

Sources of finance assignment

Law



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Executive summary I am newly appointed Financial Advisor in a Consultant Company, my Finance Director asked to write a report to Mr. Alan at Vale Filters Ltd evaluating the different sources of finance appropriate to startup stage and its expansion stage also.

The report should address the following tasks and issues: Firstly, I identify and describe the various sources of finance available to Vale Filters Ltd. Secondly, I assess the implications of the different sources of finance to Vale Filters related to risk, legal, financial and dilution of control and bankruptcy. Thirdly, I select appropriate sources of finance for Vale Filters and make recommendations on the best ways of raising finance. Fourthly, I assess and compare various costs involved with each sources of finance to Vale Filters Limited.

Finally, I explain the importance of financial planning for Vale Filters Ltd. III. Introduction Vale Filters Ltd is new company that has just been established by Mr. Alan Simpson and Mr. Geoff. Although company has not gone to productive activities but company has plan to produce and market the new filter. In the future, the company will develop expansibility into national and international markets. This will involve purchasing additional machinery and equipment to produce quality filters in addition staff training. The most important thing with the company is capital.

As I mentioned, there are two main resources I want to talk with Mr. Alan and Mr. Geoff. They are Equity Financing and Debt Financing. I will show them detail in this report. Based on the fact of the company, Mr. Alan and Mr. Geoff have three projects to increase capital for the company. Method 1: Issue ordinary share of \$1each. Method 2: Issue 70% ordinary share of \$1each and remaining required capital 8% debentures or other options. Method 3: Borrow \$150, 000 from Government and repayable over 15years at an interest rate of 5% per annum.

Each method has own advantages and disadvantages, select any of which will be based on benefits and security that it offers for the company.

Financial planning is very important with Vale Filters because if the company doesn't plan to use capital, it can be bankrupt. It will be mentioned about influents of shortages and surplus to the company in this report. IV. Main body 4. 1. Sources of finance and its advantages & disadvantages Alan Simpson has privately developed an anti-detergent chemical and with his colleague Geoff has developed a filter for use with the chemical.

In order to do this, the company can have private source such as friends and relatives, credit unions, partners etc. But the company has some other available sources of finance. Firstly, it is considered with borrowing from bank. There are different types of banks which operate within the banking system. The main functions and activities of banks can be providing a payment mechanism which firms and government can make payments to each other. it enables individuals and firms to make payments by cheque, note and coins also.

Banks provide a place for individuals, firms and government to store their wealth like money, therefore they always find out how to attract individuals and organizations like firms and government. And then Vale Filter can lend money from banks. The main advantage of borrowing from banks is that you might get money to start up your business easily, quickly. The main disadvantage is in the condition that Vale Filter can not pay back the loan, then the bank will take assets from Vale Filter. Moreover Vale Filter has to pay the interest and it is usually not small. The secondary approach to consider that is Government grants.

Government is keen that businesses should start up and prosper because successful businesses provide employment and create wealth for the country. Government would like to develop national economy especially in high technology industries and in high unemployment areas. Specifically, government will support biological and chemical technology at Vale Filter. We should know two packages of measures offered by the UK government is “ The Enterprise Initiative” and” Grant for Research and Development” which help small-medium enterprises to use and develop technologically innovative

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roducts and processes (BPP, p. 21, 2004). The third approach to consider that is Venture Capital. Venture capital is a type of private equity capital typically provided to early-stage, high-potential, and growth companies in the interest of generating a return through an eventual realization event such as an Initial Public Offering (IPO), or trade sale of the company (en.wikipedia, accessed 2009). Venture capital will bring good profit but also involve a lot of risk. The advantage of venture capital is that it can provide large sums of equity finance to the business.

But the disadvantage is that the business will be required to draw up a detailed business plan, financial projections for which the enterprise is likely to need professional help. The fourth approach to consider that Vale Filter is a limited company, therefore it has own sources of finance like: Debenture is a loan for a long term on which a company promises to pay a fixed rate of interest (Oxford Business English Dictionary). A big advantage of debentures which the company can raise a large amount of money from investor quickly.

But its disadvantage which debentures are usually secured, therefore the lenders have the right to seize assets when the loan could not be repaid.

Right issue – A company which already has a Stock Exchange listing will commonly issue further shares through a right issue. A right issue involves the offer of new shares, at a discount market value, to current shareholders in proportion to their current share holding (BPP, p. 38, 2004). The main advantage of right issue is relatively simple and cheap. Secondly, with right issue the shareholders are given some choices. The third advantage is company can often raise large amounts of capital.

Furthermore, by using right issue shares, all gains from any investment will accrue to existing shareholders. But its disadvantages include of a right issue is not feasible if small amounts of finance are required. And if many shareholders sell their rights, existing shareholders may lose some control over the company. Ordinary share is a kind of share in a company which gives the owner the right to a dividend that is the money paid to the shareholders according to how much profit the company has made, and usually the right to vote at meetings of shareholders (Oxford Business English Dictionary).

Advantages of ordinary shares are there is no fixed charge attached to them. It can also be sold more easily than debentures, because it offers a higher expected return than debentures or preference shares and provide a better hedge against inflation. Disadvantages are which it extends voting rights to the new holders, which could threaten the control over the company by the existing owner managers. More shares used leads to a wider distribution of profits.

Preference share is a type of share in a company that gives the owner the right to receive regular fixed payments “ dividends” but does not usually give them the right to vote at meetings of shareholders. People who hold them must be paid before owners of all other shares (Oxford Business English Dictionary). Its advantage of using preference shares which it carries a fixed rate of dividend and payment of this can be deferred at the company’s discretion. But its disadvantage that dividends are not tax deductible and like ordinary shares, which it can reduce taxable profits.

And it is the high cost of capital, the high risk attached to the annual returns and capital cause preference shareholders to demand a higher level of return than debt holders. 4. 2. The implications of the different sources of finance In part I of the report which recommended various sources of finance. In general, there are three forms of source which including debt financing (loan of some form, on which interest is paid), equity capital (retained earnings, or new share issues, on which dividends are paid) and government grant. The following the report is discussing about debt and equity.

Debt capital – this is some loan forms on which interest is paid annually. Vale Filter for example, when Vale Filter would like to borrow money from bank. The lending bank will examine carefully before making lending-decision. the examination will be followed by form known-word “ CAMPARI”. C – Character of borrower, A – Ability to borrow and repay, M – Margin of profit for the banker, P – Purpose of the loan, A – Amount of the loan, R – Repayment terms, I – Insurance against non-repayment (BPP, 2004, p. 13). This is the legal compelling-procedure.

And when Vale filter is allowed to borrow, the company has to ensure follow the procedure which repay each interest term. The bank also pays attention to finance of Vale filter as well as the company can make profit or not. This is very important to make decision, with the large amounts of debts can lead to high risk of bankruptcy because what if Vale Filter was bankrupt, the bank had to have the dilution of control how to protect its investment. The bank will have security method like mortgage. Equity capital means money that a company gets by selling shares in order to finance its operation.

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It may conclude of retain earning, selling assets, venture capital, issue shares and so on. As for Vale Filter's equity share (ordinary share), it is considered shareholders who hold equity shares as the first risky people. In the case of Vale Filter close down its factories, obviously these shareholders will make lost their investments into Vale Filter. Alan and Geoff take 50% current shares, but Vale filter wants to raise its fund through issuing of additional equity shares for expansion poses a threat to the existing shareholders as regards their power of control over management.

Shareholders might use their voting interest to be against the existing directors, this will make dilution of the control of existing shareholders. Although preference share helps to raise fund, as some people prefer to invest in preference shares due to the assurance of a fixed return. This helps Vale Filter attract investors, but dividend paid which can not be charged to income of company as an expense, therefore there is no tax saving as in the case of interest on loans. 3.

Appropriate sources of finance for a business project Method 1: Company will issue ordinary shares of \$1 each. Mr. Alan and Mr. Geoff would take 50% and the reminder by the six other interested people based on total requirement for Vale Filters private limited. With this method VFL does not be flexible in using capital so the company will be lost opportunities in business, especially with this method the company will not be shared risk when it is difficult so VFL can be gone bust.

In the other hand, before buying shares, shareholders must to demonstrate their asset. The number of shares purchase will be saved with the

corresponding percentage of their asset in the company. VFL has just established and has not had profit, shareholders will bargain together about the profit per share and the time they will receive (after 3years). In meetings, Mr. Alan and Mr. Geoff must to give them reports about business of the company, balance sheet. legal | | 1, 000 | | stationary | 2, 500 | | Brochures | 5, 000 | | Consultants | 15, 000 | | Insurance | 250 | | Rent | | 500 | | R | | 1, 000 | | Equipment | 3, 500 | | Miscellaneous | 5, 000 | | Expenses | 33, 750 |

With this method, Mr. Alan and Mr. Geoff will be easy to lose control the company because when a shareholder has more shares than Alan and Geoff he or she will control VFL Advantages: • Shares raise capital without debt and without a legal obligation to repay the funds, unlike bank loans or bonds, which are direct debt obligations of the issuing corporation. It is very good when Vale Filters Ltd is a new company that has just established so the company does not have customers. • Absence of “ brokerage costs” Suitability for raising large amounts of cash • Avoidance of the need to raise cash from existing shareholders • Reduction of the risk of a future takeover taking place, due to the introduction of shareholders. Disadvantages: • Insufficient earnings may be available • Do not to be flexibility in activity process • The cost of capital using higher. • The company is not deducted tax to repay loans • When one of six investors has more shares in company, they will control company replace Mr. Alan and Mr.

Geoff so risk in this situation is very high • In the present, the company does not lose expense for using the capital owners but in the future, this expense is higher than expense of debt • Do not share risk • The company has just <https://assignbuster.com/sources-of-finance-assignment-essay-samples/>

established so do not every shareholder invest into the company. They will depend on profit they earn from the company and prepare that with profit from banks. Beside, invest into our company in present to be an adventure because the company has not produced goods yet so the company has not had any income. Method 2: According to professional, companies do not use only one Equity or Debt financing. Most businesses have a mix of debt and equity financing. Too little equity could prevent company from securing or repaying loans, while carrying little or no debt could indicate that company is too risk-averse, and that business might not grow as a result (sbinformation, accessed 2009) Method 2 is to combine between two resources of capital so degree of risk is lower.

The company is pressurized by creditors who buy our debentures but it is not too high because our company debts only 30%. More over, we also issue 70% ordinary share but the company will not be lost control because Alan and Geoff take 50%. Beside, when the company is difficult, it will be received share by external resource so ability the company goes bust not to be high. The company must show report or balance sheet to investor because it is a piece of evidence that convinces investors of buying debentures:

Balance sheet	Asset:	\$	Cash	494, 000	Inventory	5, 000	Other assets	33, 750	Total assets	532, 750	Debt/Owner Equity	53, 275
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Investors can see this balance sheet and they can feel secure when invest into our company. Advantages: • VFL combines Equity financing (70%) and Dept financing (30%) so the company does not have to pay loans immediately. The company will repay after a period. • To use Equity financing and Dept financing, the company shares risks with investors;

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reduce the cost of using average capital. • The company is deducted tax to repay loans Disadvantages: • The company has to pay loans for creditors but it is not too much because dept financing takes only 30%. To increase risk of inability to payment • To increase ability bankrupt of the company • The company is controlled by creditors. • Gearing (the ratio of debt to equity capital) will lead to more of the companies' profits being available to pay dividends o If gearing > 1: company will be bankrupt o If gearing < = 1: company is safe (BPP, 2004, p. 36). • Investors will compare interest between buying our debentures with saving money in banks. If profit from banks is larger than profit of our debenture, investors will not buy debentures of the company.

Method 3 There is an idea to think that “ investors will look at two years of operation of the company since then they decide to invest into company or not”. In method 3, Mr. Alan prefers a government loan of \$150 000, repayable over 15years at an interest rate of 5% per annum. In addition remaining required capital issue shares and debentures or other option. Mr. Alan thinks that the government department's involvement adds prestige and credibility to the project. This method is Dept financing.

With this method, risk of the company is low because we have help from government, prestige and credibility to the project of our company is higher so we have more opportunities to develop our company. However, VFL is a company that has just established, we has not had profit so would be very difficult to loan from government. Beside, when we borrow money, our company must to satisfy seven factors that are abbreviated by CAMPARY. With this method, the company will not be lost control because we borrow
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money from external resource but we have to pay principal and interest for banks or government so companies will be difficult in business.

Advantages: • The company is deducted tax to repay loans • The capital of government is prestige and credibility to the project. Disadvantages – The Company has not produced yet so the company will see many difficult when borrow from government: • Government will research or critical investigation lasting between 6 and 18 months. • To research into a preproduction prototype of a technologically innovative product or industrial process. With this resource, the company must pay loan interest to government 5% per annum.

When the company bankrupt, government will be owner of the company, government can sell the company or whatever. Relying on theory, I think method two is best because the company has Equity financing while having Debt financing. Loans of debt are not too much in while company does not lose control. However, in the fact, we have to depend on the cost, realizable, opportunity cost of each method. 4. 4. The costs of sources of finance for Vale Filters Limited In Vale Filter Ltd circumstance, Alan and Geoff considering various methods of finance are under consideration.

Method 1: Issue ordinary shares of \$1 each, Alan and Geoff will issue 500,000 shares with interest rate are 2%. They would take 50%, correctively 250,000 shares; six other interested people would take 50%, correctively 250,000. Alan and Geoff would pay shareholders a dividend of so many cents per share twice a year. The company paid a dividend of 20cent per share: Cost of dividend to the business would be: $500,000 \times \$0.20 = \$100,000$ Cost of

shareholders will receive: Mr. Alan & Mr. Geoff: $100,000/2 = \$50,000$ 6 other interested people: $100,000/2 = \$50,000$ shareholders spend \$250,000 to buy 250,000 shares and profit they receive: \$50,000 To compare with interest rate of banks (0.25%), profit shareholders will receive: $0.25\% \times 250,000 = \$62,500$ Different exchange between shares profit and profit of banks is not so large. In addition, the company will develop in local markets and international markets in near future, therefore profit which shareholders earn from our shares will be larger than now. The feasibility of this method is too larger. However, by this method we are not deducted tax to repay loans (30%).

From that point, amount of tax which we have to pay would be: $30\% \times \$100,000 = \$30,000$ Total cost we must pay in this method would be: $\$100,000 + \$30,000 = \$130,000$ Expected cost in this method would be \$130,000. Now, there are not many people have enough money to start up a business, most companies are combined by two or more people. With this method, company has more capital and it is not compelled to pay interest during its starting period because shareholders negotiate together to get the dividend when the company has interest.

Method 2: Alan and Geoff would issues 70% of ordinary shares of \$1 each and remaining required capital 8% debentures or other options. 70% of ordinary shares of \$1 each, the company issues 350,000 with interest rate are 2%; 20 cents per share – similar to the first method. Share' Alan and Geoff take 50% and the six other interested people take 20%: Cost of dividend to the business would be: $350,000 \times \$0.20 = \$70,000$ Cost of

shareholders would receive: Alan and Geoff: $50\% \times \$70,000 / 70\% = \$50,000$
Six other interested shareholders: $20\% \times \$70,000 / 70\% = \$20,000$

Profit shareholders receive from banks: $0.25\% \times \$100,000 = \$25,000$ When issue debentures with interest rate 8%, investors would receive: $\$150,000 \times 8\% = \$12,000$ To compare with interest from banks, investors would receive: $\$150,000 \times 0.25\% = \375 Investors would choose to invest my company because profit they could earn here larger than banks many times. The reason my company should show a high interest which my company is a new company, we do not have wide relations with other companies therefore in order to attract external investors, we give high an interest.

However, feasibility of this method is low because we do not have to pay more money and profit for shareholders and investors. Total money we must pay shareholders and investors to be \$82,000 in while method 1 we must pay \$100,000. Tax expense we must pay: $30\% \times \$82,000 = \$24,600$ However, our company is deducted tax to repay loans (30%). This means a tax saving of: $30\% \times \$12,000 = \$3,600$ Cost of tax we would pay: $\$24,600 - \$3,600 = \$21,000$ Cost of opportunity in this method is \$103,000.

Method 3: A government loan of \$150,000, repayable over 15 years at an interest rate of 5% per annum.

In addition remaining required capital issue shares and debentures or other options. The cost our company will pay government one year to be: $\$150,000 \times 5\% = \$7,500$ The company needs \$500,000 in while it only borrows \$150,000 from government; \$350,000 the company will earn from other resources such as issue shares and debentures. The company should issue

70% of ordinary of \$1 each and remaining required the same method 2. The company has to pay \$70, 000 for dividend: Tax expense that company will pay: $30\% \times \$70, 000 = \$21, 000$ Total cost the company has to pay: $\$70, 000 + \$7, 500 + \$21, 000 = \$98, 500$

This method has benefit to be: low interest rate; the government department's involvement adds prestige and credibility to the project. In general, through three methods above, in my view point, it will be suitable to choose the second method because in the first method the company has to spend more money. And in the third method, the opportunity for the company can borrow money from government to be not high, especially when the company has just been starting its business. 4. 5. Importance of financial planning Evaluating the investing and financing options available to a firm.

Planning includes attempting to make optimal decisions, projecting the consequences of these decisions for the firm in the form of a financial plan, and then comparing future performance against that plan (financial dictionary, accessed 2009). Concurrently, financial planning is also an analyzing financial power as well as the value of future which might be achieved by enterprises. This financial planning can be updated throughout conducting planning process. A financial planning might be useful at points, firstly it can forecast making profit or loss monthly likely income, expense costs, and purchase equipments.

Secondly it can forecast cash flow monthly likely the cash flow reflects its operation, the cash flow reflects investing activities initially (purchase fixed

assets and other investments), and the cash flow reflects external investment or for lending. Thirdly, a financial planning can forecast balance sheet likely capital investment and financing. Fourthly a financial planning can forecast analysis of the main advantages of ability to transform into cash as well as ability to pay, etc. Lastly, a financial planning can forecast main risks which can influence numbers and calculating as well as measuring.

Shortage is known in finance as a capital which companies mobilize to be less than capital need of the business. Shortage can influence to business capital such as discontinuing the production and business, lose business opportunities because of the business is not enough capital, accelerating enterprise circumstance to ability to pay: reduced prestige, ability to take payment, raw materials provided by suppliers and so on. Surplus is known in finance as a capital which companies mobilize to be more capital requirements of the business.

Impact of surplus which can be dividing excess capital will be delayed, can not find benefit for enterprises do effective use of capital reduction.

Ultimately, enterprises must pay for capital in excess of time not to use.

What if a financial planning makes wrong assessment of time, duration, size of loan will affect the capital of business: One example of wrong time borrows capital which making shortages or surpluses, the enterprise requires \$ 15, 000 on September, but my company borrow on May (Surpluses.

Another example of wrong size borrows capital which making shortages or surpluses, the company needs \$15, 000 but my company just borrows \$5, 000 (Shortages. Finally, wrong duration as well as period which make

shortages or surpluses, for example the company loans money from bank with interest rate is expected 5% in five years, but because of my financial planning wrong, I loan in 8 years (Surpluses. VI. Conclusion In this report, it is mentioned about different resource of capital that VFL can use to improve.

Each method has advantages and disadvantages. It is strongly believed that, depend on situation of company at the moment, Mr. Alan and Mr. Geoff should chose method 2 because it combines between two main resources: Equity financing and Debt financing so it will limit disadvantages each other. In this report, it is also mentioned about financial planning, shortages and surpluses. In any situation, shortage and surpluses also influence to our company, it can make our company go bankruptcy so we must limit them in business.

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