cost of goods is often higher if the firm does not pay early. Delaying the payment of bills can also result in poor business relations with suppliers. Trade credit is found under current liabilities in a company's balance sheet. Its overall job is to fund working capital.

Bank overdrafts: -

This is the commonest form of borrowing for businesses. It is an effective short-term source of finance. The bank allows the firm to overdraw up to an agreed level. The amount by which a business goes overdrawn depends on its needs on its need at the time.

The advantages of a bank overdraft –

1. The firm only needs to borrow what it needs.

2. The bank may be a source of advice.

3. Overdrafts are quite flexible and interest only charged when overdrawn.

4. Interest is only paid by the business when its account is overdrawn.

The disadvantages of a bank overdraft –

1. It is an expensive way of borrowing.

2. Banks may 'pull the plug' if things go wrong.

3. Overdraft repayable on demand.

4. Usually requires collateral.

The actual sum borrowed through an overdraft facility at the end of the financial year is recorded as a current liability on the balance sheet. Its overall job is to fund working capital.

Debt factoring: -

When companies sell their products they send invoices stating the amount due. The invoice provides evidence of the sale and the money owed to the company. Debt factoring involves a specialist company (the factor) providing finance against these unpaid invoices. A common arrangement is for a factor to pay 80 per cent of the value of invoice when they are issued. The balance of 20 per cent is paid by the factor when the customer settles the bill. This is a common way to finance small, rapidly firms with high profit margins.

The advantages of Debt Factoring –

1. Improves cash flow and makes it more predictable. This increases the accuracy of cash-flow forecasts.

2. Reduces danger of bad debts.

3. Low administration costs.

4. Lower interest charges and cash provided by the factor reduces overdraft requirements.

The disadvantages of Debt Factoring –

1. Fees can take a large percentage of profits.

2. Credit procedures may upset some customers.

On a balance sheet you will find information about debt factoring under current assets and current liabilities. Its overall job is to fund working capital.

External long-term sources of finance: -

Leasing: -

This is a common way to finance the acquisition of new fixed assets. It allows businesses to buy plant, machinery and equipment without having to pay out large amounts of money. When equipment is leased the transaction is recorded as revenue expenditure rather than capital expenditure. An operating lease means that the leasing company simply hires out equipment for an agreed period of time. The user never owns the equipment, but it is given the option to purchase the equipment outright if it is leased with a finance lease.

The advantages of leasing: -

1. Avoids the damage to cash flow caused by purchasing.

2. Releases capital for other, perhaps more profitable uses.

3. Leasing payments can be offset by tax.

The disadvantages of leasing: -

1. Over a long period of time leasing is more expensive than the outright purchase of plant and machinery.

2. Loans cannot be secured on assets, which are leased.

Its overall job is to finance assets and long-term development and to a lesser extent its job is to fund working capital.

Ordinary share capital: -

This is the money put into the business by the owner or owners. For new businesses this is the most likely source of finance. Many businesses are started with individual savings.

For a limited company this is likely to be the most important source of funds. The sale of shares can raise very large amounts of money. Share capital is often referred to as permanent capital. This is because it is not normally redeemed; i.e. it is not repaid by the business. Once the share has been sold, the buyer is entitled to a share in the profit of the company, i.e. a dividend. Dividends are not always declared. Sometimes a business makes a loss or needs to retain profit to help fund future business activities. A shareholder can make a capital gain by selling the share at a higher price than it was originally bought for. Shares are not normally sold back to the business. The shares of a public limited company are sold in a special share market called the stock market or stock exchange. Shares in private limited company are transferred privately. Shareholders, because they are part owners of the business, are entitled to a vote. One vote is allowed for each share owned. Voting takes place annually and shareholders vote either to re-elect the existing board of directors or replace them.

Different types of shares can be issued:

a) *Ordinary Shares.* These are also called equities and are the most common type of share issued. They are also riskiest types of share since there is no guaranteed dividend. The size of dividend depends on how much profit is made and how much the directors decide to retain in the business. All ordinary shareholders have voting rights. When a share is first sold it has a nominal value shown on its original value. Share prices will change as they are bought sold again and again.

b) *Preference Shares*. The owners of these receive a fixed rate of return when a dividend is declared. They carry lee risk because shareholders are entitled to their dividends before the holders of ordinary shares. Preference shareholders are not strictly owners of the company. If the company is sold, their rights to dividends and capital repayments are limited to fixed amounts. Some preference shares are cumulative, entitling the holder to dividends were not declared.

c) *Deferred Shares.* These are not used often. They are usually held by the founders of the company. Deferred shareholders only receive a dividend after the ordinary shareholders have been paid a minimum amount. When a company issue shares there is a variety of ways in which they can be made available to potential investors.

The main advantages of share capital –

1. Able to raise large amounts of money.

2. No interest charges on ordinary shares.

The main disadvantages of share capital –

1. The money is at risk because if the business fails the money will be lost.

2. May involve more owners and this may mean loss of control.

In a balance sheet it will be placed in the capital and reserves section. Its overall job is to finance assets and long-term development.

Loan capital: -

Any money, which is borrowed for a lengthy period of time by the business, is called loan capital.

A loan capital is one of the many sources of finance. Banks offer a various range of loans. These loans may be medium-term or long-term with variable or fixed rates.

Banks are unlikely to loan capital if they do not feel confident that they will get their money back with interest. They will want to see a business plan and some will probably ask for collateral i.e. some form of security. Banks may call in their loans if they fear the business is in trouble.

a) Short-term loan -

A short-term loan is one usually considered to be for one to three years. An overdraft is n example of a short-term loan. This is a very common form of borrowing for a business. These loans are flexible and the firm only needs to borrow what it needs. It is, however, an expensive way of borrowing, and can be withdrawn instantly by the lender.

b) Medium-term loan -

Medium-term loans cover a period of three to ten years. Its major purposes are to purchase machinery with a corresponding life, to provide the working capital requirements of a business. An example of a medium-term loan is a bank loan, which is borrowed over a fixed period time. Loan is repaid in regular installments. Medium-term loans have the advantage of flexibility, with the possibility of early redemption, but against this the business organisation must make provision for repayment in a comparatively short time span.

c) Long-term loan -

A long-term loan is one considered to be up to 20 years. Debentures are examples of a long-term loan. These are from individuals or financial organisations. They are for a specified length of time and have a fixed rate of interest. They are the business equivalent of a mortgage.

d) Debentures (bonds or loan stock) –

They are marketable securities but, unlike shares, they confer no rights of ownership and are usually redeemed after a fixed period. Like shares they can be issued at a different price to the nominal value on which the interest rate (known as coupon rate) is fixed. They have no voting rights and the amount borrowed must be re-paid by the expiry date. Debentures are secured against specific assets or float as a charge on all assets. Debentures are an alternative to shares as a means of raising long-term capital. They do not dilute control but create the risks associated with raising gearing level.

Here are some other points about loan capital. Loan capital represents a firm's capital employed. When raising extra loan capital, a firm should consider its gearing level, i.e. the extent to which it is reliant on borrowed money. If loans represent more than 50 per cent of capital employed, the firm is considered over-geared. On a balance sheet loan capital is under creditors: amount falling due after one year. Its overall job is to finance assets and log-term development.

Venture Capital: -

These are organisations or individuals that are prepared to invest in growing businesses, hoping to see rewards in future. Venture capital is risk capital, usually in the form of a package of loan and share capital, to provide a significant investment in a small or medium-sized business. The need for it arises when a rapidly growing firm requires more capital, but the firm is not yet ready for the stock market. They often provide funds for businesses that are considered too risky by other investors. In these circumstances, merchant banks might provide the funds themselves, or arrange for others to do so. A typical venture capital investment might provide half in loans and half in shares. The problem is that they often take a certain share in the business as reward for their investment. Venture capital can be put on a balance sheet and its overall job is to finance assets and long-term development.

Conclusion: -

In conclusion there are many ways of financing the business and there isn't a certain one to choose. The type and amount of finance that a business will choose will depend on the type of business, the stage of development of the business i.e. size of business, big or small. Also how successful the firm is and the state of the economy. All these factors must be taken into consideration before choosing a suitable source of finance.

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