

# Finance Sources Budgeting Techniques

## Lecture 7

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Introduction to Finance

## Finance Sources Budgeting Techniques



## Chapter 7

# Finance Sources Budgeting Techniques

- Define different sources of finance
- Advantages and Disadvantages of different sources of finance
- Purpose of different sources of finance

**Exam Q** – Anne wanted to raise £60,000 of start-up capital from a venture capitalist rather than arranging a bank loan. To what extent do you agree with her?

**KEEP YOUR UNIT SUMMARY SHEET UP TO DATE!**

## What is Finance?

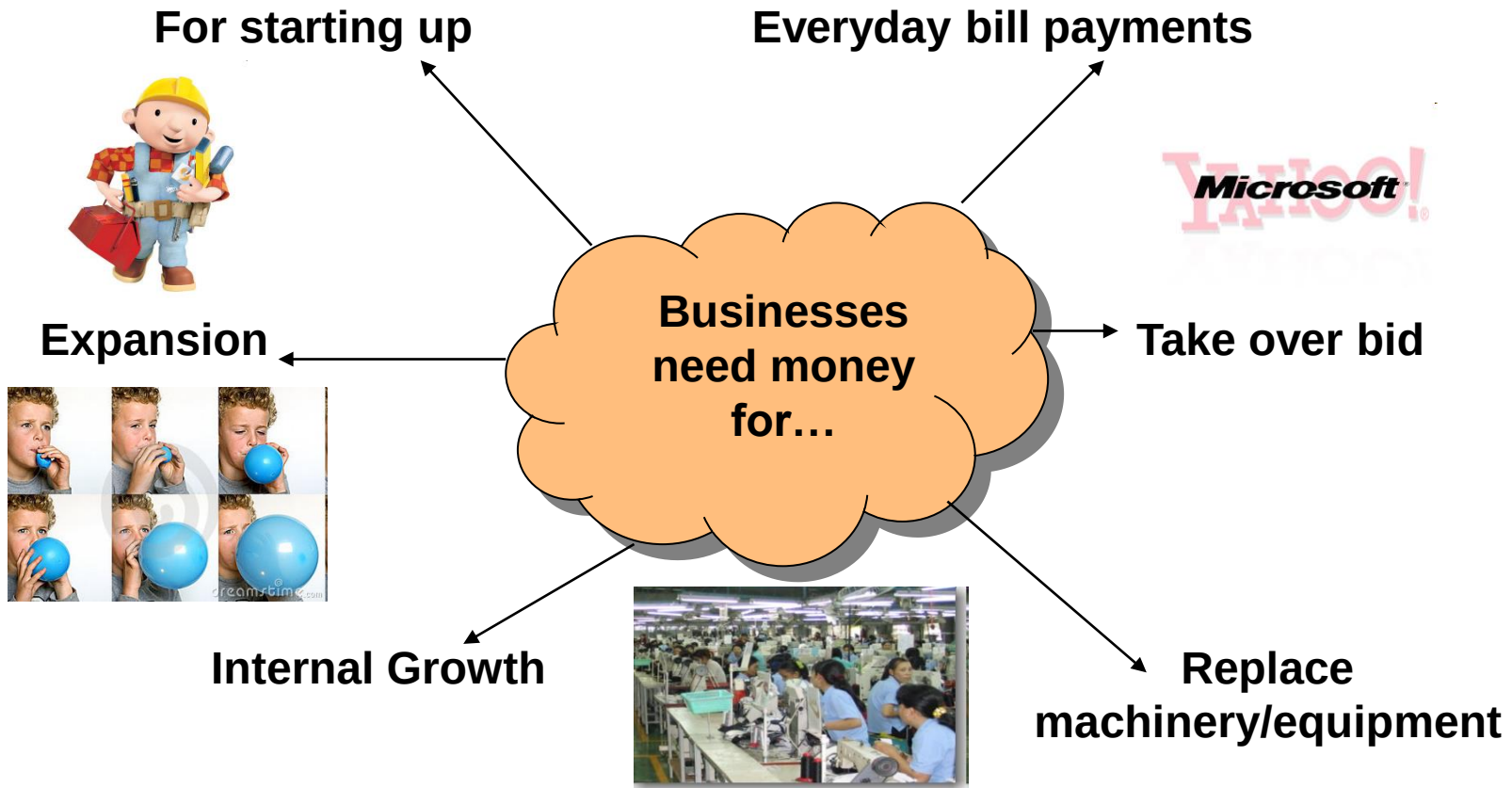


FINANCE – This is money



SOURCES OF FINANCE – This is  
**WHERE** we get finance from

# Why Do Businesses Need Finance?



## Why Do Businesses Need Finance?

- Starting Up – Buildings, machinery, raw materials and office equipment
- WORKING CAPITAL – Short term finance required for the day-to-day running of a business
- Unforeseen Events – Sudden decline in sales, large customer fails to pay on time or pay expenses quickly

## The purpose of finance

**“Different sources of finance have different implications for a business, so it is important that the most appropriate method of finance is chosen for the purpose that the business has in mind”**

## Sources of Finance

Sources of  
Finance  
can be either:

```
graph TD; A["Sources of Finance can be either:"] --> B["Internal"]; A --> C["External"];
```

Internal

External

## Internal Sources of Finance

**INTERNAL SOURCES OF FINANCE** – Finance which is raised internally, it does not increase the debts of the business.

### **Examples:**



Retained profit  
Personal savings  
Sale of unwanted assets  
Sale and leaseback

## External Sources of Finance

**EXTERNAL SOURCES OF FINANCE** – Finance provided by people or institutions outside the business, creates a debt that will require payment.

**Examples:**

Loans  
Overdraft  
Shares  
Debentures



## Time Periods for Finance

Finance is generally considered to be either:



**SHORT  
TERM**

**UP TO 3  
YEARS**

**MEDIUM  
TERM**

**3 – 10  
YEARS**

**LONG  
TERM**

**OVER 10  
YEARS**

## Short-term Finance

- Short-term Finance is needed for the day-to-day running of a business and is usually for a period of up to 3 years
- In order to understand short-term finance it is necessary to understand the concept of **CASH FLOW**

## Cash Flow

**CASH FLOW** – A business needs sufficient inflows of cash to finance its day-to-day outgoings.

**INFLOWS** refers to money received by the business

**EXAMPLES:**

- Sales revenue
- Capital
- Loans
- Grants



**OUTFLOWS** refers to money paid out by the business

**EXAMPLES:**

- Purchases
- Rent & Rates
- Wages & Salaries

Chapter 7

# Why is Cash Flow Important?

Think of a business as a bath without a plug...



There should always be cash available – so the bath is never empty!

If the bath is ever empty the business is in **TROUBLE** – it has a **CASH FLOW PROBLEM**.

**If this is not the case the business needs short-term finance to overcome this problem!**

## Sources of Short-Term Finance

All **commercial banks** offer various methods of short-term finance for businesses:

- Overdraft
- Short-term Loan



**Other sources** of Short-Term Finance:

- Hire Purchase (External)
- Trade Credit (Internal)

## External Short-term Finance

**OVERDRAFT** - The bank allows the business to draw more money from their bank account than they actually have in it.

| <u>Advantages</u>                                 | <u>Disadvantages</u>                           |
|---------------------------------------------------|------------------------------------------------|
| Very quick to arrange                             | Only suitable for smaller amounts              |
| Only pay interest on amount overdrawn             | Has to be repaid within a short amount of time |
| A good short term solution to a cash flow problem | Interest or charges are paid                   |

**SHORT-TERM LOAN** – An amount of money is borrowed from the bank, then repaid (with interest) over a set period of time (0 – 3 years).

- Tends to be used to **buy specific pieces of equipment** or to purchase a particular consignment of raw materials in order to **fulfil a contract**
- **Not a safety net** in the way an overdraft is



**Continued...**

| <u>Advantages</u>                               | <u>Disadvantages</u>                                                                                    |
|-------------------------------------------------|---------------------------------------------------------------------------------------------------------|
| Easy and quick to set up                        | Interest payable                                                                                        |
| Small or Large amounts of money can be borrowed | If repayments cannot be kept up, the business risks getting a poor credit rating or being made bankrupt |
| Structured repayment term                       |                                                                                                         |

# Factors Influencing a Bank's Decision to Lend

Type of Product?

Purpose of the Finance?

Past Trading Record?

Current Financial Position?

Business Proposal?

Financial Projections?

Nature of the Market/Sales forecast?



## Banks Use this Information to...

- Determine who qualifies for lending
- Determine what interest rate they will lend at

**INTEREST RATE** - cost of borrowing money (reward for savings)

- What credit limit to set
- Banks also use this information to determine which customers are likely to bring in the most revenue

**SECURITY** – Something that acts as assurance to a lender that it will get its money back if a business is unable to pay back money it has borrowed.



If a business fails to repay the loan, the bank – as holder of the deeds – is legally entitled to sell the factory or office in order to recover any amount outstanding on the loan.

## Other External Short-term Finance

**HIRE PURCHASE** – Pay for an item in instalments, to a hire company, over a set period of time. The item is being hired until the last payment is made.

| <u>Advantages</u>                                    | <u>Disadvantages</u>                                          |
|------------------------------------------------------|---------------------------------------------------------------|
| Large sum of money does not have to be found at once | High interest is often charged                                |
| Spread payment over a period of time                 | Item doesn't belong to the business until the end of the term |
| Improved cash flow                                   |                                                               |

**TRADE CREDIT** - Items are bought from suppliers on a **‘buy now pay later’** basis.

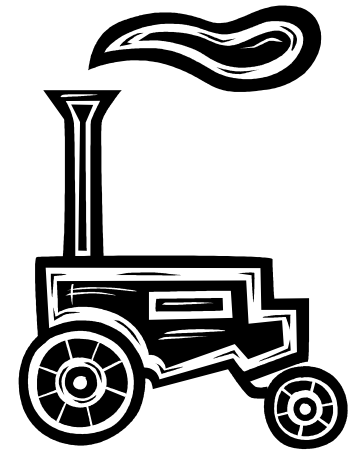
| <u>Advantages</u>                                           | <u>Disadvantages</u>                                     |
|-------------------------------------------------------------|----------------------------------------------------------|
| Gives the business more cash to use in the immediate future | Can only be used to buy certain goods                    |
| Does not incur interest charges                             | Bills usually have to be settled within 30,60 or 90 days |

## Medium-term Finance

- Medium-term Finance is normally thought of as being for between 3 – 10 years.

Purpose of obtaining medium term finance:

- Replace expensive equipment
- To expand
- Convert persistent overdraft into formal medium-term loan



## Sources of Medium-term Finance

Various different forms of medium-term finance are available to a business:

- Medium-term Loan
- Hire purchase
- Leasing



## External Medium-term Finance

**MEDIUM-TERM LOAN** - An amount of money is borrowed from the bank, then repaid (with interest) over a set period of time (3 – 10 years).

The **rate of interest** charged is **particularly important!**

The rate of interest payable on a medium-term loan depends on:

- How much is borrowed
- How long the money is wanted for
- The security that is provided

## Continued...

Businesses have the option to choose either a **variable rate** or a **fixed rate loan**.

**VARIABLE RATE** – interest varies with whatever decisions the Bank of England make with regard to interest rates.

**FIXED RATE** – interest is fixed for the duration of the loan.

| <u>Advantages</u>                                                                                                                                     | <u>Disadvantages</u>                                                                                                                                                  |
|-------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Fixed Rate:</b> <ul style="list-style-type: none"><li>● Know what repayment costs are going to be</li><li>● Financial planning is easier</li></ul> | <b>Fixed Rate:</b> <ul style="list-style-type: none"><li>● If the rate falls still have to pay the higher fixed rate</li></ul>                                        |
| <b>Variable Rate:</b> <ul style="list-style-type: none"><li>● If the rate falls business pays the new lower rate</li></ul>                            | <b>Variable Rate:</b> <ul style="list-style-type: none"><li>● Don't now what repayment costs are going to be</li><li>● Financial planning is more difficult</li></ul> |

Continued...

**HIRE PURCHASE** – Mentioned before -  
can also be medium-term finance.

**LEASING** – Pay instalments over a set  
period of time to rent an item – business  
**never actually owns  
the item!**

**Continued...**

| <b><u>Advantages</u></b>                               | <b><u>Disadvantages</u></b>         |
|--------------------------------------------------------|-------------------------------------|
| Large sum of money does not have to be found at once   | High interest is often charged      |
| Spread payment over a period of time                   | Item doesn't belong to the business |
| Improved cash flow                                     |                                     |
| Leasing company is responsible for maintenance of item |                                     |

- Long-term finance is usually thought of as being for periods in excess of 10 years.
- This Finance is for securing the resources for **long-term growth**.



## Sources of Long-term Finance

**For the long-term**, a business essentially has the choice of raising finance by **borrowing** or through the **issue of shares**.

### Sources of Long-term Finance:

- Long-term loans (External)
- Issue of shares
- Sale and leaseback (Internal)
- Retained profit



## External Long-term Finance

**LONG-TERM LOAN** - An amount of money is borrowed from the bank, then repaid (with interest) over a set period of time (10 years +).

- Used for **expensive** pieces of **machinery**
- Loans for buildings – **mortgages**
- Variable Rate or Fixed Rate
- **Fixed Rate** – not fixed for whole length of the loan

**Advantages and Disadvantages as before!**

**ISSUE OF SHARES** - A share in the business is sold to an individual or another business - also known as equity finance. This money is then used to purchase new assets.

- Shareholders are entitled to a dividend (share of company profits)

**RIGHTS ISSUE** – When a company issues more shares.

**This type of finance is only available to a company:**

- **Private Company (Ltd)** – restrictions on the transfer of shares and value not readily available as they are not traded in a market.
- **Public Company (Plc)** – Shares are traded on the stock market.

**STOCK MARKET** - A market where shares and debentures are bought and sold.

## Continued...

| <b><u>Advantages</u></b>                               | <b><u>Disadvantages</u></b>                                                  |
|--------------------------------------------------------|------------------------------------------------------------------------------|
| No need to repay the money invested                    | Need to pay the shareholders a share of future profits                       |
| Cheaper than a loan                                    | Original owners may lose control of the business                             |
| Some businesses can raise large sums of money this way | Risky for the shareholder - the investment may be lost if the business fails |

## Internal Long-term Finance

**SALE AND LEASEBACK** – Asset is sold but then leased back – usually for a long period of time.

| <b><u>Advantages</u></b>                               | <b><u>Disadvantages</u></b>                 |
|--------------------------------------------------------|---------------------------------------------|
| Large sum of money is created                          | High interest is often charged              |
| Business can operate as normal after the sale          | Item doesn't belong to the business anymore |
| Leasing company is responsible for maintenance of item | No guarantee that lease will be renewed     |

**RETAINED PROFIT** – Profit retained for the purpose of using in the future.

| <b><u>Advantages</u></b>             | <b><u>Disadvantages</u></b>                                           |
|--------------------------------------|-----------------------------------------------------------------------|
| No need to pay interest on the money | Could have been invested elsewhere, earning a higher profit           |
|                                      | The business may not have enough retained profit to meet its needs    |
|                                      | Shareholders may become unhappy if this means lower dividend payments |

## Other Sources of Finance

Other sources of finance include:

- Government Assistance
- Venture Capital
- Business Angles

**Government Assistants** falls into two categories – assistance with obtaining a loan and regional aid.

**THE SMALL FIRMS LOAN GUARANTEE SCHEME (SFLG)** – Government provided security scheme which began in 2003, to enable small firms with little security to get finance.

- Targeted at smaller businesses
- **Not** a loan from the **government** but from a bank
- Bank will want to see the usual documents
- **Decision to lend lies with the bank!**
- **Government provides 75%** of the security via the **Department for Business, Enterprise and Regulatory Reform**

**REGIONAL DEVELOPMENT ASSISTANCE (RDA)** –

Government financial assistance available if the business is located, or is prepared to locate, in certain areas of the UK.

- Usually areas where traditional industries have been in decline
- Business must safeguard and create jobs or grow so that it can compete more effectively at home or abroad
- Available to small and large businesses

**INCENTIVES:**

- Tax incentives
- Sale of land or property at discounted rate
- Reduced rent

**GRANTS:**

- Investment in equipment
- Training or retraining
- Research and Development



**VENTURE CAPITAL** – Individuals or firms who lend money, known as venture capital.

A venture capitalist might agree to provide a certain amount of **finance in exchange for a high % of the company's shares** and might adopt a “take it or leave it” approach.

**BUSINESS ANGELS** – Individuals or firms who offer management advice as well.

## A Business's Choice of Finance

The business's **choice** of source of finance **depends on several factors!**

There are too many considerations...I don't know which sources to choose!!!



## Continued...

- The type of business – Sole traders and partnerships cannot issue shares
- The amount of control desired – Becoming a partnership or company can weaken control
- Security – A lack of security may mean that banks are unwilling to grant a loan
- Existing levels of debt – If high banks will think twice about lending

- Internal Funds – If the business uses them for finance there will be no interest to pay; but once used the firm has no cushion to fall back on
- Length of time – How long will it take to generate the funds to pay back investment
- Current methods of finance being used – Inappropriate financial management will discourage the bank from lending

## Recap...

|          | <u>Short-term</u>                                                                                             | <u>Medium-term</u>                                                                                           | <u>Long-term</u>                                                                                                        |
|----------|---------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------|
| EXTERNAL | <ul style="list-style-type: none"><li>● Overdraft</li><li>● Short-term Loan</li><li>● Hire Purchase</li></ul> | <ul style="list-style-type: none"><li>● Medium-term Loan</li><li>● Hire Purchase</li><li>● Leasing</li></ul> | <ul style="list-style-type: none"><li>● Long-term Loan</li><li>● Shares</li><li>● Debentures</li></ul>                  |
| INTERNAL | <ul style="list-style-type: none"><li>● Trade Credit</li></ul>                                                | <ul style="list-style-type: none"><li>● Retained Profit</li></ul>                                            | <ul style="list-style-type: none"><li>● Retained profit</li><li>● Sale of Assets</li><li>● Sale and Leaseback</li></ul> |

