



UNIT 28_Business finance

PART 1

5.1	The need for business finance	
5.1.1	Start up capital, capital for expansion	<ul style="list-style-type: none"> • why businesses need finance to start up and to grow • why different needs for finance might mean different sources are appropriate
5.1.2	Working capital	<ul style="list-style-type: none"> • the meaning and significance of working capital as a source of finance • significance of the distinction between revenue expenditure and capital expenditure

5 Finance and accounting (AS Level) continued		
5.2	Sources of finance	
5.2.1	Legal structure and sources of finance	<ul style="list-style-type: none"> • the relationship between the legal structure of a business and its sources of finance
5.2.2	Short term finance and long term finance	<ul style="list-style-type: none"> • distinction between short and long term sources of finance
5.2.3	Internal sources	<ul style="list-style-type: none"> • internal sources of finance: retained earnings, sale of unwanted assets, sale and leaseback of non-current assets, working capital
5.2.4	External sources	<ul style="list-style-type: none"> • external sources of finance: share capital, new partners, venture capital, overdrafts, leasing, hire purchase, bank loans, mortgages, debentures, micro-finance, crowd funding and government grants
5.2.5	Factors influencing the sources of finance	<ul style="list-style-type: none"> • factors influencing the choice of sources of finance in a given situation: cost, flexibility, need to retain control, the use to which it is put, level of existing debt [but note, at Cambridge International AS Level, candidates will not be expected to know the term 'gearing']
5.2.6	Selecting the source of finance	<ul style="list-style-type: none"> • the appropriateness of each possible source in a given situation

Why business activity requires finance

- Start-up capital & Working capital
 - Business expansion require more finance (increase capital assets + working capital)
 - Extra finance needed for taking over other firms
 - Special/ unforeseen situations need greater finance
 - Need to finance R&D
-
- Short term funding: 1 year or less
 - Medium term funding: 1-5 years
 - Long term funding:



KEY TERMS

Start-up capital: the capital needed by an entrepreneur to set up a business.

Working capital: the capital needed to pay for raw materials, day-to-day running costs and credit offered to customers. In accounting terms working capital = current assets – current liabilities.

Capital and revenue expenditure

Working capital

- Everyday expense: wages, raw material, stock
- Working capital= current assets – current liabilities
- Current assets= inventories + accounts receivables + cash

Most business obtain the funding for day to day business from **current liabilities** which is not sustainable:

- Overdrafts + Creditors

Not a long term solution, because

- These are short term debts
- If had to be paid quickly, no current capital left



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.

How much working capital is needed?



KEY TERMS

Liquidity: the ability of a firm to be able to pay its short-term debts.

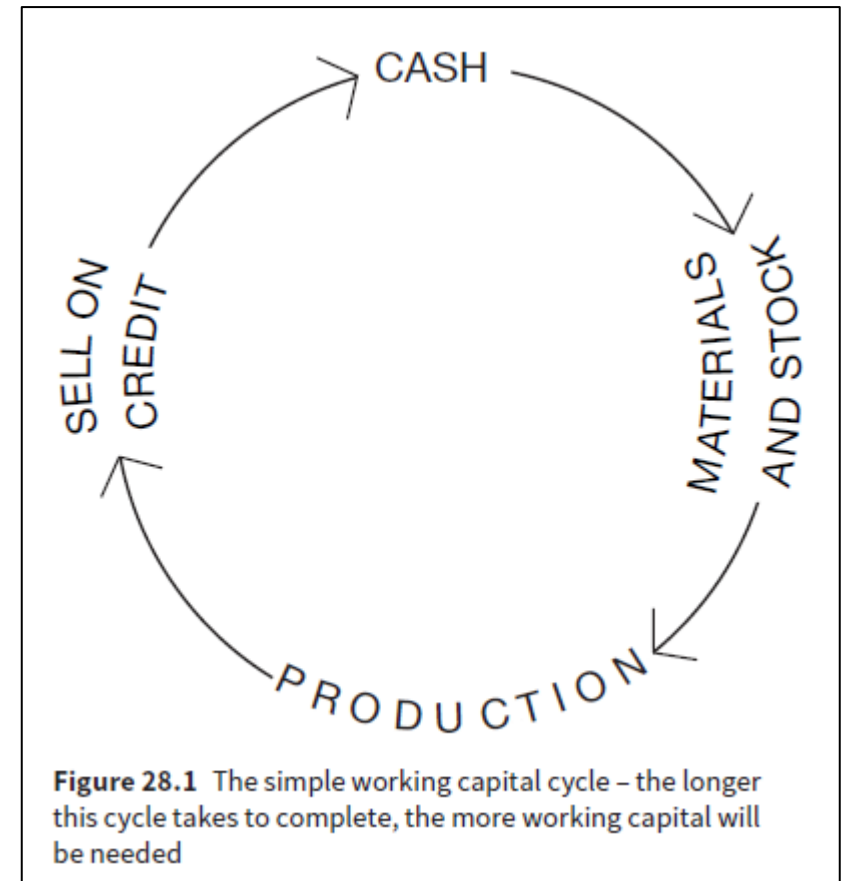
Liquidation: when a firm ceases trading and its assets are sold for cash to pay suppliers and other creditors.

Should not be too high

- Opportunity cost is too high (inventories, accounts receivable, idle cash – fixed assets, buildings)

Working capital cycle

- The longer the time period from buying the to receiving payment from customers, the greater will be the working capital needs of the business



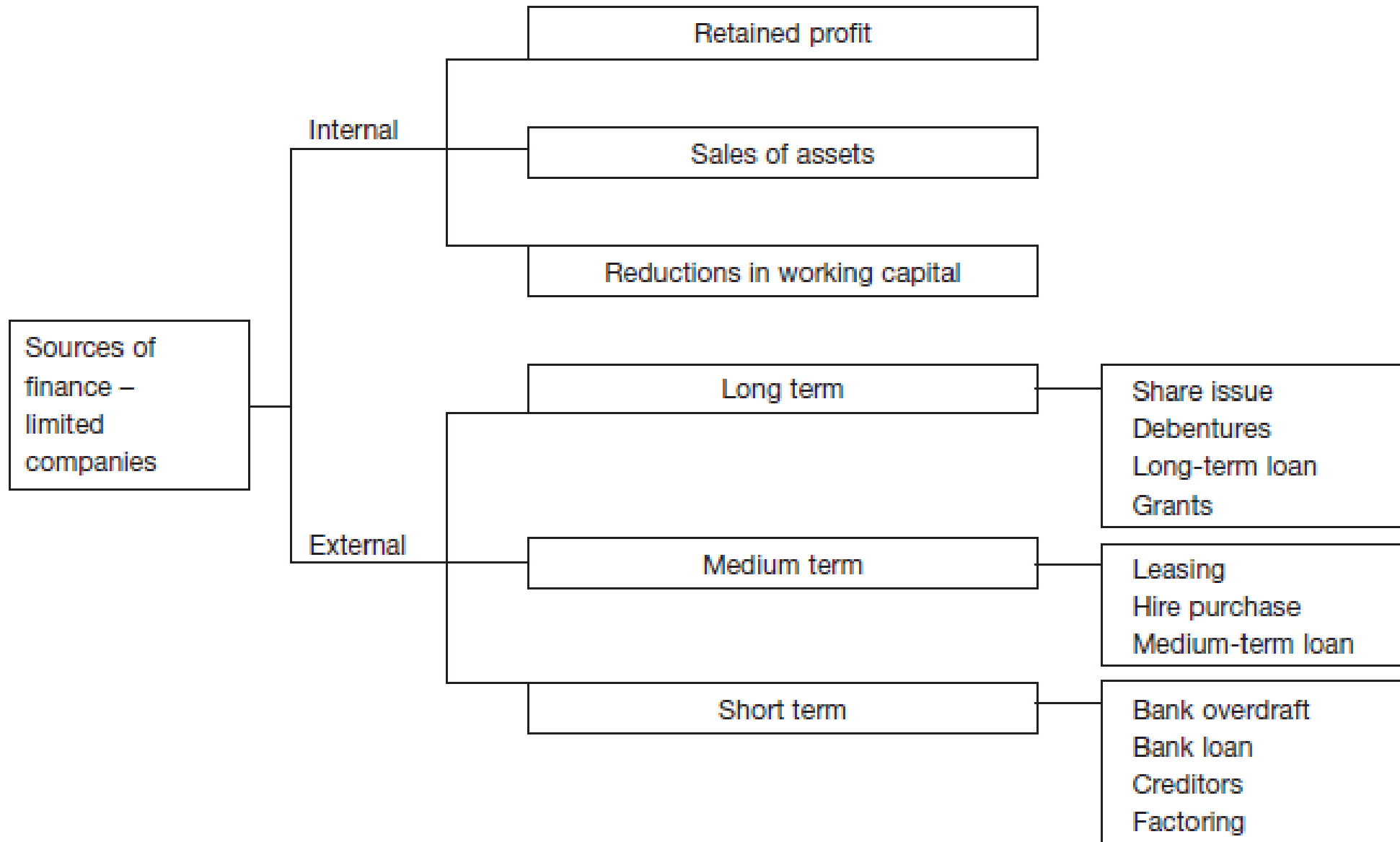


Figure 28.2 Sources of finance for limited companies

Sources of finance - INTERNAL

Profits retained in the business

- Profits are spent on: corporate tax + dividends + funding for future activities
- New vs. Established company

Sale of assets

- Excess assets
- Assets that the business no longer need to own (example of leagin apartments instead of owning)

Reductions in working capital

- Buying stock, giving credit to customers uses up capital → by reducing these assets (sell inventories, reduce debts to suppliers) business can increase finance/liquidity
- Risky steps though - less liquid, unable to pay short-term debts

Sources of finance – INTERNAL – EVALUATION

- Does not increase the liabilities and debts of a business
- No risk of control-loss by owners
- Not every business is able to finance internally (start-ups, small companies)
- If only dependent on own profits and assets, may slow down the business growth



TOP TIP

Do not make the mistake of suggesting that selling shares is a form of internal finance for companies. Although the shareholders own the business, the company is a separate legal unit and, therefore, the shareholders are 'outside' it.

Bank overdrafts

- Most flexible - can raise per their need (trade receivables are not paid on time)
- The „overdraw“ limit is agreed upfront with the bank
- Charges high interest
- If it happens more often, or if business overdraws bank is worried and can „call in“ the payment which may lead to business failure

Sources of finance – EXTERNAL –short term

Trade credit

- Delaying the payment for goods and services received – obtaining finance/ lending money
- Risks to lose the supplier confidence if payment is delayed too long

Debt factoring

- Selling goods on credit
- Selling trade receivables to a **debt factor** – NOT receiving the full amount
- Debt factor – special service provider – contracts made on the name of the service provider

Sources of finance – EXTERNAL –medium term

Hire purchase

- For of a credit for purchasing an asset over period of time
- Often used for obtaining fixed assets with a medium lifespan (1-5 yrs)
- No need to pay large initial payment

Leasing

- Leasing or financing but not necessarily purchasing
- Periodic payment, but no ownership of the asset
- Allow to avoid to spend the cash for the asset – maintenance is through the leasing company

Sources of finance – EXTERNAL –long term/ debt/ equity financing

Debt: long-term bank loan + debentures

Long-term bank loans

- Provide security/collateral to the bank – bank may sell the security if business fails to pay the loan
- Hence, more difficult to obtain for smaller firms without collateral
- Variable vs. fixed interest rate: Fixed rate might be more secure, but may be high if agreed in high interest time with bank
- UK Department of Trade and Industry – „guaranteed loan scheme“ for small businesses – guarantees to the bank the repayment purchase

Sources of finance – EXTERNAL –long term/ debt/ equity financing

Debentures (loan stock/corporate bonds/ long-term bonds)

- Issue + sell long-term bonds to interested investors
- The company agrees to pay a fixed rate of interest each year for the life of bond – can be up to 25 yrs
- Buyers may resell the bonds
- Not secured on a particular asset/ collateral
- There is one form with collateral – mortgage debenture – investor may sell the collateral

ЭТТ-БОНД
БОНДЫН НӨХЦӨЛ

	ТӨГРӨГИЙН БОНД	ДОЛЛАРЫН БОНД
НЭГЖ ҮНЭ	100,000₮	100\$
ЖИЛИЙН ХҮҮ	10% хүртэл	6.8% хүртэл
ХҮҮ ТӨЛӨГДӨХ ХУГАЦАА	6 сар тутам	6 сар тутам
БОНДЫН ХУГАЦАА	2 жил	2 жил
НИЙТ ХЭМЖЭЭ	₮ 120 тэрбум	\$ 168 сая

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Sources of finance – EXTERNAL –long term/ debt/ equity financing

Equity finance – selling shares

Private and Public limited companies both have shares

- Private Ltd company can sell shares:
 - to existing shareholders – no risk of losing control and raise finance, or
 - go public – become public Ltd. – loses certain control over business, but able to raise more finance.
- There are 2 ways:
 - List the business at AIM, part of the Stock Exchange
 - Full listing on the Stock Exchange

Sources of finance – EXTERNAL –long term/ debt/ equity financing

Debt finance – advantages

- No shares sold – ownership remains unchanged
- Loans will be paid within certain time-period, so there is no permanent increase in the liabilities of the business
- Lenders have no voting rights
- Interest charges are an expense – deducted before corporate tax is due (while dividends on shares is paid from profit after tax)

Sources of finance – EXTERNAL –long term/ debt/ equity financing

Equity capital– advantages

- It never has to be repaid – it is permanent capital
- Dividends do not have to be paid every year (while interest on loans must be paid as agreed)
- finance – advantages

Homework!

This is an oral assignment !

1. Read the case and record your voice
2. Answer to ALL the questions. The best way would be:
 - Write on down the answer first
 - Read out loud your answer and record

ACTIVITY 28.5

KOOVS lists on AIM

Online fashion retailer Koovs has been listed on London Stock Exchange AIM. Koovs successfully raised £22 million at the initial public offer (IPO), valuing the business at £36 million. Koovs is the first Indian business to list on London Stock Exchange since Nandan Cleantech, which debuted in November 2011. There are 62 Indian businesses, with a combined value of £90 billion listed in London across AIM and the main stock exchange market. Ibukun Adebayo, Head of Primary Markets, India at the London Stock Exchange Group said “We welcome Koovs to our market.

This is an important listing, not just for the company, but for Indian companies overall.”

It will focus on affordable Western fashion rather than Indian ethnic clothing, copying celebrity fashions to appeal to middle-class working men and women aged 18–30 years, exactly like the London-based company. The owners plan to float about 35% of the company with 44% owned by the Nahata family, 11% by Lord Alli and the remainder with management.

Peacocks to go public

Peacocks, the discount clothing and houseware retailer, has issued its prospectus to the public. The company is going public to raise £42 million (after expenses) to fund further expansion and to repay outstanding debt. The managing director believes that there are great benefits in replacing debt finance with equity or share finance.

the capital will be used to repay loans and the rest will be used for long-term investment and research. The rights issue is being offered at A\$2.50 per share, a 40% discount to the company’s latest traded share price. The share issue is likely to reduce the market share price, at least in the short term. The company has also announced a tripling of annual profits, reflecting gains from a recent takeover and high fertiliser prices.

Rights issue from Australian company

Australian fertiliser-maker Incitec Pivot Ltd plans to raise A\$1.17 billion through a rights issue of shares. Some of

[28 marks, 40 minutes]

- 1 Why have Indian companies such as Koovs decided to join AIM rather than the main Stock Exchange? [4]
- 2 Why has the management of Koovs decided not to sell more than 50% of the shares in the company? [2]
- 3 Peacocks decided to issue shares by prospectus to the general public. Why do you think this method of selling shares was selected? [4]
- 4 What did the managing director of Peacocks mean when he said that there were advantages in selling shares to repay debt? What are the advantages of repaying debts? [6]
- 5 Why do you think Incitec Pivot decided to use a rights issue of shares to raise capital? [4]
- 6 Evaluate whether a shareholder in Incitec Pivot should buy the rights issue of shares being offered. [8]