Financial Resources

Businesses can use a wide range of sources of funds to help finance their expansion plans and their trading activities. Not all of them take the form of cash, some take the form of assets that the business can use, which then releases funds for other uses.

Sources of Finance

Owner's Capital. This is often the only source of capital available for the sole trader starting in business. The same often applies with partnerships, but in the case of partnerships there are more people involved, so there should be more capital available. Owners capital though, when invested is often quickly turned into long term, fixed assets, which cannot be readily converted into cash. If there is a need for increased finance, the business owners could invest more money in the business. This option though, may be unavailable. In many small businesses the owner may already have all his or her capital invested, or may not be willing to risk further investment.

Shareholders' Capital. Shareholders are of course the owners of a Limited Company, they invest money in the hope of capital growth, (that is the business makes profits, grows, makes more profits, so as the business becomes bigger their investment will be worth more), and Dividend (the shareholders share of the companies profits).

It is quite normal for limited companies to issue new shares (a Rights Issue), in an attempt to raise capital, and this is normally for investment, funding expansion or restructuring. In some cases shares are issued to solve a cash flow problem, - this is occurring more and more with .com businesses. Ordinary share capital is referred to as permanent capital, this means that it does not have to be repaid. But some types of share capital do require the payment of annual interest or dividend.

The main types of share capital are:

- **Ordinary Shares.** The holder of an ordinary share has a share in the ownership of a limited (or joint stock) company. Ordinary share holders will expect to receive an annual dividend (their share of the profits), but this is in no way guaranteed. Payment of dividend depends upon the performance of the company, and the dividend policy adopted by the company.

- **Preference Shares.** These will pay a fixed annual amount to the holder, again known as a dividend. Preference share holders will receive their dividends from profits, or reserves, before the dividend to ordinary shareholders is paid. This means that preference shares are less of a risk that ordinary shares, but the payment of dividend, or return of capital is not guaranteed.

- **Debentures.** These are a form of loan stock. The holder of a Debenture has made a secured loan to the business, and these Debentures will have a fixed redemption date (the time the loan must be repaid). Debentures are more secure than ordinary shares or preference shares, but again if the business fails there is no guarantee of repayment of capital. But Debenture holders do get their 'bite of the cherry' before ordinary and preference share holders. From the businesses point of view Debentures are an effective way of raising capital because the Debenture holders have no say in how the company is run. This means that the issue of Debentures does not dilute control, the directors still run the business.

An overdraft. An overdraft is a form of bank loan. A business becomes overdrawn when it withdraws more money out of its cheque account than there is in it, this leaves a negative balance on the account. This is often a cheap way of borrowing money, as once an overdraft is agreed with the bank, the business can use as much of the overdraft as it needs at any time, up to the agreed overdraft limit. But the bank will of course charge interest on the amount overdrawn, and will only allow an overdraft if they believe the business is credit worthy i.e. is very likely to pay the money back.

A bank can demand the repayment of an overdraft at any time. Many businesses have been forced to cease trading because of the withdrawal of overdraft facilities by a bank. Even so for short term borrowing an overdraft is often the ideal solution, and many businesses often have a rolling (on going) overdraft agreement with the bank. This then is often the best solution for overcoming short term cash flow problems, e.g. funding purchase of raw materials, whilst waiting for payment on goods produced and sold.

Bank Loan. This is lending by a bank to a business. A fixed amount is lent e.g. £10,000 for a fixed period of time, e.g. 3 years. The bank will charge interest on this, and the interest plus part of the capital, (the amount borrowed), will have to be paid back each month. Again the bank will only lend if the business is credit worthy , and it may require security. If security is required, this means the loan is secured against an asset of the borrower, e.g. his house if a sole trader, or an asset of the business. If the loan is not repaid, then the bank can take possession of the asset and sell the asset to get it's money back!

Loans are normally made for capital investment, and if a loan is obtained then this frees up other capital held by the business, which can then be used for other purposes.

Leasing. With leasing, a business has the use of an asset, pays a monthly fee for its use and will never own it. If a sole trader set up business as a parcel delivery service, he could lease the van he needs from a leasing company. He will have to pay a monthly leasing fee, say £250, which is very useful if he does not wish to spend £10,000 on buying a van. This will free up capital, which can now be used for other purposes.

A business looking to purchase equipment may decide to lease if it wishes to improve its immediate cash flow. In the example above, if the van had been purchased, the flow of cash out of the business would have been £10,000, but by leasing the flow out of the business over the first year would be £3,000, leaving a possible £7,000 for other assets and investment in the business.

Leasing also allows equipment to be updated on a regular basis, but in the long run, it does cost more than outright purchase.

Hire Purchase. This is similar to leasing, but at the end of the hire period the asset belongs to the company that hires it.

Buying on Credit. This creates Creditors. If a business which sells shoes buys on credit from Clarkes shoes, it may not have to pay Clarkes until 30 or 60 days after delivery. This means it could sell the shoes at a profit, and have the money at the end of the credit period, to pay its bill to Clarkes.

Extending a credit period will help solve short term finance problems. Extension of credit could be achieved by delaying paying bills for an extra 14 days, meaning there will be more cash in the bank for this period. Unfortunately this type of action may upset a businesses' suppliers, after all they have their own cash flows to think of. The next time the business wanted credit from a supplier that they had been very slow in paying in the past, they may be turned down!

Slow payment by debtors is a problem for many businesses, and in fact the government has tried to take action against this type of behaviour in several budgets.

Selling Assets. A business can sell assets it owns to raise capital! This is often a last gasp measure as assets are usually vitally necessary to business activity. In some cases the business may lease back the asset, so that it still retains its use. But this often the preserve of big business e.g. the sale and lease back of office blocks.

Debtors. If a firm is in immediate need of cash it could chase its debtors for repayment. This may involve giving discounts for early repayment. Chasing debtors for early repayment may lead to long term loss of trade, as the debtors may buy from another business next time, but it can be an effective method of solving short-term finance problems.

Factoring. For larger firms, with a turnover (sales) of £100,000 or more a year, it is possible to let a Factor manage your debts for you.

The factor (a type of finance company) will pay 80% of the value of an invoice at the time of sale, and will take responsibility for receiving payment from the debtor. The balance of the debt will be passed on when the money is received by the factor. There is of course a charge for this factoring service and the amount of charge will depend upon several issues such as, number of debtors, size of debts, and past bad debt history. But factoring does improve a business's cash flow and it popularity amongst small to medium size businesses, proves that many managers and owners regard this service as good value for money.

Venture Capital.

A venture capital company is a business that specialises in investing in small to medium sized firms that are expected to grow quickly,. The venture capital company will purchase a shareholding in the business – providing needed funds, and will help manage the business. The venture capitalist will expect to sell their share holding, at a profit, with 3 to 5 years. Venture capitalists can provide investment funds from £10,000 up to £10's of millions.

Private Equity Funds.
Private equity funds include forms of venture capital and MBO (management buy out) financing. Private equity funds buy companies that are likely to be listed on a stock market, and then take them private—de-list. Private equity funds have injected huge amounts of capital into the take-over market in recent years.

In some deals, private equity funds use a technique known as a "leveraged buy-out" (LBO) for all or part of the purchase costs. In an LBO, the buying group uses loans, bonds or other debt instruments to raise the capital necessary to buy the target. Often, they use the target company's own assets as collateral. In the UK one of the largest private equity deals was the takeover of Boots, costing £10 billion. Of which £7 billion was financed by debt.

When the managers of a company work with private equity groups to raise the money necessary to buy the stock of the firm they're running, then a MBO is occurring.

Internal Sources of Funds

If a business needs to raise finance, it is good management to look for internal methods of solving the problem. Internal methods of raising finance should be used because firstly, internal methods are generally less expensive than external methods, and secondly, keeping raising of finance 'in-house', prevents an increase in the influence of external factors on the management of the business.
Some of the more successful methods of raising finance internally are outlined below.

Retained Profit. At the end of the trading year a business will complete it's Profit and Loss Account. All of this profit earned can be taken by the owners, (this would be a dividend in a Limited Company), or alternatively some or all of it could be reinvested in the company, to help the business grow and therefore make even more profit in the future. If a business needs to raise finance it can increase the proportion of profit it retains within the business, but this does mean that dividends paid will fall.

Stock management. Often finance problems arise because too much of a business's capital is tied up in working capital, such as raw materials, work-in-progress and stock.

Many firms are now implementing practices such as just-in-time, and Kan Ban, which are designed to reduce working capital levels and release capital, which can then be used in more effective ways within the business.

Manpower management. Examining and restructuring labour costs can reduce outflows of cash. Is it necessary to have permanent contracts for all workers? Can some work be sub-contracted, or can some work be transferred to temporarily contracted workers? Restructuring Human Resources in this way can save expenditure on pensions, National Insurance, holiday pay etc.

Improved Budgeting. Why base next years budgets on last year's budgets? Why not start with a clean slate and opt for zero budgeting? Also budgets need to be managed effectively, and variances analysed as they arise.

These internal methods can save on business costs and in larger organisations often prove the best long-term solution to finance and liquidity management problems.