FACTFILE:
GCE PROFESSIONAL BUSINESS SERVICES

Rewarding Learning

UNIT AS 3: FINANCIAL DECISION MAKING – FINANCE MANAGEMENT

Learning Outcomes

Students should be able to:

- identify, analyse and evaluate the sources of finance available to a business, including the advantages and disadvantages of:
  - internal financial resources, including retained profits, capital and disposal of assets; and
  - external financial resources, including loan capital, overdraft, share issues, leasing, hire purchase, and trade payables and trade receivables; and
- evaluate the appropriate source of finance for a given purpose, considering:
  - cost;
  - time;
  - flexibility of the finance;
  - status and size of the business; and
  - financial situation.

Sources of Finance

Sources of finance represent the different types of funding available to a business, and provide an indication of where the money came from to allow the business to function and meet its objectives. Information regarding sources of finance is usually found within the final accounts. All businesses are required to prepare final accounts, which summarise the key sources of finance and provide an indication of the ways in which finance was used.

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Internal:

Profit After Tax (Retained earnings c/fwd): this is the amount of profit a company has earned for the accounting period, after the deduction of expenses for the accounting period. It is transferred to Profit/Loss Reserve as part of shareholders funds (equity). The Profit/Loss Reserve is the accumulation of profits/losses from previous accounting periods.

- Advantage: cheaper source of finance compared with external sources;
- Disadvantage: increasing profits are not guaranteed in each trading period.

Net Profit (Sole Traders): this is the amount of profit a sole trader has earned for the accounting period, after the deduction of expenses for the accounting period. It is transferred to capital account but reducible by the amount of drawings. Profit retained in the business will represent a source of funds for use in the future.

- Advantage: cheaper source of finance compared with external sources;
- Disadvantage: increasing profits are not guaranteed in each trading period.

Owner's Capital (Sole Traders): this represents the amount of money invested in the business by a sole trader. It can be increased by the introduction of additional funds or net profits or decreased with the impact of a net loss or drawings made by the owner. An increase in profit will represent an additional source of funds for the business.

- Advantage: cheaper source of finance compared with external sources
- Disadvantage: may be difficult for a small business to find additional capital

Disposal of Assets: an asset is an item of value held by a business which is likely to generate future income.

Disposal of non-current assets: A business may gain finance from the disposal of non-current assets. Examples include:

- **Disposal of Tangible assets:**
  Property/premises, plant/machinery and equipment: items that may be physically viewed and of a tangible nature (e.g. a vehicle, factory, office furniture). A business may dispose of these at a higher value than the original purchase price, so a profit is made with the generation of additional cash flows. Conversely, if the non-current asset is disposed of at less than cost price or written down value, a loss on disposal will arise and the business will only receive cash flows equivalent to the disposal proceeds.

- **Disposal of Intangible assets:**
  Intellectual rights/property: items of value but which may not be physical in nature. A business may dispose of these at a higher value than the original purchase price, so a profit is made on disposal with the generation of additional cash flows. Conversely, if the non-current is disposed of at less than cost price or written down value, a loss on disposal will arise and the business will only receive cash flows equivalent to the disposal proceeds.

  - Intangible assets – these include investments such as part ownerships of another business (e.g. stocks/shares) or investment bonds which are held in order to earn investment income. As with comparable non-current assets, a business may dispose of these at a higher value than the original purchase price, so a profit is made on disposal with the generation of additional cash flows. Conversely, if the non-current is disposed of at less than cost price or written down value, a loss on disposal will arise and the business will only receive cash flows equivalent to the disposal proceeds;
  - Advantage: proceeds of an asset disposal can be re-invested in the business quickly;
  - Disadvantage: may not receive as much money as predicted due to depreciation of asset.

Inventories

Goods that have been purchased for resale but remain unsold as at the year end. A business may realise funds from the sale of inventories at the sale price. However, if the value of inventories is disproportionate to the other current assets or cash flows, then a consultant might suggest that such inventories might be disposed of at a discount in order to release funds for use in other parts of the business. Reasons for large stock holdings should be investigated, including:

- End-of-line product runs.
- Seasonal fluctuations.
- Business cycles.
- Out-of-date/obsolete items.

Internal sources of finance tend to be cheaper for a business.

- Advantage: inventory reductions make more cash available to fund other projects.
- Disadvantage: may be difficult to sell dated/ end-of-line products so less money is received.

External Sources of Finance

Debt:
Loan Capital: a loan is an amount of money borrowed from a lender, which is usually repaid over a fixed time period and at a fixed rate of interest. A lender may be a financial institution or financial services provider such as a bank, debenture-holder, leasing company, another business or another individual/friends/family.

- Advantage: an advance allows the business to proceed with an investment/purchase;
- Disadvantage: may be an expensive form of finance, if interest rates increase.

Share Capital (companies)

Ordinary shares: this represents the amount of money invested in the company by its shareholders. A share is a ‘unit’ or ‘part’ of the total capital of a company. An ordinary share attracts voting rights at an AGM and is entitled to a variable rate of dividend.

Preference shares: this represents the amount of money invested in the company by preference shareholders. A preference shareholder does not have voting rights and only attracts a fixed rate of dividend, paid in preference to an ordinary dividend.

Dividends: These are payments to shareholders representing a return on their investment. Dividends are usually paid on an annual basis, and whilst they represent a distribution of profits by the company, a reduction or cut in dividends paid will represent a source of finance for a company. Alternatively, a company which has invested in another company’s shares will received dividend income and this represents an additional source of finance.

- Advantage: cheaper source of finance compared with debt;
- Disadvantage: ordinary dividends are not guaranteed; preference dividends are fixed.

Leasing: a lease is an agreement between two parties to provide a business with an asset which is required for use in a business for a fixed period of time, in return for a fixed amount of money repaid over a fixed time period, however, the key difference in this context is that the lessor owns the asset at all times. The lessee returns the asset to the owner (lessor) at the end of the contract period. Examples of non-current assets which are leased include vehicles and equipment – typically accessible through the use of an Operating Lease.

- Advantage: provides a business with access to an asset to facilitate business operations;
- Disadvantage: business will not own the asset during lease agreement.

Hire Purchase: This is an agreement between two parties to provide a business with an asset which is required for use in a business for a fixed period of time, in return for a fixed amount of money repaid over a fixed time period, however, the key difference in this context is that the hire purchase company owns the asset at all times until the final payment has been made by the customer. Once the final payment has been made, at the end of the contract period ownership of the asset transfers to the customer. Examples of non-current assets which are acquired using hire purchase include vehicles and equipment.

- Advantage: provides a business with access to an asset to facilitate business operations;
- Disadvantage: may be expensive method of finance as interest is paid on top of principal amount borrowed.

Trade receivables: Money that is owed by customers to the business (i.e. goods sold on credit or provided in advance of the business receiving money for such goods/services).

Effective credit control policies enforced by a business should ensure that sufficient funding is available to finance other parts of the business.

- Advantage: may encourage an increase in sales revenues if customers take advantage of credit terms allowed;
- Disadvantage: increased risk of bad debts and credit control costs.

Trade payables: Money that is owed by a business to a supplier who provided goods/services on credit. In order to maximise opportunities for funding, a business should ensure that the maximum available credit limit is obtained.

- Advantage: a cheap source of finance since goods provided at 0% interest for a short time until invoice is paid;
- Disadvantage: suppliers may refuse to supply if original invoices/debt is not paid quickly.

Bank overdraft: a short term lending facility provided by a bank to allow a business to pay outstanding debts or expenses until additional funds/revenues/income is received. Should not be used as a source of long term finance as interest is charged on a daily basis.

- Advantage: suitable for short term financial needs, e.g. fund a cash deficit;
- Disadvantage: an expensive method of finance if used over the long term.

External sources of finance tend to be more expensive for a business and will increase operating costs.

Sources of Funding - Case Studies

When considering different sources of finance, it is important to consider each source in relation to:

- Cost (cheapest source of finance is preferable) e.g: Almac Ltd in Portadown, are more likely to fund the construction of a new factory using a loan since the cost is large and over a long time period.
- Time (the longer the repayment period, the greater the interest charged, but improves short term cash flows) e.g: If Almac Ltd in Portadown were to fund the construction of a new factory, then by its nature, it is a long term project and they can spread the repayments over the lifetime of the project, e.g. 50 years.
- Flexibility (some restrictions may be placed on the use of finance by the lender and/or the amount available). Suppliers may only grant credit for fixed time periods or lenders may insist on a fixed term loan agreement e.g: A business such as Bemis Company Inc., locating in Belfast is likely to finance short term finance requirements e.g. inventory purchases and trade payables, using a bank overdraft. It would not be effective to finance the purchase of premises using a bank overdraft since the overdraft is intended for short term use only, as opposed to the long term nature of the buildings.
- Status/Size (the larger the business, the greater the likelihood of obtaining debt finance; small businesses often incur difficulty obtaining debt finance). Blue-chip companies are the safest form of investment. In deciding to locate in Belfast, Bemis Company Inc., would use its global size/status to seek the most favourable sources of finance to allow it to proceed with business operations, such as locating to Northern Ireland.
- Financial Situation (a business must determine the reasons for seeking funding e.g. reduce current debts levels or financing a growth strategy; this will ensure that the correct funding source and amount is used for the correct purpose. In deciding to locate in Belfast, Bemis Company Inc., would use its global financial situation (e.g. high profit levels, strong solvency position) to seek the most favourable sources of finance to allow it to proceed with business operations, such as locating to Northern Ireland.

Summary

Sources of finance typically include internal and external sources.

Each source of finance should be properly evaluated with reference to a range of factors to determine suitability.

Questions

1. Explain what is meant by the term 'Sources of Finance'.

2. Compare and contrast the use of two sources of internal finance and two sources of external finance in a local business. To what extent does each source of finance enable the business to achieve its objectives?

Sources for further study

www.bbc.co.uk/news/business

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