**Chapter Six**

**Organizing and Financing the New Venture**

 **6.1. Sources of Financing**

**Financial Requirements**

Finance is a key input of production. It is a pre requisite for accelerating the process of industrial development. Financial resources are essential for business, but particular requirements change as an enterprise grows. Obtaining those resources in the amount needed and at the time when they are needed can be difficult for entrepreneurial ventures because they are generally considered more risky than established enterprises.

**Types of finance**

Depending upon the nature of the activity, the entrepreneurs require three types of finances; i.e. short term, medium term and long term finances.

**1. Short term finance-** Short term finance refers to the funds required for a period of less than one year. Short term finance is usually required to meet variable, seasonal or temporary working capital requirements. Borrowing from banks is a very important source of short term finance. Other important sources of short term finance are trade credit, installment credit, and customer advances.

**2. Medium term finance-** The period of one year to five years may be regarded as a medium term. Medium term finance is usually required for permanent working capital, small expansions, replacements, modifications etc. Medium term finance can be raised by;

* Issue of shares
* Issue of debentures
* Borrowing from banks and other financial institutions
* Plaguing back of profits by existing concerns.

**3. Long term finance-** Period exceeding 5 years are usually regarded as long term. Long term finance is required for procuring fixed assets, for the establishment of a new business, for substantial expansion of existing business, modernization etc.

The important sources of long term finance are;

* Issue of shares
* Issue of debentures
* Loans from financial institutions
* Plaguing back of profits by existing concerns.

**Sources of Finances**

1. **Equity financing-** Equity is capital invested in a business by its owners, and it is ‘at risk’ on a permanent basis. Because it is permanent, equity capital creates no obligation by an entrepreneur to repay investors, but raising equity requires sharing ownership.
2. **Venture capital-** Venture capital is an alternative form of equity financing for small businesses. Venture capitalists focus on high risk entrepreneurial businesses. They provide start-up (seed money) capital to new ventures, development funds to businesses in their early growth stages, and expansion funds to rapidly growing ventures that have the potential to “go public” or that need capital for acquisitions.
3. **Personal sources-**  Entrepreneurs must look first to individual resources for start up capital. These include cash and personal assets that can be converted to cash. Family members and close friends become involved as informal investors.
4. **Commercial banks-** Most commercial loans are made to small businesses. Commercial banks provide unsecured and secured loans. An unsecured loan is a personal or signature loan that requires no collateral; the entrepreneur is granted the loan on the strength of his reputation. Secured loans are those with security pledged to the bank as assurance that the loan will be repaid.
5. **Finance companies-** There are three types of finance companies, and although all are asset-based lenders, each serves a different clientele. These are sales finance companies, consumer finance companies, and commercial finance companies.
* ***Sales finance companies-*** focus on loans for specific purchases like automobiles and farm machinery. Most of the customers are end users such as individuals who have their new cars financed through finance companies.
* ***Consumer finance companies-*** focus on short term loans secured by personal assets, and most consumer loans are for small amounts at high rates of interest. These loans are typically negotiated directly between finance companies and consumers for purchases such as furniture, appliances, vacation trips and home repairs.
* ***Commercial finance companies***- are focused predominantly on small business and agricultural lending. Their primary business is making loans on commercial, industrial and agricultural equipment.
1. **Leasing**

Leasing allows a small firm to obtain the use of equipment, machinery or vehicles without owning them. Ownership is retained by the leasing company, although in many cases there is a purchase option at the end of the lease period.

1. **Hire purchase**

Hire purchase provides the immediate use of the asset and also ownership of it, provided that payments according to the agreement are made.

1. **Factoring**

Factoring is a specialist form of finance to provide working capital to young, undercapitalized businesses. A small firm, which grants credit to its customers, can soon have considerable sums of money tied up in unpaid invoices. Factoring is a method of releasing these funds; the factoring company takes responsibility for collection of debts and pays a percentage (Usually 80%) of the value of invoices of the issuing company.

**Control of Financial Resources**

**Financial problems**

Fast growing small businesses have particular problems in controlling their finances. Growth brings frequent changes to the internal structures and external environment of a small firm. It is often difficult to ensure that financial control systems keep pace with the changing circumstances. The small business is likely to be confronted by a variety of financial problems as it advances through its life cycle.

|  |  |  |
| --- | --- | --- |
| **Stage** | **Likely sources of finance** | **Financial issues** |
| Conception | Personal investment | Under capitalization, because of inability to raise finance. |
| Introduction | Bank loans, overdrafts | Control of costs and lack of information. |
| Development | Hire purchase, leasing | ‘Over trading’, liquidity crisis.  |
| Growth | Venture capital | ‘Equity gap’ appropriate information systems. |
| Maturity | All sources | Weakening return on investment |
| Decline | Sale of business/ liquidation | Finance withdrawn. Tax issues of business are sold.  |

**The financial life cycle of a small firm**

**Cash flow-debtors and stock**

Financial management is a small firm starts with the management of the cash flow. It is easy for cash resources of a small business to become ‘locked up’ in unproductive areas such as debtors, work in progress and finished stocks.

Debtors can hurt small business in two major ways;

1. They absorb cash and effectively increase the funding requirement of a small firm.
2. The longer a debt is alive, the greater the risk of a bad debt.

Stock represents a poor investment for a small firm’s financial resources. Stock surpluses earn no money and the risk of deterioration if not used quickly. Stock management is about balances, and the optimization of resources. Stocks need controlling in three areas- raw material stock, work-in-progress, finished stock.

**Costs and profits**

Profits and losses are theoretical figures representing the difference between total earnings and total expenditures, incurred by a small firm in achieving those earnings. Profits or losses should be translated into cash surpluses or deficits. Profitability can be improved by;

* Reduction of costs
* Increase of prices
* Increase of sales volume

Costs are classified as fixed or variable. Fixed costs remain unchanged in the short term. These costs will not vary with the volume of goods or services sold. They are the overheads of a business. Fixed costs do vary in the long term. Variable costs are operational expenses that change according to the volume of production.

**Financial analysis**

Small firms differ greatly in their approach to the provision of accounting information, and the use of forecasts and budgets for planning and controlling of business. The three most widely used financial summaries are;

* Profit and loss account or income statement
* Cash flow, and
* The balance sheet.

*The profit and loss account*, also commonly called as income statement shows how a business is doing in terms of sales and cost- and the difference between them of profit or losses.

*The cash flow summary* indicates the movement of cash into and out of the business. It differs in the important respect of reflecting credit given to customers and received from suppliers, as well as the amount of money invested in a business, or borrowed by it.

*The balance sheet* represents a summary of what money has been spent by a business, and what it has been spent on. It is usually an annual summary of the use and source of funds in a company.