Chapter 21

Business Finance: needs and resource

Key terms

1. Start up capital: the finance needed by a new business to pay for essential fixed and current assets before it can begin trading.
2. Working capital: the finance needed by a business to pay its day-to-day costs.
3. Capital expenditure: money spent on fixed assets which will last for more than one year.
4. Revenue expenditure: money spent on day-to-day expenses which do not involve the purchase of a long-term asset, for example wages or rent.
5. Internal finance: obtained from within the business itself.
6. External finance: obtained from sources outside of and separate from the business.
7. Micro-finance: providing financial services- including small loans- to poor people not served by traditional banks.

1. The main reasons why businesses need finance

- To start up business
- To expanding an existing business: expanding shops in other areas
- To increase working capital: to pay for all their day-to-day activities such as wages, raw materials, and electricity bills.
- To pay **capital expenditure** (is money spent on fixed assets such as building which will last for more than one year)

2. Source of finance:

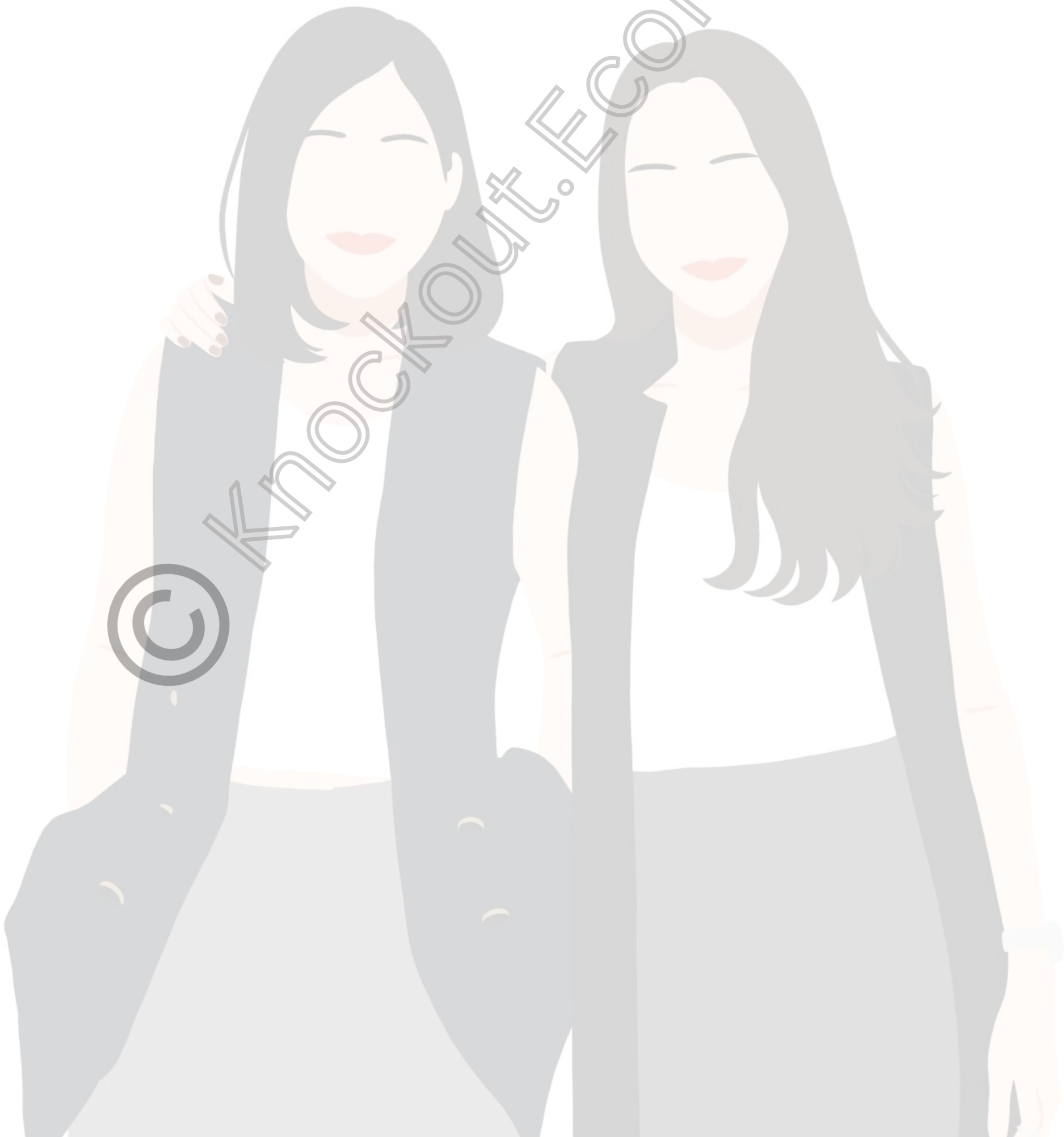
2.1 Internal VS external sources of finance

- **Internal source of finance** : is obtained from within the business itself.
- **External source of finance** : is obtained from sources outside of and separate from the business.

Internal source of finance	External source of finance
1.Retained profit : Profit kept in business after the owners have taken their share of the profits. **Advantages** : • Retained profit does not have to be repaid. • No interest rate payment **Disadvantages** : • A new business will not have any retained profit. • Small firm's profits might be too low to finance the expansion. • Keeping more profits in the business reduces payments to owners.	**1.Issue of shares** : Only possible for limited companies **Advantages** : • Permanent source of capital which does not have to be repaid to shareholders. • No interest rate payment **Disadvantages** : • Dividends are paid after tax whereas interest on loan is paid before tax is deducted. • Dividends will be expected by shareholders. • The ownership of the company could change hands if many shares are sold.

2.Sales of existing assets : e.g. building or surplus equipment. **Advantages** : • This makes better use of capital tied up in the business. • It does not increase the debts of the business. **Disadvantages** : • It may take time to sell these assets and the amount raised is never certain until the asset is sold. • It cannot be practical for new business since there is no surplus equipment.	**2. Bank loan** : is a sum of money obtained from a bank which must be repaid and on which interest is payable. **Advantages** : • It is usually quick to arrange. • It can be long term borrowing. • Large companies can get low rates of interest by banks. **Disadvantages** : • Bank loans need to be repaid and interest must be paid. • Security or collateral is usually required.
3.Sales of inventories to reduce inventory level **Advantages** : • This reduces the opportunity cost and storage cost of high inventory. **Disadvantages** : • It must be done carefully to avoid disappointing customers if there are not enough goods for them.	**3. Selling debentures** : There are long-term loan certificates issued by limited companies **Advantages** : • It can raise very long-term finance 25 years. **Disadvantages** : • Loan must be repaid and interest must be paid.
4.Owner's saving **Advantages** : • It is available to the firm quickly. • No interest is paid. **Disadvantages** : • Saving may be too low. • It increases the risk taken by the owners.	**4. Factoring of debts** : A debtor is a customer who owes a firm money for goods bought. Debt factors are specialist agencies that " buy" the claims on debtors of firms for immediate cash. **Advantages** : • Immediate cash is made available to the business. • The risk of collecting the debt is owned by the factor. **Disadvantages** : • The firm does not receive 100 % of the total value of its debt.

	5.<u>Grants and subsidies form outside agencies</u> **Advantages** : • Grants or subsidies usually do not have to be repaid. **Disadvantages :** • They are often given with "strings attached". (Conditions)
	6.<u>Micro-finance</u> : is providing financial services -including small loans to poor people who cannot served by traditional banks.



Short term and Long term finance

Short term source of finance	Long term source of finance
1.Overdraft : Spend more money than is currently in the account. **Advantages** : • The firm could use this finance to pay wages or supplies immediately. • It is a flexible form of borrowing since overdraft can vary each month. • Interest will be paid only on the amount overdrawn. • Overdrafts can turn out to be cheaper than loans in the short term. **Disadvantages** : • Interest rates are variable, unlike most loans which have fixed interest rates. • The bank can ask for the overdraft to be repaid at very short notice.	**1.Bank loans** : is a sum of money obtained from a bank which must be repaid and on which interest is payable. **Advantages** : • It is usually quick to arrange. • It can be long term borrowing. • Large companies can get low rates of interest by banks. **Disadvantages** : • Bank loans need to be repaid and interest must be paid. • Security or collateral is usually required.

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2. Trade credit
: Business delays paying its suppliers, which leaves the business in a better cash position.
Advantages :
• It is almost an interest-free loan to the business for the length of time that payment is delayed for.
Disadvantages :
• The supplier may refuse to give discounts or refuse to supply if payment is not made quickly.

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2. Hire purchase
: This allows a business to buy fixed assets over a long period of time with monthly payments which include an interest charge.
Advantages :
• The firm does not have to find a large cash sum to purchase asset.
Disadvantages :
• A cash deposit is paid at the start of the period.
• Interest payments can be quite high.

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2.Factoring of debt
: A debtor is a customer who owes a firm money for goods bought. Debt factors are specialist agencies that “ buy” the claims on debtors of firms for immediate cash.
Advantages :
• Immediate cash is made available to the business.
• The risk of collecting the debt is owned by the factor.
Disadvantages :
• The firm does not receive 100 % of the total value of its debt.

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3. Leasing
: Leasing an asset allows the firm to use an asset but it does not have to purchase it. Monthly leasing payments are made.
Advantages :
• The firm does not have to find a large cash sum to purchase the asset to start with.
• The care and maintenance of the asset are carried out by the leasing company.
Disadvantages :
• The total cost of the leasing charges will be higher than purchasing the asset.

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4. Issue of share
----- See under “External Finance----

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5. Debenture
----- See under “External Finance----

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