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Fifth edition

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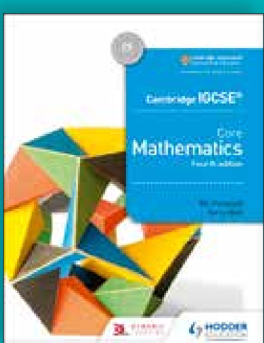

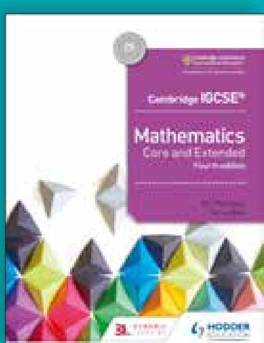

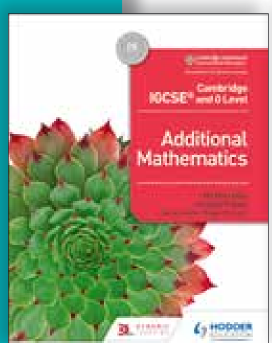

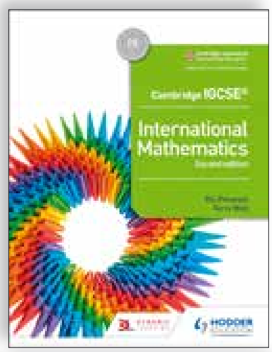

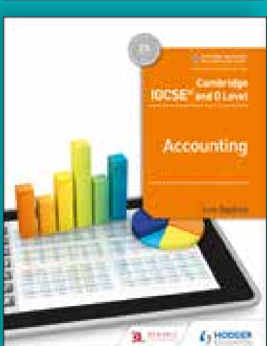

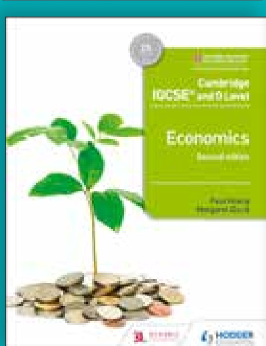

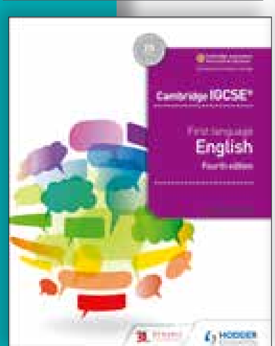

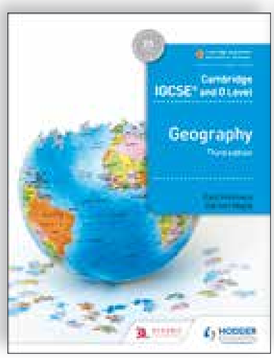

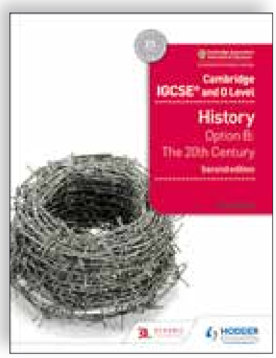

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Contents

Features for great teaching and learning

Navigate the syllabuses confidently with subject outlines clearly defined at the start of each chapter and syllabus-matching section headings.

Motivate students with learning objectives clearly outlined at the start of each chaper.

Encourage understanding with clear and lively text gradually building content knowledge.

21 Business finance: needs and sources

This chapter will explain:

★ the main reasons why businesses need finance, e.g. start-up capital, capital for expansion and additional working capital
★ how to understand the differences between short-term and long-term finance needs
★ the main sources of capital: internal sources and external sources with examples
★ short-term and long-term sources with examples, e.g. overdraft for short-term finance and debt or equity for long-term finance
★ importance of alternative sources of capital, e.g. micro-finance, crowdfunding
★ the main factors considered in making a financial choice, e.g. size and legal form of business, amount required, length of time, existing loans
★ how to recommend and justify appropriate source(s) of finance in given circumstances.

What do finance departments do?

Finance departments fulfill a very important role in business. They have the following responsibilities:

- recording all financial transactions, such as payments to suppliers and revenue from customers
- preparing final accounts
- producing accounting information for managers
- forecasting cash flows
- making important financial decisions, e.g. which source of finance to use for different purposes within the business.

Why do businesses need finance?

Finance is money. We all need money to purchase the goods and services we require – everyday goods, like food, but also more expensive items such as a house or car. Businesses need finance too – and this is often called 'capital'. Without finance, businesses could not pay wages, buy materials or pay for assets. Here are three examples of why finance or capital is needed:

- starting up a business
- expansion of an existing business
- additional working capital.

Starting up a business

When an entrepreneur plans to start their own business, they should think about all of the buildings, land and equipment they will need to buy in order to start trading. These are usually called fixed assets (see Chapter 24). Nearly all new

Engage students with authentic case studies.

Case study: 'Micro-finance changed my life'

Baji Parveen lives in Pakistan. She has nine children and she used to ask neighbours for food to help feed them all. All it took to turn Parveen's life round was a $70 loan from the Kashf Foundation. The loan allowed her to start a jewellery-making business which quickly took off. Now she also owns a restaurant and a catering business that employs eight people. She has repaid the original loan and interest on it. She is able to pay for her children to go to high school and college. 'Micro-finance has changed my life,' Parveen says.

Find answers to important questions quickly with Key info boxes.

Activity 21.4

Read the case study above.

a Why do you think that traditional banks would not lend Parveen money for her business?
b Explain the benefits that this example of micro-finance has given to Parveen, her family and her country.

Support your students with key definitions outlined throughout.

Key info

Some large and well established banks are now becoming interested in offering micro-finance loans. These banks have found out that some very small enterprises can become successful and often remain as customers of the institution that first lent them small sums. The ICICI Bank, India's second-largest bank, has opened more than 2,000 rural internet kiosks that provide financial services throughout India. Brazil's Caixa Econômica Federal Bank is extending financial services franchises to nearly 14,000 outlets, including lottery kiosks, supermarkets and local shops in Brazil.

Definition to learn

Crowdfunding is funding a project or venture by raising money from a large number of people who each contribute a relatively small amount, typically via the internet.

▲ Chilango, the Mexican restaurant chain, raised £5.41M using the Crowdcube lending platform

Crowdfunding

This idea of raising finance for new business start-ups by encouraging a large number of people to each invest small amounts has been used for many years. However, it has only become very popular since the widespread use of the internet. This allows entrepreneurs to contact millions of potential investors around the globe, usually by using '**crowdfunding** platforms' such as Kickstarter, Rocket Hub and FundAnything. It is a source which is not suitable for raising very small sums – an invitation to global investors is not worthwhile if only $1,000 is required! Crowdfunding is claimed to have these benefits:

- No initial fees are payable to the crowdfunding platform. Instead, if the finance required is raised, the platform will charge a percentage fee of this amount.
- Allows the public's reaction to the new business venture to be tested. If people are not prepared to invest, it probably is not a very good business idea.
- Can be a fast way to raise substantial sums.
- Often used by entrepreneurs when other 'traditional' sources are not available.

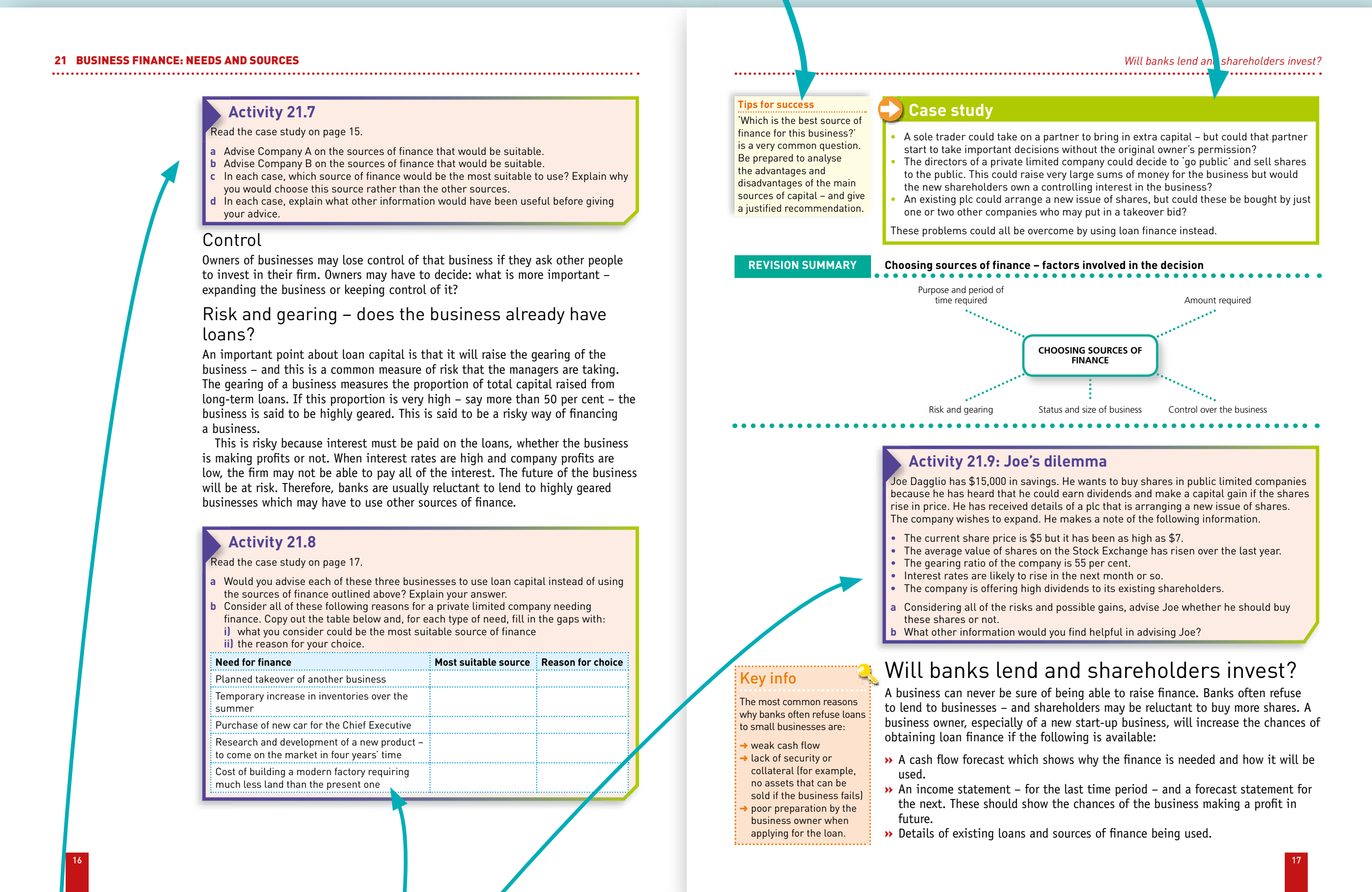
However:

- Crowdfunding platforms may reject an entrepreneur's proposal if it is not well thought out.
- If the total amount required is not raised, the finance that has been promised will have to be repaid.
- Media interest and publicity need to be generated to increase the chance of success.
- Publicising the new business idea or product on the crowdfunding platform could allow competitors to 'steal' the idea and reach the market first with a similar product.

Features for great teaching and learning

Help students to prepare with tips for success.

Help students to understand with visual explanations.



21 BUSINESS FINANCE: NEEDS AND SOURCES

Activity 21.7

Read the case study on page 15.

a Advise Company A on the sources of finance that would be suitable.
b Advise Company B on the sources of finance that would be suitable.
c In each case, which source of finance would be the most suitable to use? Explain why you would choose this source rather than the other sources.
d In each case, explain what other information would have been useful before giving your advice.

Control

Owners of businesses may lose control of that business if they ask other people to invest in their firm. Owners may have to decide: what is more important – expanding the business or keeping control of it?

Risk and gearing – does the business already have loans?

An important point about loan capital is that it will raise the gearing of the business – and this is a common measure of risk that the managers are taking. The gearing of a business measures the proportion of total capital raised from long-term loans. If this proportion is very high – say more than 50 per cent – the business is said to be highly geared. This is said to be a risky way of financing a business.

This is risky because interest must be paid on the loans, whether the business is making profits or not. When interest rates are high and company profits are low, the firm may not be able to pay all of the interest. The future of the business will be at risk. Therefore, banks are usually reluctant to lend to highly geared businesses which may have to use other sources of finance.

Activity 21.8

Read the case study on page 17.

a Would you advise each of these three businesses to use loan capital instead of using the sources of finance outlined above? Explain your answer.
b Consider all of these following reasons for a private limited company needing finance. Copy out the table below and, for each type of need, fill in the gaps with:
i) what you consider could be the most suitable source of finance
ii) the reason for your choice.

Need for finance	Most suitable source	Reason for choice
Planned takeover of another business		
Temporary increase in inventories over the summer		
Purchase of new car for the Chief Executive		
Research and development of a new product – to come on the market in four years' time		
Cost of building a modern factory requiring much less land than the present one		

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Will banks lend and shareholders invest?

Tips for success

'Which is the best source of finance for this business?' is a very common question. Be prepared to analyse the advantages and disadvantages of the main sources of capital – and give a justified recommendation.

Case study

- A sole trader could take on a partner to bring in extra capital – but could that partner start to take important decisions without the original owner's permission?
- The directors of a private limited company could decide to 'go public' and sell shares to the public. This could raise very large sums of money for the business but would the new shareholders own a controlling interest in the business?
- An existing plc could arrange a new issue of shares, but could these be bought by just one or two other companies who may put in a takeover bid?

These problems could all be overcome by using loan finance instead.

REVISION SUMMARY Choosing sources of finance – factors involved in the decision

Activity 21.9: Joe's dilemma

Joe Dagglio has $15,000 in savings. He wants to buy shares in public limited companies because he has heard that he could earn dividends and make a capital gain if the shares rise in price. He has received details of a plc that is arranging a new issue of shares. The company wishes to expand. He makes a note of the following information.

- The current share price is $5 but it has been as high as $7.
- The average value of shares on the Stock Exchange has risen over the last year.
- The gearing ratio of the company is 55 per cent.
- Interest rates are likely to rise in the next month or so.
- The company is offering high dividends to its existing shareholders.

a Considering all of the risks and possible gains, advise Joe whether he should buy these shares or not.
b What other information would you find helpful in advising Joe?

Key info

The most common reasons why banks often refuse loans to small businesses are:

- weak cash flow
- lack of security or collateral (for example, no assets that can be sold if the business fails)
- poor preparation by the business owner when applying for the loan.

Will banks lend and shareholders invest?

A business can never be sure of being able to raise finance. Banks often refuse to lend to businesses – and shareholders may be reluctant to buy more shares. A business owner, especially of a new start-up business, will increase the chances of obtaining loan finance if the following is available:

- A cash flow forecast which shows why the finance is needed and how it will be used.
- An income statement – for the last time period – and a forecast statement for the next. These should show the chances of the business making a profit in future.
- Details of existing loans and sources of finance being used.

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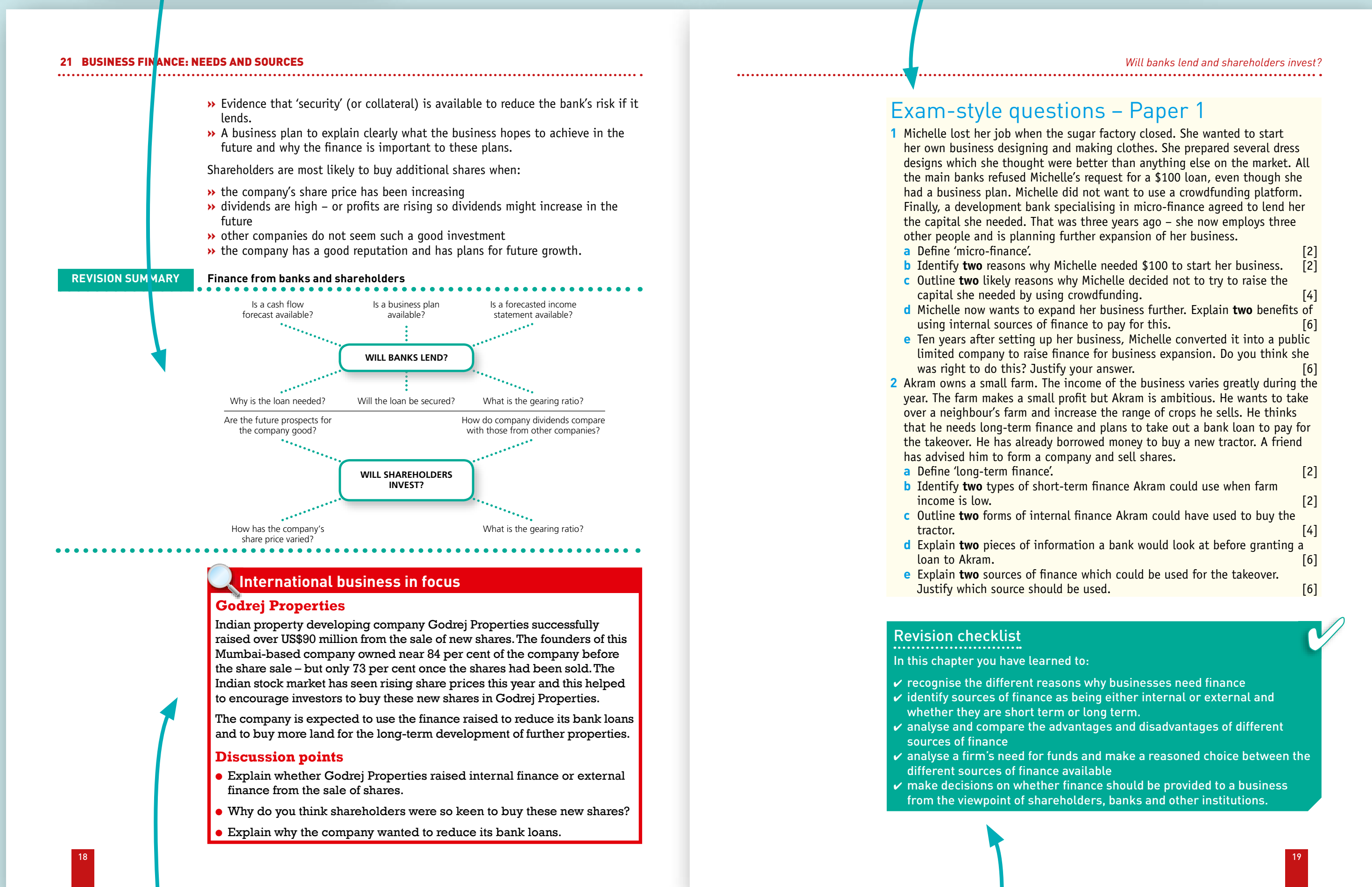
Develop application and evaluation skills with hundreds of engaging activities throughout.

Aid understanding with visual explanations and diagrams.

Improve confidence with exam-style questions throughout.



21 BUSINESS FINANCE: NEEDS AND SOURCES

» Evidence that 'security' (or collateral) is available to reduce the bank's risk if it lends.
» A business plan to explain clearly what the business hopes to achieve in the future and why the finance is important to these plans.

Shareholders are most likely to buy additional shares when:

» the company's share price has been increasing
» dividends are high – or profits are rising so dividends might increase in the future
» other companies do not seem such a good investment
» the company has a good reputation and has plans for future growth.

REVISION SUMMARY

Finance from banks and shareholders

International business in focus

Godrej Properties

Indian property developing company Godrej Properties successfully raised over US$90 million from the sale of new shares. The founders of this Mumbai-based company owned near 84 per cent of the company before the share sale – but only 73 per cent once the shares had been sold. The Indian stock market has seen rising share prices this year and this helped to encourage investors to buy these new shares in Godrej Properties.

The company is expected to use the finance raised to reduce its bank loans and to buy more land for the long-term development of further properties.

Discussion points

- Explain whether Godrej Properties raised internal finance or external finance from the sale of shares.
- Why do you think shareholders were so keen to buy these new shares?
- Explain why the company wanted to reduce its bank loans.

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Will banks lend and shareholders invest?

Exam-style questions – Paper 1

1 Michelle lost her job when the sugar factory closed. She wanted to start her own business designing and making clothes. She prepared several dress designs which she thought were better than anything else on the market. All the main banks refused Michelle's request for a $100 loan, even though she had a business plan. Michelle did not want to use a crowdfunding platform. Finally, a development bank specialising in micro-finance agreed to lend her the capital she needed. That was three years ago – she now employs three other people and is planning further expansion of her business.
   a Define 'micro-finance'. [2]
   b Identify **two** reasons why Michelle needed $100 to start her business. [2]
   c Outline **two** likely reasons why Michelle decided not to try to raise the capital she needed by using crowdfunding. [4]
   d Michelle now wants to expand her business further. Explain **two** benefits of using internal sources of finance to pay for this. [6]
   e Ten years after setting up her business, Michelle converted it into a public limited company to raise finance for business expansion. Do you think she was right to do this? Justify your answer. [6]

2 Akram owns a small farm. The income of the business varies greatly during the year. The farm makes a small profit but Akram is ambitious. He wants to take over a neighbour's farm and increase the range of crops he sells. He thinks that he needs long-term finance and plans to take out a bank loan to pay for the takeover. He has already borrowed money to buy a new tractor. A friend has advised him to form a company and sell shares.
   a Define 'long-term finance'. [2]
   b Identify **two** types of short-term finance Akram could use when farm income is low. [2]
   c Outline **two** forms of internal finance Akram could have used to buy the tractor. [4]
   d Explain **two** pieces of information a bank would look at before granting a loan to Akram. [6]
   e Explain **two** sources of finance which could be used for the takeover. Justify which source should be used. [6]

Revision checklist

In this chapter you have learned to:

✔ recognise the different reasons why businesses need finance
✔ identify sources of finance as being either internal or external and whether they are short term or long term.
✔ analyse and compare the advantages and disadvantages of different sources of finance
✔ analyse a firm's need for funds and make a reasoned choice between the different sources of finance available
✔ make decisions on whether finance should be provided to a business from the viewpoint of shareholders, banks and other institutions.

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21

Business finance: needs and sources

This chapter will explain:

- ★ the main reasons why businesses need finance, e.g. start-up capital, capital for expansion and additional working capital
- ★ how to understand the differences between short-term and long-term finance needs
- ★ the main sources of capital: internal sources and external sources with examples
- ★ short-term and long-term sources with examples, e.g. overdraft for short-term finance and debt or equity for long-term finance
- ★ importance of alternative sources of capital, e.g. micro-finance, crowdfunding
- ★ the main factors considered in making a financial choice, e.g. size and legal form of business, amount required, length of time, existing loans
- ★ how to recommend and justify appropriate source(s) of finance in given circumstances.

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- starting up a business
- expansion of an existing business
- additional working capital.

Starting up a business

When an entrepreneur plans to start their own business, they should think about all of the buildings, land and equipment they will need to buy in order to start trading. These are usually called fixed assets (see Chapter 24). Nearly all new businesses will need to purchase some of these. In addition, the owner of the firm will need to obtain finance to purchase other assets such as inventories, before goods can be sold to the first customers. The finance needed to launch a new business is often called **start-up capital**.

Expanding an existing business

The owners of a successful business will often take a decision to expand it in order to increase profits.

Additional fixed assets could be purchased – such as larger buildings and more machinery or another business could be purchased through a takeover.

Other types of expansion include developing new products to reach new markets. This form of growth could require substantial amounts of finance for research and development.

Additional working capital

Working capital is often described as the 'life blood' of a business. It is finance that is constantly needed by firms to pay for all their day-to-day activities. They have to pay wages, pay for raw materials, pay electricity bills and so on. The money available to them to do this is known as the firm's working capital. It is vital to a business to have sufficient working capital to meet all its requirements. Many businesses have stopped trading, not because they were unprofitable, but because they suffered from shortages of working capital.

So, the third major business need for finance is often to raise additional working capital.

In all three cases above, businesses may need finance to pay for either **capital expenditure** or **revenue expenditure**. It is important to understand the difference.

- Capital expenditure is money spent on non-current assets such as buildings which will last for more than one year. These assets are needed at the start of a business and as it expands.
- Revenue expenditure is money spent on day-to-day expenses, for example, wages or rent.

Definitions to learn

Start-up capital is the finance needed by a new business to pay for essential fixed and current assets before it can begin trading.

Working capital is the finance needed by a business to pay its day-to-day costs.

Capital expenditure is money spent on fixed assets which will last for more than one year.

Revenue expenditure is money spent on day-to-day expenses which do not involve the purchase of a long-term asset, for example, wages or rent.

Key info

One of the most common reasons for new business start-ups failing is not a lack of finance for buildings or equipment but a lack of finance for meeting regular expenses - especially before cash starts to flow in to the business from sales to customers. This is a shortage of working capital.

REVISION SUMMARY

Financial needs of business

Activity 21.1

Look at the list below of expenses for a sports centre. Copy out the table and tick whether you consider each is either revenue expenditure or capital expenditure.

	Revenue expenditure	Capital expenditure
Purchase of building		
Water rates		
Staff wages		
Office computer		
Gym equipment		
Maintenance of equipment		

Activity 21.2: Paul's taxi business

Paul has decided to leave his job to set up his own taxi business.

a Explain to Paul why he will need finance for his new business.
b Make a list of the likely set-up costs of this business for its first month of operation.
c Indicate which of these costs are revenue expenditure and which are capital expenditure. Explain your answer.

Definitions to learn

Internal finance is obtained from within the business itself.

External finance is obtained from sources outside of and separate from the business.

Sources of finance

There are many different sources of finance available. It is common to split them up, or classify them, into different groups. The two most common ways of doing this are:

- **internal** or **external** sources of finance
- short-term or long-term sources of finance.

Internal finance

The most common examples of internal finance are as follows.

Retained profit

This is profit kept in the business after the owners have taken their share of the profits. It has the following advantages.

- Retained profit does not have to be repaid unlike, for example, a loan.
- There is no interest to pay – the capital is raised from within the business.

There are disadvantages too.

- A new business will not have any retained profits.
- Many small firms' profits might be too low to finance the expansion needed.
- Keeping more profits in the business reduces payments to owners, for example, dividends to shareholders who might invest in other businesses instead.

Sale of existing assets

Existing assets that could be sold are those items of value which are no longer required by the business, for example, redundant buildings or surplus equipment.

- This makes better use of the capital tied up in the business.
- It does not increase the debts of the business.

However:

- It may take some time to sell these assets and the amount raised is never certain until the asset is sold.
- This source of finance is not available for new businesses as they have no surplus assets to sell.

Sale of inventories to reduce inventory levels

- This reduces the opportunity cost and storage cost of high inventory levels.

However:

- It must be done carefully to avoid disappointing customers if not enough goods are kept as inventory.

Owners' savings

A sole trader or members of a partnership can put more of their savings into their unincorporated businesses. As we saw in Chapter 4, the owners of these firms are not separate from their businesses and therefore such finance is called internal.

Advantages include:

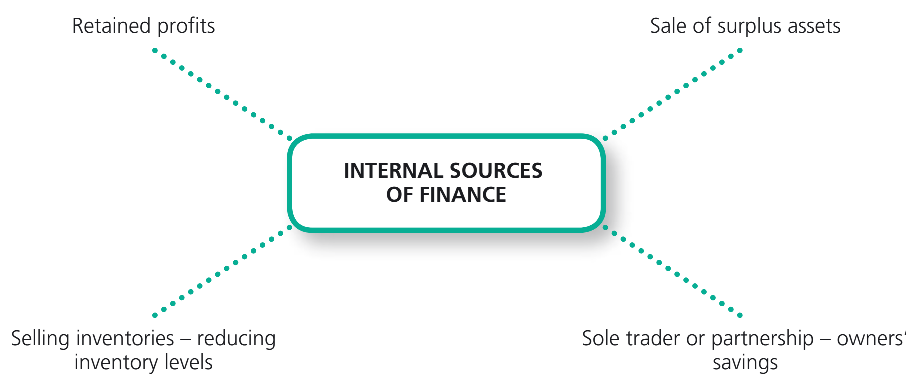
- It should be available to the firm quickly.
- No interest is paid.

However:

- Savings may be too low.
- It increases the risk taken by the owners as they have unlimited liability.

REVISION SUMMARY

Internal sources of finance



Activity 21.3: Paul asks for your help

Paul needs advice on sources of finance before going ahead with his business plan (Activity 21.2). Explain to him why:

a retained profits are not, to start with, a possible source of finance
b his savings will likely be an important source of funds
c selling off inventories is never likely to be an available source of finance to his taxi business.

External finance

The most common forms of external finance are as follows.

Issue of shares

This source of finance is only possible for limited companies.

- This is a permanent source of capital which would not have to be repaid to shareholders.
- No interest has to be paid.

However:

- Dividends are paid after tax, whereas interest on loans is paid before tax is deducted.
- Dividends will be expected by the shareholders.
- The ownership of the company could change hands if many shares are sold, which the original owners might object to.

Bank loans

A bank loan is a sum of money obtained from a bank which must be repaid and on which interest is payable.

- These are usually quick to arrange.
- They can be for varying lengths of time.
- Large companies are often offered low rates of interest by banks if they borrow large sums.

However:

- A bank loan will have to be repaid eventually and interest must be paid.
- Security or collateral is usually required. This means the bank may insist that it has the right to sell some of the property of the business if it fails to pay interest or does not repay the loan. A sole trader may have to put his or her own house up as security on a bank loan.

Selling debentures

These are long-term loan certificates issued by limited companies.

- Debentures can be used to raise very long-term finance, for example, 25 years.

However:

- As with loans, these must be repaid and interest must be paid.

Factoring of debts

A debtor is a customer who owes a business money for goods bought. Debt factors are specialist agencies that 'buy' the claims on debtors of businesses for immediate cash. For example, a debt factor may offer 90 per cent of an existing debt. The debtor will then pay the factor and the 10 per cent represents the factor's profit – when the factor collects payment from the debtor.

- Immediate cash is made available to the business.
- The risk of collecting the debt becomes the factor's and not the business's.

However:

- The business does not receive 100 per cent of the value of its debts.

Grants and subsidies from outside agencies

Outside agencies include, for example, the government.

- These grants and subsidies usually do not have to be repaid.

However:

- They are often given with 'strings attached', for example, the firm must locate in a particular area.

Alternative sources of capital

The sources of finance that have been explained so far are very widely used by existing businesses or start-up businesses with a detailed business plan supported by owners' capital. In recent years, other sources of capital have become available to very small business start-ups, especially in developing economies, and to start-ups that carry significant risk, which can make sources of capital difficult to obtain.

Micro-finance

In many low-income developing countries, traditional commercial banks have been very unwilling to lend to poor people – even if they wanted the finance to set up an enterprise. Banks did not lend because:

- The size of the loans required by poor customers – perhaps a few dollars – meant that the bank could not make a profit from the loans.
- The poorer groups in society often have no asset to act as 'security' for loans – banks are usually not prepared to take risks by lending without some form of security (assets they can sell if the borrower cannot repay).

Definition to learn

Micro-finance is providing financial services – including small loans – to poor people not served by traditional banks.

Specialist institutions have been set up in most developing countries to meet the financial needs of poor people – especially poor entrepreneurs. The most famous of these is the Grameen Bank in Bangladesh. These institutions, including postal savings banks, finance cooperatives, credit unions and development banks, focus on lending small sums of money to people – hence the term **micro-finance** or micro-credit.

▲ Kaneez Fatima used a micro-finance loan to set up her textiles business – now she employs 20 workers

Case study: 'Micro-finance changed my life'

Baji Parveen lives in Pakistan. She has nine children and she used to ask neighbours for food to help feed them all. All it took to turn Parveen's life round was a $70 loan from the Kashf Foundation. The loan allowed her to start a jewellery-making business which quickly took off. Now she also owns a restaurant and a catering business that employs eight people. She has repaid the original loan and interest on it. She is able to pay for her children to go to high school and college. 'Micro-finance has changed my life,' Parveen says.

Activity 21.4

Read the case study above.

a Why do you think that traditional banks would not lend Parveen money for her business?

b Explain the benefits that this example of micro-finance has given to Parveen, her family and her country.

Key info

Some large and well established banks are now becoming interested in offering micro-finance loans. These banks have found out that some very small enterprises can become successful and often remain as customers of the institution that first lent them small sums. The ICICI Bank, India's second-largest bank, has opened more than 2,000 rural internet kiosks that provide financial services throughout India. Brazil's Caixa Econômica Federal Bank is extending financial services franchises to nearly 14,000 outlets, including lottery kiosks, supermarkets and local shops in Brazil.

Crowdfunding

Definition to learn

Crowdfunding is funding a project or venture by raising money from a large number of people who each contribute a relatively small amount, typically via the internet.

This idea of raising finance for new business start-ups by encouraging a large number of people to each invest small amounts has been used for many years. However, it has only become very popular since the widespread use of the internet. This allows entrepreneurs to contact millions of potential investors around the globe, usually by using '**crowdfunding** platforms' such as Kickstarter, Rocket Hub and FundAnything. It is a source which is not suitable for raising very small sums – an invitation to global investors is not worthwhile if only $1,000 is required! Crowdfunding is claimed to have these benefits:

- No initial fees are payable to the crowdfunding platform. Instead, if the finance required is raised, the platform will charge a percentage fee of this amount.
- Allows the public's reaction to the new business venture to be tested. If people are not prepared to invest, it probably is not a very good business idea.
- Can be a fast way to raise substantial sums.
- Often used by entrepreneurs when other 'traditional' sources are not available.

However:

- Crowdfunding platforms may reject an entrepreneur's proposal if it is not well thought out.
- If the total amount required is not raised, the finance that has been promised will have to be repaid.
- Media interest and publicity need to be generated to increase the chance of success.
- Publicising the new business idea or product on the crowdfunding platform could allow competitors to 'steal' the idea and reach the market first with a similar product.

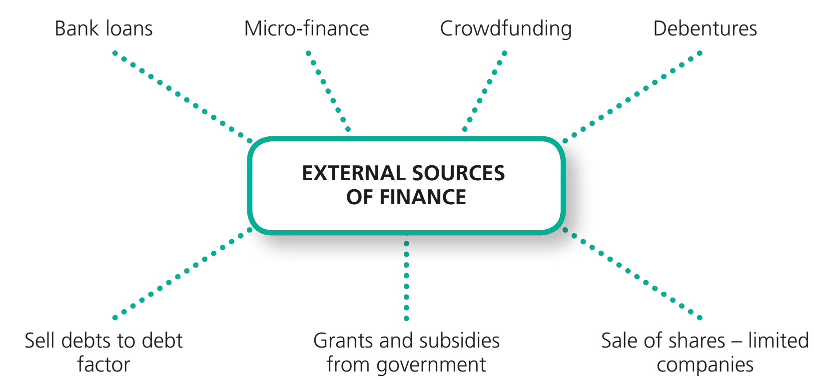
▲ Chilango, the Mexican restaurant chain, raised £5.41M using the Crowdcube lending platform

Key info

Crowdfunding is now the fastest growing source of finance for business start-ups. Globally, US$34.3 billion was raised in this way in 2015. The World Bank forecasts this could reach US$90 billion by 2020 – some analysts think this is too pessimistic and this total might be reached by 2018! One of the biggest crowdfunded projects was for a video game called Star Citizen which raised US$148 million.

REVISION SUMMARY

External sources of finance



Activity 21.5: Paul's business expands

Paul's taxi business has now been operating for two years. He wants to expand by buying another taxi and employing two drivers on a shift system.

a Explain to Paul the benefits of using the business profits to buy the taxi rather than taking out a bank loan.
b When would you advise Paul to take out a bank loan to expand his business?

Short-term and long-term finance

Short-term finance

This provides the working capital needed by businesses for day-to-day operations. Shortages of cash in the short term can be overcome in three main ways.

Overdrafts

These are arranged by a bank.

- The bank gives the business the right to 'overdraw' its bank account (that is, spend more money than is currently in the account).
- The business could use this finance to pay wages or suppliers but, obviously, it cannot do this indefinitely.
- The overdraft will vary each month with the needs of the business – it is said to be a 'flexible' form of borrowing.
- Interest will be paid only on the amount overdrawn.
- Overdrafts can turn out to be cheaper than loans in the short term.

However:

- 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.

Trade credit

This is when a business delays paying its suppliers, which leaves the business in a better cash position.

- It is almost an interest-free loan to the business for the length of time that payment is delayed for.

However:

- The supplier may refuse to give discounts or even refuse to supply any more goods if payment is not made quickly.

Factoring of debts

See page 9 under 'External finance'.

Long-term finance

This is finance which is available for more than a year – and sometimes for very many years. Usually this money would be used to purchase long-term fixed assets, to update or expand the business or to finance a takeover of another business. The main sources of long-term finance are as follows.

Bank loans

These are payable over a fixed period of time. The advantages and disadvantages of these have already been considered under 'External finance'.

Hire purchase

This allows a business to buy a fixed asset over a long period of time with monthly payments which include an interest charge.

- The business does not have to find a large cash sum to purchase the asset.

However:

- A cash deposit is paid at the start of the period.
- Interest payments can be quite high.

Leasing

Leasing an asset allows the business to use an asset but it does not have to purchase it. Monthly leasing payments are made. The business could decide to purchase the asset at the end of the leasing period. Some businesses decide to sell off some fixed assets for cash and lease them back from a leasing company. This is called sale and leaseback.

- The business 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.

However:

- The total cost of the leasing charges will be higher than purchasing the asset.

Tips for success

Remember that only limited companies can raise capital by selling shares – and that only public limited companies can offer shares for sale to the public. See Chapter 4 for details of how sole traders and partnerships can convert to limited company status.

Issue of shares

As we have seen already, this option is available only to limited companies. Shares are often referred to as equities – therefore the sale of shares is sometimes called equity finance.

Public limited companies have the ability to sell a large number of shares to the general public. These new issues, as they are called, can raise very large sums of money but can be expensive to organise and advertise. A rights issue of new shares is a very common way for public limited companies to raise additional capital. This gives existing shareholders the right to buy new shares in proportion to their current holding. This avoids the problem of new shareholders changing the balance of ownership.

See page 9 for the advantages and disadvantages of selling shares to raise finance.

Long-term loans or debt finance

Loans differ from share capital in the following ways:

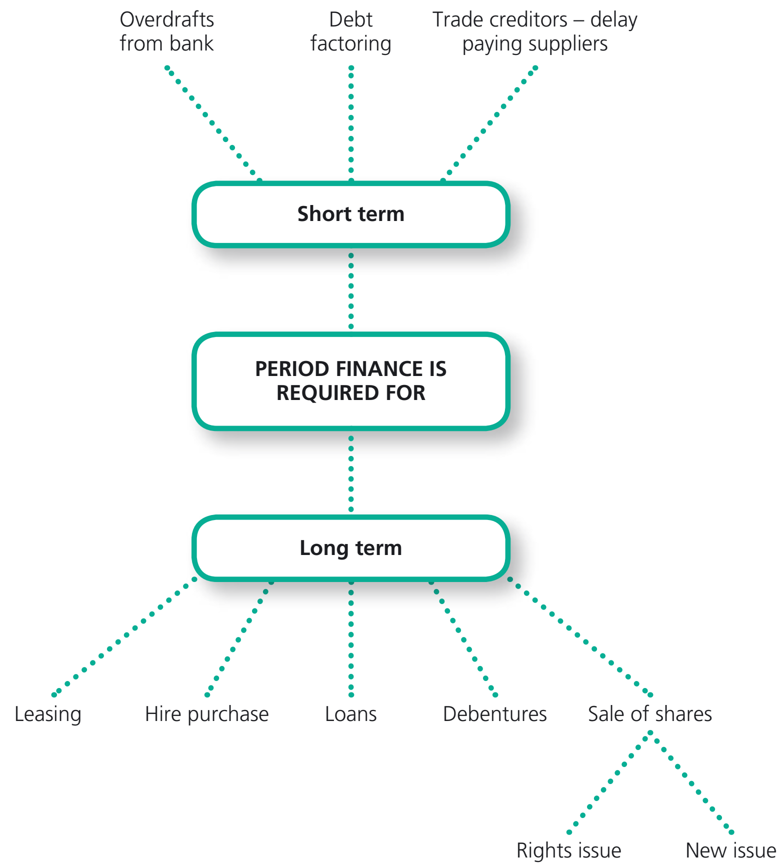
- Loan interest is paid before tax and is an expense.
- Loan interest must be paid every year but dividends do not have to be paid if, for example, the business has made a loss.
- Loans must be repaid, as they are not permanent capital.
- Loans are often 'secured' against particular assets.

The advantages and disadvantages of loans have already been mentioned under 'External finance'.

Debentures

See page 9 under 'External finance'.

REVISION SUMMARY: **Over what period of time is the finance required?**



Activity 21.6

Consider all of the following sources of finance. Are they short-term or long-term sources of finance? Copy out the table and tick the relevant column for each source.

Source of finance	Short-term	Long-term
Overdraft		
Debentures		
Issue of shares		
Four-year bank loan		
Trade credit		
Hire purchase		

Sources of finance: how business makes the choice

We now know the main sources of finance available to businesses. What factors do managers consider before deciding where to obtain finance from?

Purpose and time period

What is the finance to be spent on? Is it to be used to pay for non-current assets or is it needed to pay for a short-term cash flow crisis?

The general rule is to match the source of finance to the use that will be made of it.

- If the use is long term, for example, the purchase of a non-current asset, the source should be long term.
- If the use is short term, for example, the purchase of additional inventories to cover a busy period, the source should be short term.

Think about the disadvantages of buying additional inventories that will only be needed for a few months with a long-term bank loan. Can you see why this would be unwise? What source of finance would be suitable for this?

Amount needed

Different sources will be used, depending on the amount of money needed. A company would not go to the expense of arranging a new share issue if only $5,000 of capital was needed for a short time period.

Legal form and size

Companies, especially public limited companies, have a greater choice of sources of finance. Issuing shares or debentures is not an option for sole traders and partnerships. These businesses, if they have plans to expand, may have to depend on the savings of their owners personal capital. They also often have the disadvantage of having to pay higher interest rates to banks for loans than large and well-established companies.

Case study: Choosing the right source of finance

Company A sells fashion clothing. It needs $15,000 to decorate its shop. A new issue of shares would be the wrong choice. This is because the issue of shares is complicated, expensive to arrange and would take a long time – the firm wants the shop decorated now!

Company B owns three restaurants. It plans to take over another restaurant company and offers $5 million. Company B already has a large bank loan.

Activity 21.7

Read the case study on page 15.

a Advise Company A on the sources of finance that would be suitable.
b Advise Company B on the sources of finance that would be suitable.
c In each case, which source of finance would be the most suitable to use? Explain why you would choose this source rather than the other sources.
d In each case, explain what other information would have been useful before giving your advice.

Control

Owners of businesses may lose control of that business if they ask other people to invest in their firm. Owners may have to decide: what is more important – expanding the business or keeping control of it?

Risk and gearing – does the business already have loans?

An important point about loan capital is that it will raise the gearing of the business – and this is a common measure of risk that the managers are taking. The gearing of a business measures the proportion of total capital raised from long-term loans. If this proportion is very high – say more than 50 per cent – the business is said to be highly geared. This is said to be a risky way of financing a business.

This is risky because interest must be paid on the loans, whether the business is making profits or not. When interest rates are high and company profits are low, the firm may not be able to pay all of the interest. The future of the business will be at risk. Therefore, banks are usually reluctant to lend to highly geared businesses which may have to use other sources of finance.

Activity 21.8

Read the case study on page 17.

a Would you advise each of these three businesses to use loan capital instead of using the sources of finance outlined above? Explain your answer.
b Consider all of these following reasons for a private limited company needing finance. Copy out the table below and, for each type of need, fill in the gaps with:
  i) what you consider could be the most suitable source of finance
  ii) the reason for your choice.

Need for finance	Most suitable source	Reason for choice
Planned takeover of another business		
Temporary increase in inventories over the summer		
Purchase of new car for the Chief Executive		
Research and development of a new product – to come on the market in four years' time		
Cost of building a modern factory requiring much less land than the present one		

Tips for success

'Which is the best source of finance for this business?' is a very common question. Be prepared to analyse the advantages and disadvantages of the main sources of capital – and give a justified recommendation.

Case study

- A sole trader could take on a partner to bring in extra capital – but could that partner start to take important decisions without the original owner's permission?
- The directors of a private limited company could decide to 'go public' and sell shares to the public. This could raise very large sums of money for the business but would the new shareholders own a controlling interest in the business?
- An existing plc could arrange a new issue of shares, but could these be bought by just one or two other companies who may put in a takeover bid?

These problems could all be overcome by using loan finance instead.

REVISION SUMMARY

Choosing sources of finance – factors involved in the decision

CHOOSING SOURCES OF FINANCE

- Purpose and period of time required
- Amount required
- Risk and gearing
- Status and size of business
- Control over the business

Activity 21.9: Joe's dilemma

Joe Dagglio has $15,000 in savings. He wants to buy shares in public limited companies because he has heard that he could earn dividends and make a capital gain if the shares rise in price. He has received details of a plc that is arranging a new issue of shares. The company wishes to expand. He makes a note of the following information.

- The current share price is $5 but it has been as high as $7.
- The average value of shares on the Stock Exchange has risen over the last year.
- The gearing ratio of the company is 55 per cent.
- Interest rates are likely to rise in the next month or so.
- The company is offering high dividends to its existing shareholders.

a Considering all of the risks and possible gains, advise Joe whether he should buy these shares or not.
b What other information would you find helpful in advising Joe?

Key info

The most common reasons why banks often refuse loans to small businesses are:

- weak cash flow
- lack of security or collateral (for example, no assets that can be sold if the business fails)
- poor preparation by the business owner when applying for the loan.

Will banks lend and shareholders invest?

A business can never be sure of being able to raise finance. Banks often refuse to lend to businesses – and shareholders may be reluctant to buy more shares. A business owner, especially of a new start-up business, will increase the chances of obtaining loan finance if the following is available:

- A cash flow forecast which shows why the finance is needed and how it will be used.
- An income statement – for the last time period – and a forecast statement for the next. These should show the chances of the business making a profit in future.
- Details of existing loans and sources of finance being used.

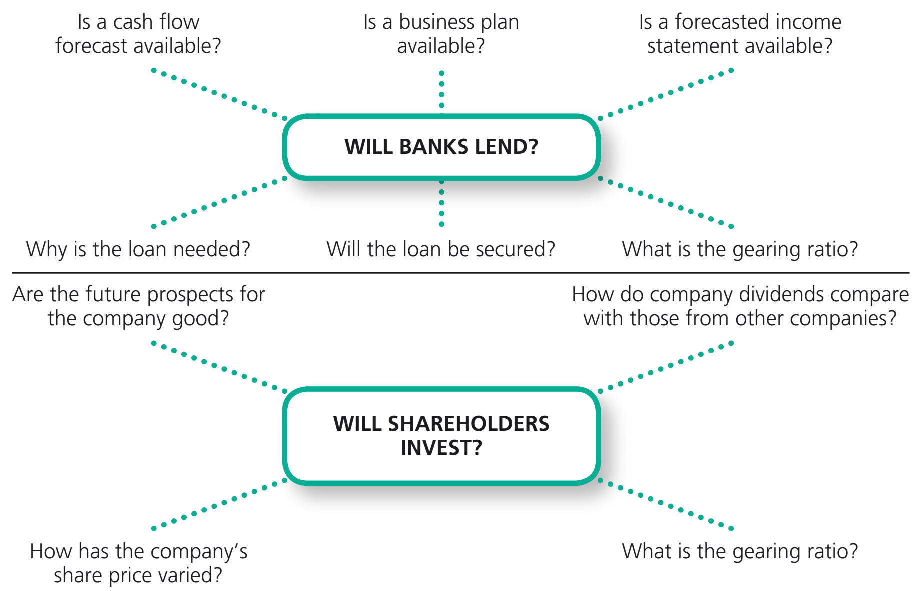
- Evidence that 'security' (or collateral) is available to reduce the bank's risk if it lends.
- A business plan to explain clearly what the business hopes to achieve in the future and why the finance is important to these plans.

Shareholders are most likely to buy additional shares when:

- the company's share price has been increasing
- dividends are high – or profits are rising so dividends might increase in the future
- other companies do not seem such a good investment
- the company has a good reputation and has plans for future growth.

REVISION SUMMARY

Finance from banks and shareholders



International business in focus

Godrej Properties

Indian property developing company Godrej Properties successfully raised over US$90 million from the sale of new shares. The founders of this Mumbai-based company owned near 84 per cent of the company before the share sale – but only 73 per cent once the shares had been sold. The Indian stock market has seen rising share prices this year and this helped to encourage investors to buy these new shares in Godrej Properties.

The company is expected to use the finance raised to reduce its bank loans and to buy more land for the long-term development of further properties.

Discussion points

- Explain whether Godrej Properties raised internal finance or external finance from the sale of shares.
- Why do you think shareholders were so keen to buy these new shares?
- Explain why the company wanted to reduce its bank loans.

Exam-style questions – Paper 1

1 Michelle lost her job when the sugar factory closed. She wanted to start her own business designing and making clothes. She prepared several dress designs which she thought were better than anything else on the market. All the main banks refused Michelle's request for a $100 loan, even though she had a business plan. Michelle did not want to use a crowdfunding platform. Finally, a development bank specialising in micro-finance agreed to lend her the capital she needed. That was three years ago – she now employs three other people and is planning further expansion of her business.

- **a** Define 'micro-finance'. [2]
- **b** Identify **two** reasons why Michelle needed $100 to start her business. [2]
- **c** Outline **two** likely reasons why Michelle decided not to try to raise the capital she needed by using crowdfunding. [4]
- **d** Michelle now wants to expand her business further. Explain **two** benefits of using internal sources of finance to pay for this. [6]
- **e** Ten years after setting up her business, Michelle converted it into a public limited company to raise finance for business expansion. Do you think she was right to do this? Justify your answer. [6]

2 Akram owns a small farm. The income of the business varies greatly during the year. The farm makes a small profit but Akram is ambitious. He wants to take over a neighbour's farm and increase the range of crops he sells. He thinks that he needs long-term finance and plans to take out a bank loan to pay for the takeover. He has already borrowed money to buy a new tractor. A friend has advised him to form a company and sell shares.

- **a** Define 'long-term finance'. [2]
- **b** Identify **two** types of short-term finance Akram could use when farm income is low. [2]
- **c** Outline **two** forms of internal finance Akram could have used to buy the tractor. [4]
- **d** Explain **two** pieces of information a bank would look at before granting a loan to Akram. [6]
- **e** Explain **two** sources of finance which could be used for the takeover. Justify which source should be used. [6]

Revision checklist

In this chapter you have learned to:

- ✔ recognise the different reasons why businesses need finance
- ✔ identify sources of finance as being either internal or external and whether they are short term or long term.
- ✔ analyse and compare the advantages and disadvantages of different sources of finance
- ✔ analyse a firm's need for funds and make a reasoned choice between the different sources of finance available
- ✔ make decisions on whether finance should be provided to a business from the viewpoint of shareholders, banks and other institutions.

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