LESSON 8

UNIT 8: SOURCES OF FINANCE

Lesson Objectives:
Student should be able to:

- **Understand the concept of finance in workplace**
- **Develop the knowledge on finance**
- **Differentiate between internal sources of finance and external sources of finance**

Definition:

Sources of Finance

Introduction

Financial accounts are the records of the financial dealing of business, their everyday transaction.

Role of financial accounting:

- record financial transaction
- Help the manager to manage the business
- Provide other stakeholders with legal information

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Internal sources of finance are available to the firm, but these may be more limited in scope, and for large projects, the firm may be forced to turn to banks or other institutions (external sources) to help them raise sufficient funding. The main internal and external sources are:

Internal sources

Internal sources are often preferable to a firm as they will usually be cheaper and perhaps easier to arrange at short notice. However, the potential for arranging large amounts of finance may be low. The main internal sources are:

- **Profit** - the company of course has to be profitable for this to be a source, and it must be available in cash. Often, this is not viable as they may have paid the profit in dividend to the shareholders, or perhaps already tied the money up for other reasons.

- **Reduce working capital** - the firm may be able to raise some money for investment if they can reduce their stock level (through improved stock control) or perhaps improve their credit control and ensure that they collect their debts more promptly and delay payment to creditors for as long as is possible.

- **Sale of assets or perhaps sale and leaseback** - this will depend on the value of the assets, but the firm may either be able to sell surplus assets (if they have any) or perhaps sell existing assets that they use to a specialist leasing company and then lease them back. This will give them access to some capital, though they are then burdened with annual leasing costs.

External sources

- **Loans** - this is where the banks start to come into play. Banks will lend for either short-term or long-term purposes, but the nature of the loan will tend to differ. The main types are:

  - **Overdrafts** - this is a short-term facility where you can spend money, to an agreed limit, as you want. The bank will charge interest on any overdraft amount. They may only offer this as a short-term facility, but it can be very valuable for firms to fill short-term shortages of working capital or any possible brief cash flow problems.

  - **Long-term loans** - long-term loans usually refer to lending over five years. The bank lends you a sum of money for a set time at an agreed rate of interest. It is more expensive than an overdraft, but lasts longer. The bank may well want some sort of guarantee for this type of loan to ensure that they get it back. It could perhaps be secured against an asset of the business.

  - **Debentures** - a debenture is a specialised form of loan. It is effectively a loan from people to the firm that will be repaid at a fixed date. Between the issue of the debenture and the maturity date, the firm will pay a set level of interest. They are a common way for businesses to raise money and are relatively low risk, though this will depend on the stability of the business.

- **Shareholders** - limited companies or plc's can issue shares. These shares can be issued at a certain price though this price will depend on the profitability of the company and its prospects, so how successful the issue is will depend on how the markets view this.

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- **Factoring debts** - the firm may be able to sell their debts to a specialist debt-factoring company. This means that the firm sells their debts to the factoring company who pays them a proportion of the debts immediately. In this way the firm raises some immediate finance. The debt factoring company makes their money by collecting the whole debt when it is due (having only paid the original firm a proportion of the debt).

Raising funds - which source is best?

The choice of source of funds that a business makes will depend on a number of factors. These include:

- **Cost** - this has to be one of the most important. To use an overdraft for the medium- to long-term may be an expensive way of raising money and so businesses need to look carefully at the cost of each of their loan options. This will mainly be the rate of interest charged, but there may be other costs as well (charges for debt factoring, leasing charges and so on).

- **Financial outlook** - the financial strength of a business may also be a key determinant. If the business already has a very high gearing ratio, then they may want to look carefully to see if they can access internal sources of funds

before borrowing even more. They may also find that banks and other lenders are going to be less willing to lend if they are not in a strong financial position.

- **Legal status** - a sole trader will be unable to issue shares and may also face much higher rates of interest on loans as they may be considered a greater risk. The business status may therefore influence the routes that are available to them for raising money.
- **Time period** - the company needs to plan ahead carefully to see how long they will need the funds for. The shorter the time period, the more they may be able to reduce the cost of the borrowing. If it is very long-term finance required, then they may want to look at debentures or share issues. In the short-term, a simple overdraft may be the most flexible solution.

The Balance Sheet

The balance sheet is one of the financial statements that limited companies and plc's produce every year for their shareholders. It is like a financial snapshot of the company's financial situation at that moment in time. It is worked out at the company's year-end, giving the company's assets and liabilities at that moment.

It is given in two halves - the top half shows where the money is currently being used in the business (the net assets), and the bottom half shows where that money came from (the capital employed). The value of the two halves must be the same - Capital employed = net assets, hence the term balance sheet.

The money invested in the business may have been used to buy long-term assets or short-term assets. The long-term assets are known as fixed assets, and help the firm to produce. Examples would be machinery, equipment, computers and so on, none of which actually get used up in the production process. The short-term assets are known as current assets - assets which are used day to day by the firm. The current assets may include cash, stocks and debtors.

The top half of the balance sheet will therefore be made up of the total of the fixed and current assets, less any current or long-term liabilities the firm may have (creditors, loans and so on). It may look as follows:

			£ million
Fixed assets			200
Current assets	- stock	40	
	- debtors	50	
	- cash	20	
	TOTAL	110	
less Current liabilities		(40)	70
NET ASSETS			£270m

The bottom half of the balance sheet then looks at where this money came from. This depends on how the business was originally funded. The main source of money for a limited company starting up is the issue of shares. This is termed the share capital - the money the original shareholders put into the business. From then on the assets of the company may be built up by ploughing profit back into the business. This is called

retained profit, and is the other source of money usually included in the bottom half of the balance sheet. This may therefore look as follows:

Share capital	100
Retained profit	170
CAPITAL EMPLOYED	£270m

Profit and Loss Account

This page tells you all about what a profit & loss account is and how it is constructed. The profit and loss account differs significantly from the balance sheet in that it is a record of the firm's trading activities over a period of time whereas the balance sheet is the financial position at a moment in time.

The profit and loss account looks at how well the firm has traded over the time period concerned (usually the last 6 months or year). It basically shows how much the firm has earned from selling its product or service, and how much it has paid out in costs (production costs, salaries and so on). The net of these two is the amount of profit they've earned. In essence this is what the P & L account shows. It just shows it in more detail!

A profit and loss account would usually be made up as follows:

	£ million
Turnover (sales revenue)	500
less Cost of goods sold	(200)
Gross profit	300
less other costs @	(100)
Trading / operating profit	200
****	
Profit for shareholders (dividends)	75
Retained profit	125

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@ These other costs may include marketing and distribution costs, office costs and so on. They are also known as indirect costs or overheads.

**** In here may also be included any other income or expenses. These may include interest - paid or received - tax, extraordinary items (profits from selling assets or parts of the company) and so on.

The final retained profit figure is the one that goes to the balance sheet as a source of funds for the company to use. This retained profit may be used to buy fixed assets (machinery, equipment etc.) or it may remain as current assets (cash in the bank perhaps).

Main references

Buckley, Martin W (1994), The Structure of Business, 3rd Edition, Pitman Publishing.
Floyd, David (2001), GCSE Revise Study Guide: Business Studies, Letts Educational.

Additional Reading
Website: www.bized.ac.uk