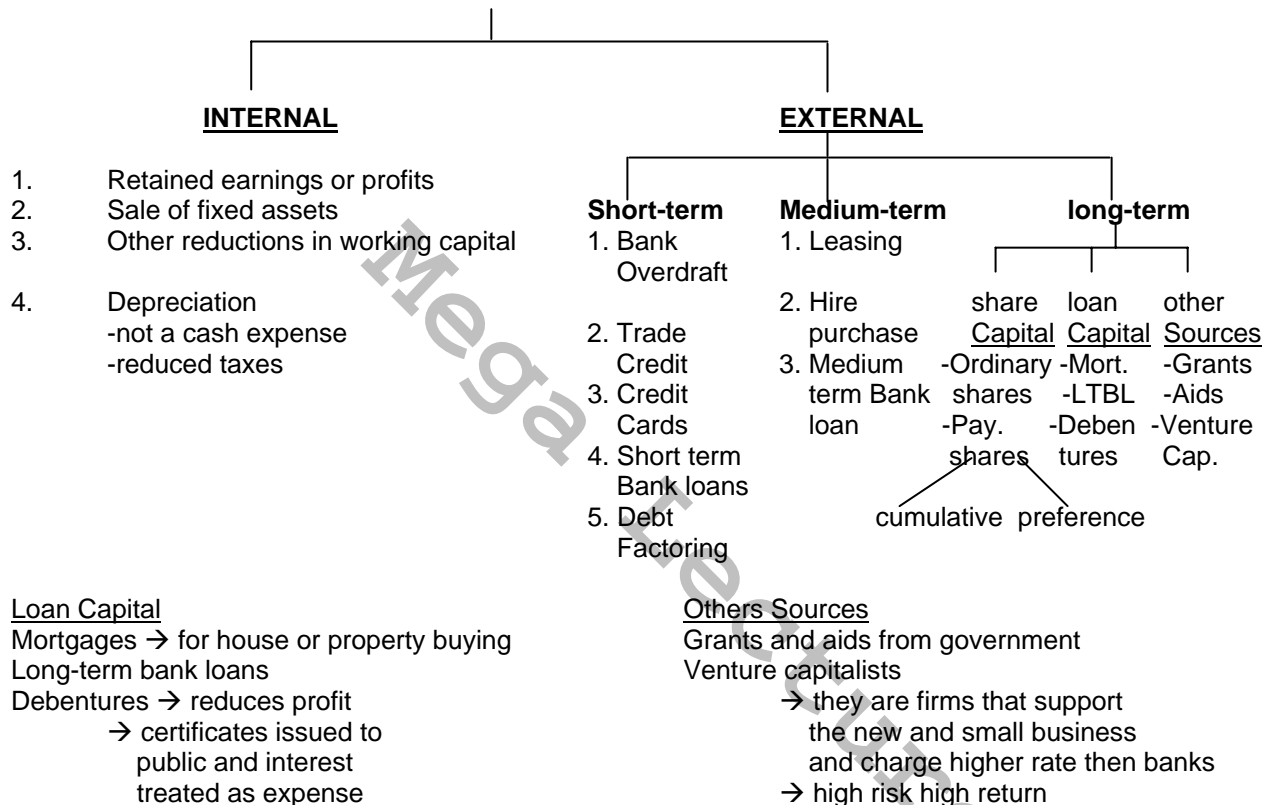


BUSINESS FINANCE

NEED FOR FINANCE

1. for setting up a business i.e. start up capital
2. to finance the working capital i.e. to pay daily expenses
3. for business expansion, both internal and external
4. to support sudden losses and decline in sales
5. for survival in economic recession or any other uncertainty in the market (strikes, law and order situation etc.)
6. for research, engineering and development

Sources of Finance



FACTORS INFLUENCING CHOICE OF RESOURCES OF FINANCE

1. Costs involved – interest costs
2. Use of funds – revenue or capital expenditure
3. Status and size of the business
4. Financial situation
5. Gearing

It is the relationship between the loan capital and share capital of a business. A firm is said to be highly geared if their loan capital is more than the share capital. Business can have a lot of liquidity problems in such a situation.

$$\text{Ratio} = \frac{\text{loan capital}}{\text{share capital}}$$

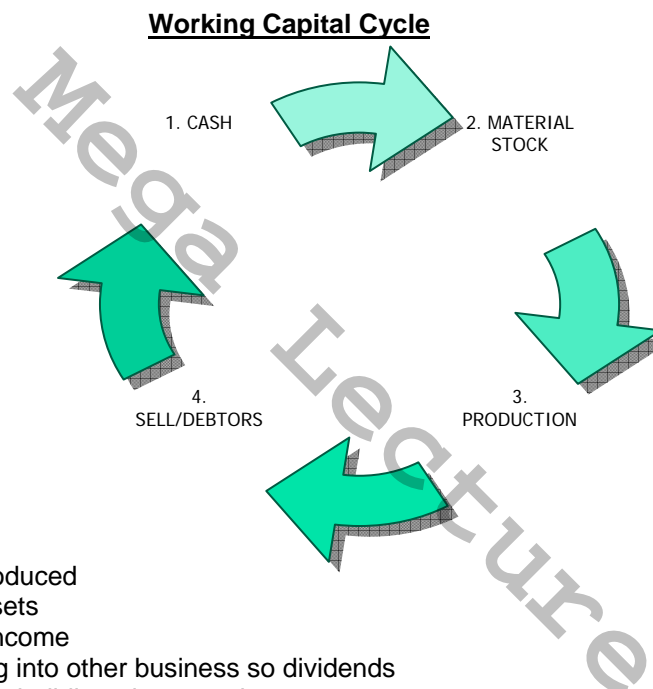
CAPITAL EXPENDITURE: It is a spending on fixed assets that will last for more than one year and that can be used repeatedly. Capital expenditure goes in the balance sheet as the value of an asset e.g. buying of a building, machinery or land etc.

REVENUE EXPENDITURE: It is an expenditure needed to meet day to day expenses of the business. It does not add to asset values but pays for their maintenance and other incurred costs. Revenue expenditure goes into the profit or loss account for e.g. rent, wages and salaries and maintenance expenditures.

WORKING CAPITAL: Working capital is also known as circulating capital or life blood of the business. It is the amount of money needed to pay for the day-to-day trading or expenses of the business. It is the net current assets of the business. It can be calculated by the following formula:

Working Capital = Current Assets – Current Liabilities

$$\text{W.C. ratio or current ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$



CASH INJECTIONS

1. Loans
2. New capital introduced
3. Sale of fixed assets
4. Non-operating income
 - investing into other business so dividends
 - rent from building given to others
 - grants, donations, interest from banks on cash investments in banks

CASH DRAINS

1. Cash dividends
2. Repayment of loan or interest
3. Taxes
4. Buying new assets (fixed)
5. Drawings (cash, stock)

CAPITAL AND MONEY MARKETS

A number of financial institutions hold funds for savers paying them interest. In addition they make funds available to investors who in turn are charged interest. Some institutions deal in capital i.e. permanent or long-term finance. They are known as the capital market. Others deal with money i.e. short-term and medium term loan and bills of exchange. They offer a variety of financial and commercial services.

MONEY MARKETS controlled by central bank (State)

1. Commercial Banks
2. Merchant Banks
3. Other financial institution for short and medium-term loans

CAPITAL MARKETS

1. Stock Exchange-most powerful
2. Investment interests
3. Insurance companies

RELTAEED QUESTIONS:

Q.1. Why is it significant for a business to manage its working capital?

Ans. Working capital or the circulating capital of a business is the finance required to pay for its day-to-day expenses and trading. It is the difference between the current assets and current liabilities of the business. Management of working capital is necessary to avoid liquidity problems for business.

It is necessary that the business has sufficient working capital i.e. stocks, debtors and cash so that business is easily able to pay back its current liabilities i.e. the creditors (suppliers of the business) and any other accrued expenses. So it has to maintain a ratio of 2:1 in favour of current assets so that it won't go into problems like not being able to pay back its creditors on time and suppliers may then stop their supply to the business.

However, there shouldn't be a very high level of working capital which would show too much of stocks and a high quantity of idle cash. Such a situation means that there'd be opportunity of cost of cash tied up in stocks which may have been better invested in other profitable things like other companies or fixed assets. Also a high level of stocks would mean high storage costs too. And high cash levels could be better used to finance expansion or by more research and development.

The working capital cycle of a business should be developed as this is very helpful for working capital management. It would enable managers to reduce production time, storage time for finished goods by reducing stock holding or encouraging JIT production as well as reduce the time it takes for customers to settle their bills by monitoring late payments.

Q.2. Explain and evaluate 3 ways of increasing and 3 of decreasing the working capital of the business.

Ans. There are several ways to increase or decrease the working capital of the business depending on its situation. One way to increase is by the sale of fixed assets. This would increase the cash of the business while the business gets rid of assets it no longer fully employees. Also businesses can sale assets that they need yet don't have to own i.e. through sale and leaseback. However, the drawback is that assets sold may be required later on.

Another way of increasing working capital is by the issue of shares or raising share capital. This can raise very large sums of capital. Also it is a permanent way to raise working capital. On this no interest has to be paid. However, dividends do have to be paid and the ownership is shared so a loss of control for original owners may occur.

The third way of increasing the working capital is by loan capital like long-term bank loans. This could also enable the business to have a large amount of cash from the bank. However, a fixed rate of interest has to be paid and at times loans are also secured against assets of the business which would have to be given up in the event of business fails to repay loan on time.

But if business has an excess of working capital then it may wish to reduce it. One way to decrease the working capital is by buying fixed assets i.e. investing into assets. New modern, high technology machinery could be bought which may help to reduce average costs of business while increasing productivity. However, it may be possible that buying fixed asset may cause the

working capital to fall drastically that result in a liquidity crisis as the company miscalculated its affordability. Therefore care has to be taken in such matters.

Another way of reducing the working capital is by making financial investments which is buying shares into other companies. This could generate income for the business as it would have a share in the profits in the form of dividends. It may also lead to a diversification of risk as in case business incurs losses in its major production then it may be able to cover it up by income from holding shares. Disadvantage is that if the business where shares are bought goes into losses and declines then the investment is compromised.

Finally working capital is also reduced by pay back of long-term loans like bank loans or mortgages to reduce burden of interest as well as long-term liabilities. However few institutions charge an additional percentage of remaining amount being paid that contributes to wastage of resources.

Q.3. Compare share capital with loan capital. Which method is better in what kind of situation? (Share capital = Equity finance).

Ans. Share capital is the sum of money which comes into the business by the issuance of shares to friends and relatives in the case of private limited companies or issue of shares to the general public through Stock Exchange in the case of public limited companies. Loan capital on the other hand is borrowing money from an individual or institution which is a long-term liability for the business.

Examples of share capital include ordinary shares, preference shares (participative and cumulative) and deferred shares. Loan capital examples are debentures, mortgages and industrial loan. Both share capital and loan capital are used to raise very large sums of money usually to finance expansions or high costly investments.

Share capital, however, is permanent finance i.e. it doesn't have to be repaid while loan capital is not permanent finance and has to be repaid after a certain time period and is also secured against the company's assets. Share capital causes an increase in the number of shareholders of a business i.e. owners of a business who require to be paid dividends from the profits of the business. Loan capital on the other hand increases the total long-term liabilities of the business and has to be paid a fixed rate of interest on. This interest is an expense on the business and reduces profits of the business and so may prove to be off-set against taxes while dividends are paid before tax.

If a company is highly geared i.e. majority of finance, say 70%, is by loan capital and only 30% by share capital then it is in a bad financial situation. In such case it would be reluctant to borrow more due to the high interest rates that have to be paid, uncertainty caused by changing of interest rates over time as well as there is high risk of insolvency in case of non-repayment of loan. Company would be better off if it raises finance by share capital. However a lowly geared company with less interest to be paid, less risk of uncertainty and a strong financial situation like high profits may wish to avoid share capital (so reduces situation of loss of ownership) and prefer loan capital for financing.