**Chapter 13 – Finance Notes**

**To finance something means to raise money for something**

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| --- | --- |
| **Households need finance for:** | **Businesses need finance for:** |
| Paying Bills | Paying wages, other bills and expenses |
| Paying back loans | For expansion |
| Living expenses | To buy stock and raw materials |

**Households and Businesses need to know**

* Their sources of finance i.e. where it comes from
* Their expenditure i.e. where there money goes
* Their cash flow i.e. when they spend and receive money.

**Finance can be offset by income:**

|  |  |
| --- | --- |
| **Household Income** | **Business Income** |
| Wages/salaries/Social Welfare | Sales Revenue |
| Savings Interest | Return on Investments |
| Share Dividends | Grants |
|  |  |

**Sources of Finance**

|  |  |  |
| --- | --- | --- |
| **Short Term** | **Medium Term** | **Long Term** |
| **Less than 1 year** | **1 – 5 years** | **Over 5 years** |
| Bank Overdraft | Medium Term Bank Loan | Long Term Bank Loan |
| Trade Credit | Hire Purchase | Share Capital |
| Accrued Expenses | Leasing | Owners Capital |
| Credit Card |  | Reserves |
| Factoring |  | Govt. Finance |

**Short Term Sources of Finance**

**1 - Bank Overdraft**

* The current account holder gets permission from the bank to withdraw more money from their account than they have in it (up to a certain limit). Interest is charged on the amount outstanding every quarter (i.e. every three months) and this interest is calculated on a daily basis. The Interest is High.
* eg. you have €10,000 in your account. You have an overdraft of €2,000. You withdraw €10,700. You have to repay €700 to the bank as well as interest on this €700 at approx. 18% per annum (18/12 per month)
* No security (collateral) is needed to obtain an overdraft.
* Banks retain the right to recall the overdraft at any time.
* There are penalties for those who exceed their overdraft.
* Overdrafts should only be obtained when they are required and they are thus a flexible source of finance.
* They cover temporary cash shortfalls

**Why do households need overdrafts?**

Many bills might be incurred at once (in September with kids going back to school or at Christmas time with presents, decorations, light and heat, etc.). Income received in later months allows households to pay off the overdraft.

**Why do businesses need overdrafts?**

It may allow businesses to pay suppliers if their own customers delay payment to them. Their own customers pay them later and the income received from these customers can be used to pay off the overdraft

**2 - Trade Credit**

* A Creditor is someone who we buy goods or services from now but who we pay later - *buying on credit*.
* A Debtor is someone who we sell goods or services to now, but who we receive payment from later - called *selling on credit*.
* Business allow a certain period of time to their customers between buying goods and services and paying for them (usually 0-3 months)
* If we buy goods on credit, we can use the money owed to the creditor in the business until it has to be paid - the money can be deposited for two months and can earn interest.
* Alternatively we can sell these goods and collect the income before it is due to be paid.
* Firms that over use this source of finance are ‘*leaning on the trade’*. Their credit worthiness and financial reputation may suffer. They may lose out on discounts offered for prompt payment of debts.

**3 - Accrued Expenses**

* Accruals are services which we have the use of now but which we pay for later
  + **eg.:** telephone, electricity, tax
  + **i.e.** we pay these expenses in arrears
* No costs are attached to these expenses.
* Tax is an accrual as there is a time delay between deducting tax or P.R.S.I., collecting V.A.T., calculating tax on a businesses’ profits and paying the money onto the Government. This money can be used to benefit the business in some way before it is passed on to the government.

**4 - Factoring**

* A Debtor is someone who we sell goods or services to now, but who we receive payment from later.
* Debtors pay us at different times, some in two weeks, some in a months, some in two months; this makes it difficult to plan expenditure and increases the risks of Bad Debts.
* Firms can thus sell their debtors to a factoring firm.
* The factoring firm pays 80% of the debt off now and the rest when the debt is due to be paid. The factoring firm in turn gets paid by the debtor

**Medium Term Sources of Finance**

**1 - Medium Term Loans**

* Loans given to houses for up to five years are called Personal Loans.
* Loans given to businesses for up to five years are called medium term loans.

**Features of Term Loans**

1. Agreed period of time
2. Agreed amount
3. Repayment of loan by instalment agreed in advance
4. Interest rate in line with general interest rates and the category of borrower

**Interest**

* The Loan must disclose the APR Annual Percentage Rate of the interest on the loan.
* The APR is the true rate of interest paid per annum on the loan taking into account the frequency of repayments, the duration of the loan and any additional charges involved
* Interest Rates vary between banks
* The higher the risk category of the borrower, the higher the interest rate charged

**Repayments**

* The borrower obtains a loan and can purchase, own and utilise assets.
* Repayment of the loan will should suit the ability of the borrower to repay the loan.
* Instalments don’t have to be equal. Car Sales are slow in summer months, toyshops sell more toys at Christmas. In these cases loan repayments can be adjusted to suit the cash flows of the respected firms
* Most loans require collateral (i.e. security for a loan) – Land, buildings, other Assets

2 **- Hire Purchase (HP)**

* This is a form of credit which allows customers to have immediate use of goods while paying for them over an agreed period of time in instalments.
* The customer has to pay an initial deposit and an agreed number of instalments.
* The customer only owns the asset when the last instalment has been made.
* Hire Purchase is available from retailers or specialist finance companies
* It is used to buy asset such as motor vehicles, equipment, etc.
* It carries a high rate of interest and is thus an expensive form of finance.
* Goods cannot be repossessed by the hire purchase company without going through a legal process, so the purchaser of an asset has certain legal rights. A Contract will include:

1. The amount of the initial deposit
2. The number of deposits and there due date
3. The amount of APR involved
4. The amount of each deposit

**Advantages of Hire Purchases**

* + Immediate use of the good
  + Sales and profits increase
  + Commission paid increases thus raising employees income and standard of living
  + The firms capacity to expand increases

**3 - Leasing**

* Leasing is like renting. The asset acquired is at all times owned by the lessor who rents it to the lessee over an agreed period of time in return for regular payments. Ownership thus never passes to the person renting it (the lessee).
* Leasing is a popular source of medium term finance for both individuals and businesses.
* Leasing is cheaper than hire purchase as no change of ownership is involved.
* A lease agreement involves the payment of a deposit and a number of deposits being paid (the number of which is agreed in advance.
* Repayments are fixed - At the end of the agreement the asset is returned to the seller.
* Leasing is a flexible source of finance.

**Advantages of Leasing**

1. Leasing is cheaper than Hire Purchase
2. Repayments are regular over a period of time so businesses can thus plan expenditure.
3. Leasing can be used by firms which find it difficult to obtain a loan
4. No security is needed.

**Long-Term Sources of Finance**

**1 – Long term bank Loan – Mortgage/Debenture**

* Mortgage (20-40 years) are used by households to finance the purchase of a house. The Mortgage is paid back with interest in agreed monthly repayments. It can be fixed, variable or tracked to ECB rates.
* A Debenture is a Long Term Business Loan secured on a Businesses Assets such as Buildings or Land. The business pays monthly interest repayments only and pays back the borrowed amount in a lump sum in the future
* A Long Term Business loan acts just like a mortgage and is used to finance Fixed Assets

**2 - Share Capital**

* Equity is the funds that have invested in the business by its owners and not loaned to the business by other individuals or financial institutions. It is any security or stock representing ownership of the business.
* It is provided by shareholders who purchase ordinary shares in the hope of a future dividend.
* A dividend is a share of a business’s profit’s which shareholders receive as repayment to them for investing in the company.
* Share Capital is not repaid. It can be repaid when the business winds up, but this is not compulsory.
* Dividends are not paid if there are insufficient profits or if the business decides to use all profits for expansion

*Preference Shares*

1. Preference shareholders receive payment BEFORE ordinary shareholders
2. They receive their capital on the winding-up of a company BEFORE ordinary shareholders
3. They have no voting rights
4. Preference shareholders receive a fixed dividend regardless of the profit.

Eg The Government is a preference shareholder in AIB as they bailed them out

*Ordinary Shares*

1. Ordinary shareholders receive payment AFTER preference shareholders
2. They receive their capital on the winding-up of a company AFTER preference shareholders. This places them at risk, because the capital they invested may be used to pay other debts or other shareholders and they may lose their investment.
3. They do have voting rights. They have one vote per share. This vote can be used to decide on company policy or to elect directors at an A.G.M.
4. Ordinary shareholders are risk takers. The dividends they receive vary and may not be paid at all.

**Advantages of Share Capital**

1. Flexibility due to payment of dividends
2. It acts as a signal to banks and credit institutions about the commitment of its owners
3. It doesn’t have to be repaid which eases the strain on the business
4. A successful company will find it easier to raise more capital

**3 - Owner’s Capital**

* This refers to the money put into the business by the individual setting up the business.
* This money is left in the business for as long as the business stays in operation or until the individual decides to leave the business.
* This is a cheap source of finance and signals the owners commitment to the business

**4 - Retained Earnings**

* These can be known as reserves and mean that profits are ploughed back into the business to assist its growth. It may cause conflict with shareholders
* When a business makes profit, these profits don’t have to be paid to the directors or paid to the shareholders; they can be put on deposit or invested. These profits build up over a period of time, and are effectively the same as savings for a household.
* If the business keeps reserves, this means that profits are not being paid to shareholders in the form of dividends and thus needs permission from its shareholders to do this.

**5 - Government Finance**

* Government grants are non-repayable amounts of money given to enterprises by state agencies for specific purposes.
* Grants are given by Forbairt, the County Enterprise Boards, EU agencies, and encourage certain activities that help develop the business.

Examples of Grants

1. Capital Grants - These help with the purchase of fixed assets
2. Feasibility Study Grants - These enable market research to be conducted on new products
3. Training Grants - These help meet the training needs of staff

**6 - Venture Capital**

* This is provided as start-up (seed) capital for new business enterprises and as development capital for existing businesses in which there is a higher than average degree of risk.
* Finance is provided by venture capital companies through a direct loan, through the purchase of shares in a company or through a mixture of both.
* The venture capital company will usually want to place members of its own staff on the board of directors to oversee the new firm’s progress. This is known as a partnership approach and raises the image of the business with customers, suppliers and banks. Eg Dragons Den investors

**Factors Considered by lenders when applying for Loans/Finance**

* Character – are you trustworthy and reliable
* Capacity – Will you be able to pay back the loan
* Collateral – have you any assets to provide security in the event the loan is not repaid.
* Credit Rating – have you a good credit history – what is your level of risk

**Factors to consider when choosing a source of Finance:**

**1 - Costs**

Households and businesses should shop around for the cheapest source of finance. The interest charged is the cost of borrowing and it can vary widely from lender to lender. Also factor in number of years – the longer the term the lower the monthly repayment will be but the higher the overall repayment will be.

**2 – Purpose**

A business should match the source of finance to the Item it is buying. The term of the loan should not exceed the lifespan of the asset (not applicable to short term). If you borrow €50000 for a car and pay it back over 20 years at 10% interest p.a. you will pay back €624 per month for 240 months totalling €149760 which makes the finance arrangement very very expensive!

Therefore: Short Term – Day to Day running expenses

Medium Term – for assets of life span of 5-10 years

Long Term – for assets with life span of 20 years or more

**3 – Security**

**Collateral** - What collateral is needed to acquire that asset? Could my home be re-possessed?

**4 – Tax Implications**

Are there any tax incentives? Is there any tax relief for mortgage or debenture interest?

**5 – Control**

Loans do not require giving away any control of the business but share capital and venture capital will? How much are you prepared to give away?

**Cash Flow Forecasting and Cash Flow Management**

Used to predict and manage the flow of cash in a business in the future (short and medium term). It will allow you to plan for future deficits or surpluses of cash which may arise. If you can plan for them they should not cause you any trouble.

**Dealing with an Expected future Deficit**

**1. Increase cash receipts** – tighten credit control and ensure debtors pay on time. You could also sell an investment or asset if the need arose

**2. Reduce cash payments** – reduce expenses such as wages and spread loan repayments. Make cutbacks to other expenses such as energy, fuel and advertising. Reduce dividends paid to shareholders.

**Dealing with a future surplus**

**1. Pay off debts –** pay off loans with banks, expenses due to creditors as this will reduce interest costs and incur credit discounts

**2. Reinvest** – reinvest the money into the business by upgrading technology and equipment – this improves efficiency.

**Banking Facilities for Households and Businesses**

**A. Current Accounts**

These allow customers to lodge (put money in) and withdraw (take money out) funds on a regular basis

**1. ATM - Automated Teller Machines**

**2. Laser Card/Debit Card**

* Money is effectively transferred from your account into the account of the retailer/supplier that you are paying.
* Customer’s can withdraw money from their account using the same method i.e. ‘cash back’.
* These are very popular. They are cheaper and more convenient than writing a cheque.

**3. Cheques**

A cheque is an order by the current account holder, to the bank to pay a stated amount of money to a named person or order (or order means that one can pass ownership of the cheque on to someone else).

**4. Direct Debit**

This is an arrangement that authorises a firm, such as Eircom/Vodafone/ESB, to make regular withdrawals of variable amounts from a specified account.

**5. Standing Orders**

This is an arrangement with the bank to pay a regular, fixed amount out of an accouns

**eg.:** mortgage repayments, rent, etc.

**Characteristics of Current Accounts**

1. Money can be withdrawn in a number of ways
   1. Over the counter
   2. ATM
   3. Cheque
   4. Laser
2. Overdrafts can be obtained on accounts
3. Direct payments can be made into and out of these accounts by using standing orders and direct debit
4. Regular statement are received showing the state of the account
5. Inters is normally not earned on money in these accounts
6. Fees are charged for using these accounts

**Businesses applying for a Loan**

* They must submit a loan application form
* This is more complicated than the application submitted by a householder. The business manager usually has to meet with the bank manager.
* It gives
  + Details of the business – what does it do? Where is it based? Where is it’s primary market? What are its assets? etc.
  + Details of the owners of the business – their age, the management capability
  + Prospects for the business supported by research – what is the economic climate?
  + Accounts of the business showing the existing financial commitments of the business, its performance over the past number of years – this indicates the businesses ability to repay the loan