13 Business Finance

13.1 Introduction and objectives

Management accounting decisions whether short-term or long-term cannot be made without some consideration of how they are to be financed. The financing decisions that an organisation makes will generally relate to the length of time the finance is required, the cost of capital and the capacity to borrow.

After studying this chapter you should be able to:

- Identify the main sources of short-term finance
- Identify the main sources of long-term finance
- Distinguish between the financing sources available to different sizes of organisation
- Understand the specific financing options available to hospitality, tourism and events organisations.

13.2 Short-term sources of finance

Short-term finance generally refers to sources of funding which will not be required for more than one year. The previous chapter showed that a sound working capital financing policy requires short-term assets to be generally financed by short-term liabilities. The most common sources of short-term finance are considered below.

13.2.1 Bank overdraft

One of the most important external sources of short-term finance, particularly for smaller businesses, is the overdraft. An overdraft facility allows the business to spend more money than is deposited in the bank account. The amount of the overdraft will rise and fall as funds are deposited and spent from the account. Features that make the overdraft popular are:

- The bank will agree to a maximum overdraft limit or facility. The borrower may not require the full facility immediately, but may draw funds up to the limit as and when required which promotes flexibiiity.

- Legal documentation is fairly minimal when arranging an overdraft. Key elements of the documentation will be to state the maximum overdraft limit, the interest payable and the security required.
- Interest is only paid on the amount borrowed, rather than on the full facility.

The drawbacks of overdraft finance are:

- The overdraft is legally repayable on demand, which means that the facility could be withdrawn at any time.
- Security may be required over the businesses assets.
- Interest costs vary with bank base rates.

13.2.2 Term loans

The retail banks offer term loans these are also a useful source of funds for smaller businesses due to their accessibility. A term loan is for a fixed amount with a fixed repayment schedule. Usually the interest rate applied is slightly less than for a bank overdraft. The lender will require security to cover the amount borrowed and an arrangement fee is payable dependent on the amount borrowed.

The advantages of term loans are:

- Easily and quickly negotiated
- Flexible payments may be offered
- Variable interest rates.

A term loan also has the following advantages over overdrafts:

- Both the customer and the bank know what the repayment schedule is which is important for planning cash flow and also the precise terms of the agreement.
- Peace of mind – no risk of immediate withdrawal of the loan.

13.2.3 Trade credit

Trade credit is an important source of finance for most businesses. Trade credit is the money owed to the suppliers of goods and services as a result of purchasing goods or services on one date, but paying for those goods on a later date. The management of trade credit was discussed in the previous chapter. The amount of trade credit available will vary depending on the nature of the industry, the product being supplied and the ability of the two parties to negotiate.

Advantages of trade credit:

- Convenient/informal/cheap
- Available to organisations of any size.

13.2.4 Deferred income

A key feature of service business such as events operators and tour operators is the advance payment of fees and ticket sales. In such businesses customers pay well in advance for the services they are going to use, such as fees for an exhibition stand or advance payment for a holiday. This is a vital source of finance for these businesses as they receive the cash up to 12 months ahead of delivering the service and can use this to fund their operations. It should be noted that if the company subsequently fails to deliver the service they will have to repay this money plus additional penalties.

Advantages of deferred income

- Convenient/informal/cheap
- Occurs naturally as part of business operations
- Available to organisations of any size
- Must be repaid if services not provided.

Example 13.1: the balance of short-term liabilities for ITE (international large events company). Extracted from ITE Annual Report 2011.

ITE short-term finance	**%**
Bank overdraft	13.5
Trade and other payable	19.2
Deferred income	65.9
Provisions and derivatives	1.4
	100.0

The clearly shows that deferred income is their major source of short-term finance.

13.3 Long-term sources of finance

Long-term sources of finance are required when the organisation requires funds for investment, which will take more than 12 months to mature. The capital investment decisions considered in the next chapter rely on the ability to raise finance from long-term sources. Long-term sources can usually be divided into two types:

- Equity
- Debt.

13.3.1 Equity

Equity refers to funds provided by the owners of the organisation. In a small business the initial capital is supplied by either an individual owner (known as a sole trader) or by several owners (known as a partnership).