

Sources of Finance

Financial Hedging:

The useful life of an asset will determine the type and duration of the financing of it e.g. – Buildings are normally financed by a long term loan secured by a registered charge on the buildings (generally known as a Mortgage).

Capital Allowances:

In preparing accounts, allowance is made for wear and tear of fixed assets. The deduction against profit is called Depreciation and is arrived at making due allowance for the useful life of the asset. Notwithstanding the rate used to calculate depreciation, the deduction allowed for tax purposes is known as a Capital Allowance and the rate of wear & tear is 12½% (i.e. over 8 years).

1. Long Term Sources:

Share Issues:

- (a) Public are invited to subscribe for shares.
- (b) In exchange for the funds subscribed, share certificates are issued.
- (c) No security is available to investors.

Retained Profits:

Where a company trades successfully over many years, it may prefer to refrain from paying dividends to the shareholders and keep the profits for internal investment in the company. Once-off or windfall gains (e.g. sales of land and buildings in Ballsbridge by Jury-Doyle Hotels) are often retained in the company particularly if shareholders have high tax exposure on a distribution. Like share issues, there is no security available to the shareholders for the profits retained.

Term Loans:

- (a) Application is made to a financial institution for funds.
- (b) The funds advanced are secured on the assets of the borrower.
- (c) The term of the loan is generally approximate to the useful life of the asset for which funding is obtained.
- (d) The borrower can avail of capital allowances where the asset is plant, machinery and vehicles.
- (e) Interest is imputed in the repayments and can be at a variable or fixed rate.

2. Medium Term Sources:

Hire Purchase:

- (a) The HP Company buys the asset.
- (b) The borrower/hirer pays a regular periodic payment (called a “rental”) to the HP Company for the use of the asset.
- (c) The interest imputed in the rental is often set at a high rate and does not vary with movements in base interest rates after the agreement has been signed and this can make HP a costly source of finance.
- (d) The borrower claims capital allowances as, under the agreement, title (or ownership) transfers to him.
- (e) Title is generally transferred to the borrower when 2/3rds of the rentals have been paid or, if specifically stated, on payment of the final rental.
- (f) The asset (being owned on commencement) is the security of the HP Company.
- (g) Borrower assumes all responsibility of ownership and must insure & maintain the asset.

Leasing:

- (a) Similar to Hire Purchase.
- (b) However, the agreement is solely for rent of the asset for use by the lessee.
- (c) Title never transfers to the lessee under the agreement.
- (d) Consequently, the Leasing Company claims the Capital Allowances (important consideration where the asset is green / environmental and qualifies for accelerated capital allowances).
- (e) The lessee can acquire title to the asset by acquiring it from a “Leased Asset Disposal Company”.
- (f) The lessee assumes all responsibility of ownership and must insure & maintain the asset.

3. Short Term Sources:

Trade Credit:

- (a) A spontaneous source of finance obtained in the normal course of business.
- (b) The amount of credit & the duration is dependant on the credit rating of the business.
- (c) It effectively finances the company’s trade debtors and stocks.
- (d) Some suppliers secure themselves by supplying under reservation of title though this only works with goods that are not subject to conversion.

Bank Overdraft:

- (a) A negotiated source of finance.
- (b) Dependant on the past results and projected earning of the business.
- (c) Is normally secured either on assets of the business though more often by the proprietors personally (personal guarantee).
- (d) It is expected that the account should operate for a minimum of 30 days in credit (in the black).
- (e) The overdraft is repayable at call (i.e. called in at the instance of the bank).

Factoring:

- (a) Accelerates the realization (payment) of funds tied up in debtors.
- (b) The factor company agrees to advance to the company a high percentage of amounts set out on invoices to domestic customers.
- (c) The advance is made on date of issue of invoice.
- (d) When the factor company collects payment from customers, a “fee” is withheld from the payment of the balance to the business.
- (e) An expensive source of finance and has been replaced in recent years by commercial finance.

Commercial Finance:

- (a) Bank given on-line access to debtor’s ledger.
- (b) Bank advances 60% of Debtors Balances less than 2 months old.
- (c) Line of credit moves with variations in amounts owed by customers.
- (d) Costly form of finance.
- (e) Security is a first charge on book debts.
- (f) Funds are drawn down from a dedicated bank current account (i.e. transferred from this account to the normal checking account).