Unit 3.1 Sources of finance

Task 1: Classification of assets and liabilities

Classify the following into either assets or liabilities and whether they represent an expense or a source of income (revenue) for a large book publisher. Use ticks (✓) to indicate your answers.

Category	Asset	Liability	Expense	Revenue
Bank interest receivable				
Bank loans				
Bank overdrafts				
Debentures				
Insurance premiums				
Motor vehicles				
Rent accruals				

Task 2: Vocabulary quiz

Identify the key terms from the clues given. *Hint*: the answers are in reverse alphabetical order!

Key term	Definition
	High-risk capital invested by specialist finance firms, usually at the start of a business idea, usually in the form of loans and/or shares in the business.
	The day-to- day spending required for the running of a business, e.g. rent, raw materials, wages and utility bills.
	The most common type of shares issued by a limited company, which gives owners voting rights and dividends based on the company's profits.
	A long-term source of finance that requires the borrower to provide property and land as collateral (security guarantee) to the lender in case the borrower defaults on the loan.
	Refers to the generation of finance from within an organization's own resources and funds, e.g. retained profit and the sale of assets.
	Refers to the original sales of a company's shares on a listed stock exchange, by offering its shares to the general public for the first time.
	Source of credit finance that allows firms the chance to use assets without having to pay for them in one lump sum. Once the final repayment (instalment) has been made, the asset legally belongs to the business.
	A long-term source of external finance which gives holders a fixed rate of return (interest) but without any ownership or voting rights.
	The spending on items considered as fixed assets, such as: land, buildings, machinery and motor vehicles.
	Wealthy entrepreneurs who risk their own money by investing in small to medium sized businesses that have high growth potential.

Task 3: Outline the differences between ...

a. capital expenditure and revenue expenditure.

b. short-term and long-term finance.

c. an overdraft and a bank loan.

d. a loan and a mortgage.

e. ordinary shares and debentures.

f. debt finance and equity finance.

g. owners' capital and loan capital.

Task 4: True or false?

		True/False
a.	Capital expenditure is used to pay for the working capital of an organization.	
b.	Personal finance is the cheapest source of finance.	
c.	Directors own the money of incorporated companies and use these on behalf of their shareholders.	
d.	Government grants and subsidies are a form of external financing.	
e.	A share issue by an existing company is considered to be an internal source of finance.	
f.	Collateral acts as security to the lender in case debtors default on their loans.	
g.	Relying on loan capital means the business is likely to suffer during times of rising interest rates.	
h.	Overdrafts are easier to obtain than most other forms of external finance.	
i.	Permanent capital is equal to the value of shareholders' funds, i.e. share capital.	
j.	It is best if a business limits external financing from a variety of sources simply because this raises its financial risks.	
k.	Venture capitalists tend to invest their money in medium to large sized businesses since they have the best investment track record.	

Task 5: Multiple choice

1. Which of the following is the most suitable reason for using personal finance?

   A. Insufficient internal sources of finance

   B. Insufficient external sources of finance

   C. There is no interest obligation

   D. To please the owners (shareholders) of a company

2. Which of the following is not a feasible source of finance for an ordinary partnership?

   A. Secured bank loans

   B. Sale and leaseback

   C. Debt factoring

   D. Initial public offering

3. Advantages of internal finance do not include

   A. Greater flexibility in the use of finance

   B. Greater choice of finance

   C. No need to go through administrative procedures

   D. Tax concessions for the use of internal profit

4. Which of the following is the most feasible advantage of using internal funds to purchase a new office building?
   - **A.** Limited impact on the firm's working capital
   - **B.** Lower level of gearing
   - **C.** Dilution of ownership
   - **D.** Increased value of fixed assets

5. Businesses might choose to use external sources of finance because
   - **A.** There are no interest charges
   - **B.** Potential cash flow problems are avoided
   - **C.** There is insufficient retained profit
   - **D.** There is an expected rise in interest rates

6. Which of the following is not a source of external financing for a public limited company?
   - **A.** Overdraft
   - **B.** Debentures
   - **C.** Retained profits
   - **D.** Share capital

7. Advantages of funding growth through a share issue include all those listed below except
   - **A.** An extra source of finance
   - **B.** Less financial risks due to the spreading of risks amongst shareholders
   - **C.** Control of the company is diluted
   - **D.** It acts as a form of motivation for employees who own shares in the company

8. Which of the following is a drawback to a business that issues debentures?
   - **A.** Lenders do not have any voting rights
   - **B.** There is dilution of control
   - **C.** There is a dilution of ownership
   - **D.** The value of liabilities increases

9. Debenture holders
   - **A.** Own a part of the company in which they hold debentures
   - **B.** Are paid a return from the profits of the company
   - **C.** Receive payments from companies before any shareholders
   - **D.** Are represented as current liabilities on the company's balance sheet

10. Debentures can best be described as a form of

    A. Short-term loan with variable interest rates

    B. Medium-term loan with variable interest rates

    C. Long-term loan with a fixed interest rate

    D. Long-term security giving the holder part ownership of the business

11. Which of the following is not a clear difference between debenture holders and shareholders of a company?

    A. Voting rights in the company

    B. Ownership of the company

    C. Interest and dividends as a form of financial return

    D. Impact on the company's working capital

12. Which of the following is the least likely source of funds for a non-profit organization?

    A. Fund-raising events

    B. Charitable donations

    C. Brand recognition

    D. Sponsorship deals

13. Which of the following best describes hire purchase?

    A. Hiring of equipment for a period of time

    B. Repaying loans by making fixed regular payments

    C. Hiring out equipment as a source of finance

    D. Differs from leasing in that ownership occurs with the last instalment

14. The contract used to raise finance by selling the freehold of an asset and then renting it back immediately on a long-term basis is known as

    A. Working capital

    B. Sale and leaseback

    C. Fixed assets

    D. Trade creditors

15. Which statement does not apply to the use of sale and leaseback?

    A. The firm can continue to use the asset it has sold and leased back

    B. The value of fixed assets remains unchanged since the firm keeps use of the asset

    C. The firm can carry on trading as if nothing has happened

    D. The finance released through the sale improves the firm's liquidity position

16. The debt factoring service that allows the client to be protected against bad debts is known as

A. Overdraft

B. Non-recourse factoring

C. Collateral

D. Discount factor

17. Mei Ling Photography Corp. has a cash flow deficit of $85 000. If it has debtors to the value of $100 000 on its balance sheet, what is the maximum charge that a factoring service could impose to make this source of finance feasible?

A. 5%

B. 10%

C. 15%

D. 20%

18. Which source of finance below would best be described as loan capital?

A. Ordinary share capital

B. Equity finance

C. Debt factoring

D. Debentures

19. There must be sufficient finance to pay for the daily running of the business. This money is known as

A. Working capital

B. Work-in-progress

C. Retained profit

D. Buffer stocks

20. Which of the following is a disadvantage of leasing capital equipment?

A. It is cheaper in the long run to buy capital equipment

B. The firm might not have sufficient funds to purchase the equipment

C. Capital equipment needs replacing if technology is changing rapidly

D. The management of cash flow is easier with regular repayments

