Sources of finance available to a business

There are many types of business entity defined in the legal systems of various countries. These include sole traders, partnerships, limited companies, corporations, cooperatives and other specialized types of organization.

Sole traders:

A sole trader is also known as a sole proprietorship it’s a type of business entity that is. owned and run by one individual and in which there is no legal distinction. between the owner and the business. Partnership: A legal contract entered into by two or more persons in which each agrees to furnish a part of the capital and labor for a business enterprise, and by which each. shares a fixed proportion of profits and losses

Companies or corporations are distinct artificial persons. created in order to separate legal responsibility for the affairs of a business from the personal affairs. of the individuals who own or operate the business.

That are traded on an. official stock market. It is the most common form of legal organization for really. large business, for the very good reason that they have access to very substantial funds. for expansion.

The protection that comes from being a company is therefore substantial. Small firms can gain this protection when the owner. create a private limited company.

If Mr. Javed start business by his own in a form of sole trader ship so the survival will be a bit difficult because the opportunities of businesses are very less so there will be barrier of entries to the market. He also don’t know about the rules and regulations of the country and the tax formats so sole trader ship will give him a bit tough time.

Internal sources of finance: is the name. for a firm using its profits as a source of capital for new investment, rather than distributing them to firm's owners or other investors and. obtaining capital elsewh Hire purchase and leasing: is the legal term for a contract, in this persons usually agree to pay for goods in parts or a percentage at a time. Medium term bank loans: This will have the same advantages. and disadvantages as long term loans. Asset sales: As firms grow they build up assets. These assets could be in the. form of property, machinery, equipment, other companies or even logos. In some cases it may be appropriate for a business to sell off some. of these assets to finance other projects.

Q. 1 Scenario 1:

Mr. Javed has recently come back from US and wants to invest in Pakistan. Javed wants to invest Rs. 5 million personally for a viable business project. He has mentioned his intentions to some of his friends who would also like to invest with him, but he is not sure about adding any further partners to his business. Though there are many advantages of having partners but I want this project to be my baby and don't want to have hassling relationships.

P1: Identify the various forms of business.

There are many types of business entity defined in the legal systems of various countries. These include sole traders, partnerships, limited companies, corporations, cooperatives and other specialized types of organization.

Sole traders:

A sole trader is also known as a sole proprietorship it’s a type of business entity that is. owned and run by one individual and in which there is no legal distinction. between the owner and the business. The sole proprietor is an unincorporated business with one owner. who pays personal income tax on profits from the business. With little government regulation, they are the. simplest business to set up or take apart, making them popular among individual self.. contractors or business owners.

Partnership:

A legal contract entered into by two or more persons in which each agrees to furnish a part of the capital and labor for a business enterprise, and by which each. shares a fixed proportion of profits and losses. A partnership is an arrangement where entities and/or individuals. agree to start a business to achieve their mutual goals. Its relation between two or more persons. who have agreed to share the profits and losses according to their ratio of business run. by all or any one of them acting for all. All agreed conditions of partners. are written in PARTNERSHIP DEED.

Companies or Corporations:

Companies or corporations are distinct artificial persons. created in order to separate legal responsibility for the affairs of a business from the personal affairs. of the individuals who own or operate the business. The business debts are not owners. responsibility, they belong to the company, which is regarded as a separate person in its own right. The. companies acts distinguish between:

Public limited company:

That are traded on an. official stock market. It is the most common form of legal organization for really. large business, for the very good reason that they have access to very substantial funds. for expansion. The standard legal designation of a company which has offered shares to the general public. and has limited liability. A Public Limited Company's stock can be acquired by anyone and holders are only limited. to potentially lose the amount paid for the shares.

Private limited companies:

The protection that comes from being a company is therefore substantial. Small firms can gain this protection when the owner. create a private limited company. The word limited tells us that the. business has this legal form. Usually the shares will be owned by the original sole trader, relatives, friends and employees.

Cooperatives:

Cooperative is a business organization owned and operated. by a group of individuals for their mutual benefit. A cooperative may also be defined as a. business owned and controlled equally by the people who use its services or. by the people who work there. Cooperative enterprises are the focus of study in the field of cooperative economics.

P2: Assess the implications of the different forms of business.

Sole trader:

Advantages:

Choose. hours of work

Make your. own decisions

All the profit made. is your own

Claim expenses and certain. costs against tax

The business can be based on. the interests or skills of the owner

Disadvantages:

No sickness. pay.

No set holiday. pay

The time consuming. accounting is done in your own “ free” time

If the owner dies. there is no one to control his business

Job security. is not a fact

Partnership:

Advantages:

You can pool resources, expertise, and strengths.

There are limited startup costs.

There are few formalities

You have a shared financial commitment.

Capital is contributed by partners

Losses are shared by partners(if written in partnership deed)

Decision making is. easy because there is someone to give advice about the business

Disadvantages:

Partners may have. different visions or goals for the business.

There may be unequal commitment in terms of time and finances.

There may also be. personal disputes.

Partners are personally liable for business debts and liabilities.

Profits are. distributed among the partners

Usually decision making takes time

Conflicts can raise among. the partners about the decisions

Private limited companies:

Advantages:

Shareholders have. limited liability

Separate legal. personality

Continuity in the event. of the death of a shareholder

Original owner is still. often able to retain control

Able to raise capital. from sale of shares to family, friends and employees

Greater status than. an unincorporated business.

Disadvantages:

Legal formalities. involved in establishing the business

Capital cannot be raised by sale. of shares to the general public

Quite difficult for. shareholders to sell shares

Public limited companies:

Advantages:

Limited liability

Separate legal identity

Continuity

Ease of buying and selling of shares for shareholders

Access of substantial capital sources due to the ability to issue a prospectus to the public and to offer shares for sale

Disadvantages:

Legal formalities in formation

Cost of business consultants. and financial advisers when creating such a company

Share prices. subject to fluctuation

Risk of takeover due to the availability. of the shares on the Stock Exchange

Directors influenced. by short term objectives of major investors

P3 and M1: Select an appropriate form of a business. Justify your selected form a business in light of the proposed case and its implications.

As Mr. Javed has come to me for suggestion so I will advise him the best and more feasible business in the current situation and in the future. Mr. Javed wants the project to be his baby and wants more profits and more feasible in current market of Pakistan and he recently came back from US so he don't know much about Pakistan's market and the people of Pakistan. As his some of friends also want to be his partners in the business so he could take some capital and expertise from his friends to startup the business. His investment of 5million is also a bit less because the inflation rate in Pakistan is high and the currency is lower than many countries, so doing business by adding partners to his business will bring more investments so he can go further. The risk is going to be less because in case of loose the loose is going to be divided between the partners. His friends know the market and current situation of the country better than him so they can give better advises about the business and can make business more successful, as the current activities can affect the businesses very badly and Mr. Javed don't know much about it so his partners can also help him in the survival of the business by their expertise.

If Mr. Javed start business by his own in a form of sole trader ship so the survival will be a bit difficult because the opportunities of businesses are very less so there will be barrier of entries to the market. He also don't know about the rules and regulations of the country and the tax formats so sole trader ship will give him a bit tough time.

Q. 2 Scenario 2:

Biz Training is a private limited company formed ten years ago by a group of five ex-lecturers. The five are the main shareholders but there is also a shareholder who was a local businessperson who initially approached two of the five to run a training course for her company.

P1 and P2: identify the sources of finance available to a business. Assess the implications of the different sources.

Businesses are able to raise finance from a wide range of sources. Some of are:

Internal sources of finance: is the name. for a firm using its profits as a source of capital for new investment, rather than distributing them to firm's owners or other investors and. obtaining capital elsewhere. It is to be contrasted with external financing . which consists of new money from outside of the firm brought in for investment. Internal financing is. generally thought to be less expensive for the firm than external financing because the firm does not have to incur transaction costs to obtain it, nor does it have to pay the taxes associated. with paying dividends. Many economists debate whether the availability of internal financing is an important determinant. of firm investment or not. A related controversy is whether the fact that internal financing is. empirically correlated with investment implies firms are credit constrained and therefore depend. on internal financing for investment.

Profits retained in the business:

The accumulated net income retained. for reinvestment in a business, rather than being paid out in dividends to stockholders.

Sale of assets:

Established companies often find that they have. assets that are no longer fully employed. These could be sold to raise cash.

Reductions in working capital:

When businesses increase stock levels or sell goods. on credit to customers they use a source of finance. When companies reduce these assets by reducing. their working capital, capital is released, which acts as a source of finance for other uses.

External sources of finance:

Short term sources: There are three main sources of short term external finance:

Bank Overdrafts:

Bank overdraft: An overdraft occurs when some. one withdraws from a bank account and they exceed the available balance. In this situation a person is said to be “ overdrawn”.

If there is a prior agreement with the account. provider for an overdraft protection plan, and the amount overdrawn is within this authorized overdraft limit, then interest is. normally charged at the agreed rate.

Advantages

An overdraft is flexible. you only borrow what you need at the time which may make it cheaper than a loan.

You only pay for the funds. you use.

It’s quick to. arrange.

There is not normally a charge for paying. off the overdraft earlier than expected.

Disadvantages

It has to be rearranged regularly.

It can be called in. by the lender at any time.

Overdrafts may be secured against business assets. the lender can take control of these if you don’t repay the overdraft.

Trade credit:

Trade credit is an arrangement between businesses to buy goods or services on account, that is, without making immediate cash payment. The supplier typically. provides the customer with an agreement to bill them later, stipulating a fixed number of days or other date by which the customer should pay. It can be. viewed as an essential element of capitalization in an operating business because it can reduce the required capital investment required to operate the business if it is managed properly

Advantages

You can buy the stock and pay later. when you have sold the stock and made enough money to pay them back

Eases the cash flow as you can pay after 28-30 days

Disadvantages

If you do not pay them back on time you can build up a bad credit history

Only companies with good credit history. can be accepted the trade credit grant

Debt factoring:

When a business sells goods on credit it creates a debtor. The longer the time allowed to this debtor to pay up, the more finance the business. has to find to carry on trading. One option, if it is commercially unwise to insist on cash payments, is to sell these debts to a debt factor. In this way immediate cash is obtained, but not for the full amount of the debt. This is because the debt factoring company's profits are made by. discounting the debts and not paying their full value. When full payment is received from the original customer, the debt factor makes a profit. Smaller firms who sell goods on hire purchase. often sell the debt to credit loans firms, so that the credit agreement is never with the firm but. with the specialist provider.

Sources of medium term finance: there are two main sources of medium term external finance:

Hire purchase and leasing:

is the legal term for a contract, in this persons usually agree to pay for goods in parts or a percentage at a time. In cases where a buyer cannot afford to pay the asked price for an item of property as a lump sum but can afford to pay a percentage as a deposit, a hire-purchase contract allows the buyer to hire the goods for a monthly rent. When a sum equal to the original full price plus interest has been paid in equal installments, the buyer may then exercise an option to buy the goods at a predetermined price (usually a nominal sum) or return the goods to the owner.

Medium term bank loans:

This will have the same advantages. and disadvantages as long term loans.

Long term finance:

Long term loans from banks:

Bank loans: As with short term finance, banks are an important source of longer term finance. Banks may lend sums over long periods of time . possibly up to 25 years or even more in some cases. The loans have. a rate of interest attached to them. A mortgage is a loan specifically for the purchase of property. Some businesses. might buy property through a mortgage. In many cases, mortgages are used as. a security for a loan. This tends. to occur with smaller businesses.

Advanatages: You can borrow. large amounts.

Disadvantage: You can pay back with interest

Debentures: Debentures are generally freely transferable by the debenture holder. Debenture holders have no rights to vote in. the company’s general meetings of shareholders. Debenture holder charges a specific percentage of interest. rate from the company as they are investing in the company.

Advanatages: You can borrow large amounts.

Disadvantage: You can pay back with interest

Debentures:

A company wishing to raise funds will issue. or sell these to interested investors. The company agrees to pay a fixed rate of interest each year for the life of the debenture (which is often 25 years). The buyers may resell to other. investors if they do not wish to wait until maturity before getting their original investment back. Debentures are often secured. on a particular asset, which means that the investors have. the right, if the company ceases trading, to sell that particular asset to gain repayment. When this is part of the agreement, the debentures. are known as mortgage debentures.

Asset sales: As firms grow they build up assets. These assets could be in the. form of property, machinery, equipment, other companies or even logos. In some cases it may be appropriate for a business to sell off some. of these assets to finance other projects.

Advantage – You get the money back straight away.

Disadvantage – In the long run, it is more expensive to lease the. piece of machinery or building.

Retained profit: it’s the remaining profits. after deducting taxes, owners profits and dividends to shareholders. It can be kept. for other business uses or expansions.

Advantage: No interest will have to be paid

Disadvantage: Not available for start up business

P3 and M1: Select appropriate sources of finance for a business project. Justify your source of finance in light of the proposed business and its implications.

Before selecting a source of finance for the firm we must know which finance is going to be used in biz training. Biz training is about to buy a online learning system which they will use for a long period of time. As Biz Training is a private limited company they can not sell their shares in the stock exchange to generate funds to buy the online system so Biz Training is going to lease for buying the system as it is an fixed asset. By leasing they will not have to collect large amount such as for an asset like system A which is 120, 000 pounds by this way their cash will not be disturbed and will not put Burdon on the business. By leasing they would get the system and would start using it they will get to know how profitable the system is and if the online learning system is profitable they will buy the asset after the leasing period and if it is not giving the firm desired profits then the system will be returned or they can sell it after the lease time has finished. The best part of leasing is that all the maintenance cost of the system would be on the leasing company. In this case using other sources such as bank loan or hire purchase would not be a good decision. Taking a bank loan is not easy banks investigate a lot in the companies accounts and will need to be convinced that they will receive their loan back and will charge a lot of interest an will mortgage some of the property or any other assets and if the system is not earning profit and they cant give loan bank so the bank ill sell there property or the asset they have mortgaged so in bank loan the risk is high and in hire purchase Biz training will own the asset. By leasing will be get a clear picture of what decisions need to be taken in the future as they will know if the system they leased will be profitable or not and decide to buy it or let go of it so its better to lease the system and there is going to be less risk in the business.

D1. Some firm finance its seasonal (temporary) working capital with long term funds. Explain the impact of these decisions on the profitability and risk of these firms.

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