Sources of finance assignment

Law

Long term Is generally over one year and used or things such as buying property or expanding a business. In this assignment It Is going to look at how existing businesses and new businesses will use these types of borrowing as a source of finance. Long term finance Owners capital refers to the amount of money the owner puts Into the business themselves. This is regarded as long term finance as the money will stay with the business as long as it exists. This could be savings, money received in result of a redundancy payment or money left to them in a will.

The advantage of this source is that it doesn’t have any interest because it’s the owners money so you don’t need to ay anyone back unlike bank loans. In comparison to loans, this is generally more convenient because you don’t need to worry about paying back the bank and the interest rates. This source is more flexible than others because there is no restriction on the money so the owner can spend it on whatever they like. However, the disadvantage of this would be if the business fails then you are likely to lose your investment. It also comes with an opportunity cost.

This is defined as what you could have done with the money; for example, you were going to use it to buy a house but o contribute it to starting up a business, this is the opportunity cost. If businesses do not contribute the owners capital then it is unlikely they will receive any loans from banks or other investors. This is because if you were an investor and you saw a business that isn’t willing to take the risk and contribute their own money, you wouldn’t invest your own money in them. Depending on how much the owner’s capital is going to be, this can be mixed with bank loans to go towards a business start-up.

For example, I am going to open a Chinese take-away and invest EIA, OHO into he business but my priority is to buy utensils and refurbish the building. I could use my Investment into refurbishing and since I contribute my own money I could get a loan from the bank to buy my utensils. This source of finance Is suitable for new businesses to get them up and running however It can also be used for existing businesses who want to expand. Venture capital Is the money that Is provided to businesses by Investors.

These Investors are named venture capitalists who could either be a group of wealthy Individuals or a company who make their money by Investing on businesses. They re often seeking for new or growing businesses who they believe have potential and hope to develop them. There are some advantages for this source: it is a good option it’s harder for them to secure a bank loan. The money the venture capitalists contribute is usually more than what banks are willing to lend. Businesses are also interested in but the contacts these wealthy people have which could help their business expand in many different ways.

For example, in Dragons Den, Peter Jones offers EYE 000 to a business for 50% of the company which is 25% more than what the business was prepared to give away however with Peter being a wealthy and expectable entrepreneur they gave him what he wanted. They believe Peter has the contacts which could help their business expand rapidly. If a business could secure a venture capital, it is more beneficial than a bank loan because there are no interest rates however the disadvantage is you risk losing some independence to the investors.

They calculate how much money they are willing to invest and the percentage by considering the risk and reward. Usually, a new business is considered high risk because they have limited operating history but if they are believed to have potential then the investors will ask for a high percentage of the cuisines for it to achieve a high profitable reward. It is likely the venture capitalists will make decisions for the company. If businesses are willing to sacrifice part of their business then this source is recommended because it could broaden the company.

Bank loans are regarded as long term finance because the money can be borrowed up to 25 years or longer in some circumstances. All loans have an interest rate attached to them. The interest rate is often calculated by how much the business borrows. The more you borrow the more interest you are going to pay. For example, if I borrow EYE from Barclay bank, I will be charged 4. % PAR whereas if I borrow E30000 1 will be charged at 6. 9% PAR. It could affect your loan if the interest rates go up so more businesses take out a loan on a fixed rate of interest where they won't be charge any extra costs if the interest rates increase.

If a variable rate loan is taking out, the interest rates can change which makes it harder to manage finance. Bank loans could be used by new and existing businesses; a new business can use it to buy equipment and an existing business could use it to expand the company for example, buying new premises. An existing business will tend to be able to borrow ore than a new business. This is because they have been operating for longer and banks generally find them more reputable. If these companies wish to

borrow an excessive sum of money then extra security is needed to ensure the money is paid back.

Often banks will ask the business to use their property as a security for the loan. It means if the business fails then the bank could recover the money from selling their property. This is usually referred as a second mortgage. Most businesses use this source to their advantage because it is convenient and the money could be borrowed for a lengthy period. For some businesses, it could be looked at as a better option than securing a venture capital because you aren't losing a share of the business for money but you also have decision on where the money could be spend; you have more independence with the money.

The disadvantage is the interest rate could be quite high whereas if an owner's capital was available, a repayment is not necessary. Also, if your business fails and you have taken out a second mortgage you could lose your property. Generally, bank loans work out quite expensive in the long A mortgage is a loan used for purchasing a property and could be paid back in the pace of 25 years or sometimes more. The property then becomes the borrower's collateral which needs to be paid off as they agreed with the lenders.

If there is a failure of payment then the lenders can repossess the property and sell it at an auction to recover the money. This source is common for both new and existing businesses that need a mortgage for their work premises. The advantage of mortgages is the fact they are usually more manageable and affordable than renting because the repayments are spread

out over a lengthy period. This also depends on the type of the property and other factors such as location and price.

Here is an example, in 2008, house prices dropped in Northern Ireland; therefore buying a house was cheaper. In addition, getting a mortgage was easier and cheaper than renting. Also, once you have paid off your mortgage, you own the property and it could be worth far more than what you paid for it. Often, interest rates on mortgages are lower than a loan because the property is used as collateral. Mortgages fall into two main categories; fixed rate and various rates. Fixed rate is where the interest stays the same over a number of years and various rate means the interest can hanged.

This source also comes with many disadvantages; it is not as flexible as renting because if you want to move out of the property, it is not as easy as canceling a contract with your landlord, you will have to sell the property which can be difficult. Maintenance is one of the problems for instance, if the roof leaks you will have to fix it yourself whereas a rented property it can be repaired for you. The main disadvantage is that you have to keep up with your repayments or you can end up losing your property.

For example, during the credit crunch there was many people add redundant and therefore they struggled to make repayments so their house was repossessed. Although the interest rate is lower on mortgages, it does carry high risk as you are repaying over a long period of time. For a new business it would be advisable to start off with a bank loan to establish a steady flow of finance into a business before considering a mortgage. Retained profits

are defined as capital which is kept in the business. The owner(s) can decide what they want to do with the companies' profits.

This could be for personal use, paid out to shareholders as a dividend or withdrawn as wages for sole reader's also known as owner's drawings. If the owner decides not to touch this money it is referred to as polishing back the profits or organic growth. This is regarded as important long term finance but only relates to existing businesses. There are many advantages of retained profits; the money which is left in the business rather than paid out as a dividend is the opportunity cost for shareholders. The money is reinvested and helps the company expand and could be used for buying new equipment or machinery.

It is an advantageous source of finance because it doesn't have any interest rates attached. It also has a lot of flexibility because the company has control of what is left in the business and what is paid out to dividends. This source of finance has some disadvantages. It could lead to the company getting criticized for restricting the value of dividends and holding on too could cause arguments amongst shareholders and you risk losing them. The shareholders may think the money would be better in their own hands rather than the business.

In order to use this source accordingly, you must maintain good relationships with the shareholders and show that the business has potential to succeed. This is highly recommended for existing businesses because as long as the company exist while making profits, money will be reinvested each day and it could help with the growth of the business. Selling assets is a common

source of long term finance for an existing business. An asset is categorized as any item owned by a business or individual which could range from land to machinery. Business may sell some assets because they have no further need for them.

By selling assets the company can raise money to fund other projects. For example; selling a JOB digger because there is limited work on in the construction tie and it is taking up too much valuable space. These assets can turn into cash which could help the business with advertising or paying off debts. Often businesses sell a successful division of their business to another firm because they believe there is a declining market for their product or service. While it is still going good they will sell this in order to use the money to expand in a new and growing market.

The advantage of selling an asset is you get your money back straight away. Generally, this is a cheaper source of financing your business unlike bank loans where you have to worry about the high interest rates. For many, selling an asset is a good way to reduce or eliminate debt. Although, this seems like a convenient method, the cost of selling assets must be considered. In some cases, you won't receive full market value for the goods but this depends on how quick you want to sell them. The assets could grow in value faster than what you can yield with the cash and also it could come with tax consequences.

This means if you buy an asset and later sell it on for profit, you could be landed with what is called ' Capital Gains Tax'. You could end up with less money than you expected. This financing source mostly applies to existing

genuineness because they would have built more assets than new businesses starting up and would most likely have more debt on their hands. For new businesses, getting a bank loan or owner's capital would be more suitable. Overall; this is a recommended source of finance for existing businesses as it carries little risk in the procedure.

This benefits a lot of businesses because they are usually selling something they no longer require, in order to use the money on something which can help their company grow or eliminate debt. For example, you are investing on a delivering service for your company and plan to get a loan for a van. Your warehouse has several forklifts so you would plan to sell one in order to buy a van. To conclude, you aren't losing money because you are using the money from the asset to start a new service; to expand your business.

Share capital is the capital of a company divided into equal amounts known as shares. There are two companies' which share capital relate to which are private limited companies, (Lad's) or public limited companies (Ply's). In a private limited company, these shares are often sold to family firms but could be sold to family and with all the shareholders. On the other hand, a public limited company can sell hares on a stock exchange to members of the public. This means anyone could buy shares which results in them having a wider source of capital.

A new business is usually classed as a private limited company and may have as little as two shareholders. However, if they expand over time and cannot issue any more shares they might consider about becoming a public limited company. This process is known as floating the business' which has

to go through a number of administrative and legal procedures. A public limited company can raise more because they can sell their shares on the stock exchange. If they want to expand their business but need OHIO million then they can sell OHIO million shares at the stock exchange for El each.

This needs to come with a prospectus which is very important because it gives the investors a better understanding of the company before they commit to buying shares. You will tend to find information such as; how the business is managed, what does the business specialist in, etc. Businesses often use the services of a merchant bank such as Morgan Stanley or Merrill Lynch who specialize in share floatation. This means if all shares are not sold, they will buy them so the business can still raise the none they need. This is a type of insurance policy and you can imagine the cost it has attached to it.

Share capital is attractive and very helpful in raising long term finance for both new and existing businesses. The main advantages are; you will have commitment from your shareholders because like the owner they also want to see the business succeed. In terms where a Pl becomes successful then they will most likely sell more shares to the public. However, if there comes a time when they want to raise more money, they can issue cheaper shares to existing shareholders through a rights issue'. If the company is doing well, and needs money for expansion, this is a quick and cheap way of raising finance.

In comparison to loans, this source is cheaper; all you have to do is pay the shareholders their dividends each year instead of repaying high interest on

bank loans. This financing source is similar to venture capital; if you have the right business angels and venture capitalist, they can bring useful contacts, valuable skills and experience to your company. This could help with business strategy planning, new products ideas or expansion plans. Although, there are some disadvantages too. Depending on the investor, you may lose some independence of the decision making in your business.

For a potential investor to want a share of your business they will want to see reports and forecasts of the company; you may have to provide information for the investor(s) to monitor. This can be time consuming and may take management focus away from core business activities. Overall, share capital is a secure way to raise finance for your company. The money which is invested will stay within the company as long as the company exists and if it is a growing company then it could get good reputation selling shares through the stock exchange. Short term finance

A Bank overdraft is when someone makes an agreement with the bank to spend more than what they have in their account but the money will need to be paid back. This cash flow problems. The money a business receives from sales and the amount they spend is called cash flow. There are two types of overdrafts; authorized and unauthorized. An authorized overdraft is where you are allowed to borrow up to a limit agreed with the bank. An unauthorized overdraft is where you are exceeding your authorized overdraft limit or going below zero in your account without agreeing on an overdraft facility; this should be avoided at all costs.

This source of finance does carry an interest rate but only for the amount overdrawn and the length of time overdrawn. For example, if an overdraft facility allows you to borrow up to EYE; you need EYE on the 1st July to pay rent until you get a payment of EYE from a customer on the 4th July, you will only be charged interest rates on the EYE for 4 days you borrowed. Some banks will charge a fee for customers to use this facility. A bank overdraft is suitable for companies that need the money for a short period of time whether it's for paying staff wages or utility bills.

Although, they must ensure hey have money coming in to cover the cost of the overdraft as it can carry high interest rates; usually higher than bank loans. It can help avoid cheeses bouncing and returned direct debit. This is where there are insufficient funds in the account to make a payment. If this happens, the business will have to pay bank charges and it can also damage relationships with suppliers as they will see the business as untrustworthy and they may not want to supply them with any more stock.

The main advantage of a bank overdraft is the fact that is there when you need it and doesn't cost anything (except for a small fee). You only need to borrow what you need. It can also help maintain the cash flow within the company and allows the business to make essential payments while chasing their own payments. There are many disadvantages too, as mentioned before overdrafts can carry higher interest rates than bank loans which make them expensive for long term financing. In some cases, you may have to secure your business assets to get an overdraft and failing to make repayments can risk you losing your assets.

The main disadvantage and probably most important one is, if you find yourself going over the overdraft limit it would be leased as an unauthorized overdraft where you will be charged high interest rates and bank charges. If the business keeps using over their limit, it could damage their reputation with banks although they can get the limit raised but this is not advisable. If this is done repeatedly the banks will assume the business has financial issues and they can refuse further use of the overdraft service. This source of finance is useful if lending short term but a business should never rely on it.

Trade credit is the time given to a business from the supplier to pay for their stock. It s used in business to business (BIB) transactions. Trade credit is usually 30 days although this can be different depending on the organization. If you agreed 30 days credit with your supplier, you can sell the stock and have the money in your bank account before you pay the supplier. This means you are getting an interest free loan for 30 days. Usually small suppliers prefer to sell their products only to one big company instead of many small companies; this makes payments more manageable.

An example is Carbondale farm only sells their milk to Sad so they will get one invoice from them at the end of the credit period. This is better than having multiple However, big companies like Sad often use this to their advantage and pay the supplier back late. They usually get away with this because Carbondale farm know Sad are their only customers so they cannot afford to lose them. Trade credit is a very important source of finance and has many advantages. It does not carry any interest rates therefore it is better than using bank overdraft.

It can save you from spending money in your account to buy stock and with that money you can use it elsewhere in the business. For new businesses it may be hard to get trade credit cause they have limited operating history but if they shop around they might find a supplier that will offer them a small credit limit to begin with. If they can make payments on time and prove to the suppliers they are reliable then it is possible the credit limit will increase. However the downfall of this source is, if you do not pay the supplier back on time you will get a bad reputation in the industry.

If you constantly make late payments then the suppliers can withdraw this facility and ask for cash payments. It will also be hard for you to get new suppliers because they may be ware of your reputation of late payments; this should be avoided at all costs. Trade credit is a good source of finance being interest free and it can help you build good credit history. This will be useful for getting bank loans or using the overdraft facility. Business credit cards are useful for short term borrowing. It is similar to using trade credit.

If you pay for goods with a credit card, you will receive a statement once a month with the amounts spent in the last month. You will be given a time to pay for what you spent. If the amount is paid off in full you won’t have to pay any interest charges. Although, you do have the alternative of paying a minimum amount in which case you will have to pay interest on the remaining amount owed. This source of finance is recommended for new businesses as it gives them time to receive money from sales before they have to pay their expenses.

It is also a good option for existing businesses but new businesses will tend to use it more to their advantage because it helps to maintain their cash flow and makes it easier for them to get started. An example of this source is if I have Just opened a Chinese take away then I can use my business credit card to buy stock. Once I have sold all my stock and I can pay the amount in full then I will get an interest free loan. Business credit cards have some advantages. It helps track purchases because you will get a statement each month which shows what the business has spent money on.

You can get interest free credit if you pay the balance by the due date. With a business credit card being so convenient it does have its disadvantages. The card can be fixed with high interest rates and if you make late payments or failure to make a payments it can resolve in the interest rate to rise. This can have a significant impact on the companies' credit story and rating. This source is very useful although you should avoid making late payments because if you constantly have debt on the credit card, it can cost the business more money by paying interest rates.

You will have to clear all debt before you can take advantage of the interest free credit again. You should always make payments on time to take advantage of this source. Failure to make payments can cause the business to get bad credit which means it will be harder to use other reputation. A business should take full advantage of trade credit and credit cards for short term enhancing. They are both very similar and suitable for new and existing businesses. However, I recommend using trade credit over credit cards because repayments are more flexible too supplier than too bank.

I mean if you pay your credit card bills late you will be charged with interest but some suppliers are flexible with their payment and they can possibly excuse a late payment. Although, you should always try to make payments on time to avoid damaging company reputation and having bad credit history. Retained profits are considered to be a cheaper source of finance than ann. loans and mortgages. It is the best option available to help an existing company expand because it doesn't carry any interest rates which means more capital for the business.

If the business fails after taking out a bank loan and they can't repay the loan, they can destroy their credit rating, making it difficult or impossible to get loans in the future. If retained profits are used and the business fails then it is Just the companies' investment that will be lost. For a new business, venture capital is considered to be the best source of long term finance. It is not only the investor's none that is important but their skills and experience is crucial and could be the difference between a successful business and an unsuccessful one.

If you are planning to start up your own business you need an owner's capital in order to secure a bank loan. Once the business starts operating it will be able to secure higher loans and take advantage of the retained profits. The retained profits can help the company expand without carrying any interest rates meaning more capital for the business. Trade credit comes in when the business is set up and you want to start selling products. You should shop around and find a good supplier that ill offer you this source and if it's used appropriately you will find it very convenient.