Chapter 8 - Finance

1 (2018)

4.

1	2	3	4	5
E	**D**	**A**	**B**	**F**

10

3+2+2+2+1

2 (2017)

5.

A.	**25,000**
B.	**(3,000)**
C.	**11,000**
D.	**5,000**
E.	**16,000**

10

3 (2011)

(a) Explain the term 'Short-term finance'.
Short-term finance is finance that is available for a period of up to one year. It should be repaid within twelve months.

(b) Illustrate a business situation where 'short-term finance' **would** be appropriate.
Trade credit could be used to purchase stock for resale.

A	i	Name the type of production process used by Sarah. **Job Production**		
	ii	Outline **two** challenges for Sarah of this type of production process. The product involved i.e. the designer wedding dress, requires highly skilled labour. Sarah will have to continue her professional development to keep up with new production techniques, IT developments, and changes in fashion and style. Highly skilled labour will mean a higher wages bill. This type of work is very labour intensive and the high salaries will increase the running costs of the business. Raw materials, equipment, tools, machinery are expensive for this specialised production. In addition it is generally a small scale operation and does not benefit from economies of scale. It is a very slow process. Quality standards have to be very high. There is no room for error. The slightest fault with the product will have to be corrected in an efficient manner to prevent the loss of the sale and business reputation. Once-off production to a specific order. If the customer ordering the product is unable to pay (goes bankrupt) it may be difficult to find an alternative buyer.		
	iii	Discuss **two** implications for Sarah of changing to another type of production process. Both batch and flow (mass) production are heavily automated production processes. Substantial investment in machinery, equipment, IT, premises etc. will be required. Finance will be required to fund the necessary investment. Sarah will have to look carefully at her finance options. Are her reserves adequate? If not, long term loans, for capital investment and finance for increased working capital needs will have to be sourced. Sarah will have to review the ownership structure and maybe change to a private limited company in order to be able to raise finance through selling shares and benefit from limited liability. This involves a loss of control of business. Sarah will no longer be making goods to order. She will be creating goods for stock. A stock control system will have to be developed, leading to increased costs. A marketing plan will have to be implemented.		

6	**B**		Outline **three** factors that Sarah's bank may consider when assessing her bank loan application. <u>Creditworthiness:</u> The bank will look at her credit history and her record in terms of repayment of previous loans. Any bad debt history will affect her loan application. <u>Ability/capacity to repay the loan/Business Plan:</u> Sarah will be expected to provide a business plan outlining her trading history and predicted profit trends for the short and medium term. Profitability/liquidity/gearing. <u>Amount /purpose of the loan/Time period for the loan:</u> The larger the loan amount required the riskier it is for the bank in terms of default. As a consequence, the loan application may be affected. Furthermore it will be expected that the loan application is for a productive purpose e.g. business expansion. <u>Availability of Security:</u> A valuable asset such as premises will be required as collateral for the loan. In the event of a default the bank will be able to sell the asset to recover its loan. <u>Level of own investment/Grants</u> etc.	15
6	**C**	**i** **ii**	Explain the term 'short term finance'. Short-term finance is finance available for a period of up to one year. It should be repaid within twelve months and should be used for short term needs. Outline **two** sources of short term finance Sarah may consider to meet her working capital needs. <u>Bank Overdraft</u> This is a facility offered by a bank that allows current account holders to withdraw more money from their account than they actually have in it. Interest is charged on the outstanding balance on a daily basis. It can be recalled by the bank at any time. Sarah could use an overdraft facility to purchase stock or pay the wages of part- time staff**.** <u>Accrued Expenses:</u> This source of finance frees up money by delaying the payment of regular bills such as utilities, rent or insurance. This would free up cash for Sarah to pay for supplies which in turn could be sold allowing these bills to be paid later. <u>Trade Credit</u>**:** Sarah may buy stock for resale on a "buy now and pay later" basis. The amount of credit available may be dependent on her reputation and creditworthiness. There is no direct charge but cash discounts can be sacrificed if Sarah chooses to buy raw materials and stock on credit**.** <u>Factoring Debts/ Short Term Loan from a credit union</u>**..........**	20

The benefits/risks of franchising as a form of expansion (evaluate) **for the franchisor:**

Benefits:

- It is a form of expansion which requires, **low capital investment** by the franchisor as the capital used to expand the business comes from franchisees. Very suitable/popular in the current economic climate as a form of expansion.

- Franchising permits a **more rapid expansion.** By using the franchisees' capital, the franchisor is able to establish a large number of outlets in a short period of time. Rapid expansion can be achieved without incurring the overheads and costs associated with opening company-owned restaurants.

- An owner will be **more attentive** than a manager. This is the central point which makes franchising so attractive. Marie's Pizza, the franchisor can be assured that the person operating its restaurant will be "attending to business" as much as Marie would. By franchising the restaurant, the franchisor places the expansion of his/her business in the hands of people who are **motivated** to make it work. Having invested, in many cases, their life savings in a franchise, franchisees will strive to make the restaurant successful. Their livelihood depends on it.

- There is **strength in numbers**. The successful franchisor can command deals with various suppliers.

- The **return on investment is much higher** for a restaurant that expands through franchising. Because there is less capital employed, the franchisor's profits are generated on a much lower capital investment. Although the revenue from franchised restaurants may be less than that received from company-owned restaurants, a higher percentage of the revenue is profit.

- A franchise system requires **less management** than a company owned chain of restaurants. Hiring, training, motivating and retaining competent staffing are all functions handled by the franchisee, not the franchisor.

- There is **low risk** to the franchiser as should the franchisee not adhere to the conditions of the contract it could be cancelled.

Risks :

- **Control** is lost over the day-to-day management of the franchise businesses.

- The **reputation** of the whole business could be affected by the actions of one franchisee /poor quality standards/staff problems
- Maintaining a **brand's integrity** through the process may be difficult.

Example of franchise in Ireland:

Supermacs is Ireland's largest indigenous fast food restaurant group with a policy of continued expansion and growth. It now has 90 stores throughout Ireland and Northern Ireland. Pat Mc Donagh, the founder, has created a success story in the Irish restaurant industry. It has a total staff of over 2,500. It has plans to open 6 new stores in 2010.

(B) Outline two benefits to Marie's Pizzas of preparing a Business Plan

- **Finance/Grants:** a business plan will be required when or from government agencies. Without it, the future, and therefore the success of the business, will not be fully appreciated. No financial institution/government agency will give funds to a business without being convinced that the investment has a good chance of being recovered. Necessary to obtain/qualify for Grants.

  The business plan markets **Marie's Pizzas** business and encourages potential investors.

- **Performance Measurement**: it can be used in the future to measure the performance of the business against the objectives/targets set out in the plan. By having realistic figures available they can be used as a benchmark or standard against which the operations and performance of the business can be measured.

  If the standards are not reached then **Marie's Pizzas** may take actions to fix the problem.

- **Viability:** It sets out thoughtful, well presented/laid out logical steps designed to implement both short term and long term strategies over agreed time periods, e.g. one year, five years ten years etc. It plans how to get where the business wants to go over those time periods.

  By planning ahead **Marie's Pizzas** can foresee difficulties and take steps to address the problems.

(C) (i) Discuss the factors that should be considered before choosing between different sources of finance.

- **Cost:** a business should try to obtain the cheapest source of finance available. The rate of interest is of great importance. All loans advertised by financial institutions should quote the **APR**. Close examination of the **APR** attached to each type of loan finance is needed when making the choice.

- **Purpose/Correct match:** sources of finance must be matched with uses e.g. a long term business expansion plan should not be financed by a bank overdraft. Assets which are going to last a long time are paid for with long term finance. Day-to-day expenses are financed or paid for with short term finance.

- **Amount:** large amounts of money are not available through some sources. Some sources of finance may not offer flexibility for smaller amounts.

- **Control:** issuing new voting shares in a company could lead to a change of power.. The use of loan capital will not affect voting control but financial institutions such as banks may take control of fixed assets or impose conditions as part of the loan agreement.

- **Collateral:** lenders often seek security before giving finance. This restricts the freedom of the borrower regarding what it wishes to do with these particular assets. Sometimes the borrower may not have enough assets to give as security, which can then limit the sources of finance available.

- **Risk:** a business which has less chance of making to a profit is deemed more risky than one that does. Potential sources of finance (especially external sources) takes this into account and may not lend money to higher risk businesses, unless there is some guarantee that their money will be returned.

- **Status of the business:** Private Limited (Ltd) or Public Limited (PLC) companies will find it easier to obtain finance than a sole trader as LTDs and PLCs are required to prepare much more detailed financial information, which can assist the finance raising process by the banks.

- **Availability/Credit crunch:** The effects of the credit crunch have impacted on business banking relationships. Liquidity is extremely tight at present, with banks currently exhibiting extreme caution. While banks may advertise that it is business as normal, many businesses in search of finance or renewal of existing facilities would say that this is not the case. More onerous conditions may be attached to borrowings and increased difficulty in renegotiating existing facilities may exist.

(ii) Analyse two appropriate sources of finance for acquiring an additional delivery van at "Marie's Pizzas".

Medium Term Loan

- A medium term loan is obtained for a period of one to five years.
- Interest must be paid but it is tax deductible.
- The loan is repaid in agreed instalments.
- The bank may require security or personal guarantees to ensure the loan is repaid.

Leasing

- This involves renting rather than purchasing the asset.
- The business will never get to own the asset.
- Payments may be offset against tax.
- No security is required.
- While it costs more than cash purchase it helps a businesses cash flow.
- The business may have an option to replace the asset if it becomes obsolete.

Hire Purchase

- This is purchasing an asset in instalments and ownership passes with the final payment.
- It is expensive and carries a high rate of interest.
- No security is required but the lender may repossess the asset if you default on repayments.
- It is not as tax efficient as leasing.