SOURCES OF FINANCING AND FINANCIAL INSTITUTIONS

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WHAT WE NEED TO KNOW

- Here are all the points this PowerPoint aims to cover from the BME Y12 Syllabus.

- types of financial institutions, including:
  - banks
  - finance companies
- sources of internal funding, including:
  - retained profits
- sources of external funding, including:
  - debentures
  - share capital
  - trade credit
  - venture capital
  - secured loans
  - financial institutions
  - government

FINANCIAL INSTITUTIONS

A **financial institution** is defined as a firm engaged in the business of dealing with financial and monetary transactions. Examples include deposits, loans, investments and currency exchange.

There are **two** main types of financial institutions in Australia:

- **Authorised Deposit Taking institutions (ADIs)** – these are regulated through the Australian Prudential Regulation Authority
  - **Banks** – These are financial institutions that provide a wide range of financial services to all sectors of the economy. This includes funds management and insurance services. Businesses commonly use them for bank overdraft, which is a form of finance where you can withdraw more money than you have in your accounts
- **Non-Authorised Deposit Taking Institutions (Non ADIs)** – these are regulated through the Australian Securities and Investments Commission (ASIC)
  - **Merchant banks** – These financial institutions operate in wholesale markets (large volume production of goods), borrowing and lending with large firms and government agencies. Firms will use them to acquire “commercial bills” to finance inventory
    - Other services include advisory, relating to a firm’s finances, capital markets, and investments
    - Provides financial help and supplies capital in launching initial public offerings (IPOs, when a firm first goes on a public stock exchange), and mergers
  - **Finance companies** – These financial institutions provide capital loans to households and small to medium sized businesses. Firms typically use them to finance non-current assets (machinery, equipment) through obtaining a secured loan
    - **They raise funds from wholesale markets** and using debentures (will be explained later!)
    - **Unlike banks they do not accept deposits**

RETAINED EARNINGS & INTERNAL FINANCING

In this course, there is only one main source of internal funding covered which is **retained earnings** (also known as retained profits). This is the residual (left over), undistributed profits after deducting all expenses, taxes and dividends (payments made to shareholders).

- It is considered a form of **Equity** for firms
- Usually used as long-term financing for non-current assets
- There is no debt-repayments in this form of financing, making it easily accessible
- Can be used for emergency funding, with no distribution of control allowing the business to use retained earnings as they see fit
- It does limit dividends which makes it less attractive to shareholders
  - **Definition of Dividends**: *a sum of money paid regularly (typically annually) by a company to its shareholders out of its profits (or reserves).*

FACTORS TO CONSIDER WITH RETAINED PROFITS

Advantages	Disadvantages
• Money does not need to be paid back	• Limited in availability (as it purely depends on profitability) which may result in the need for additional funds acquired from borrowings (loans etc.)
• Low costs (or gearing) allows the firm to grow and gain profits	• Comes at the expense of dividends which shareholders may disagree with
• Provides absolute control to the firm in how funds are used, this is not the case for certain bank loans	• Management may resolve to spend the money for the sake of doing so, can result in waste
• Ability to pay off debts increases	• No future returns are possible, as it isn't something that accumulates interest
• Ability to reinvest for business growth or expansion	

SOURCES OF EXTERNAL FINANCING

	Definition	Characteristics
Share Capital	A form of capital (the amount of cash or assets held by a company) which comes from issuing shares to shareholders. • It is a form of equity • Considered a long-term source of finance • Can be raised by private firms by selling shares to a select few shareholders, or alternatively they covert into a public company and offer shares on stock exchanges	• Finances non-current assets • A share is one unit of ownership within a firm • Can be used to cover long-term debt • Considered 'one-off' • Publicly listed firms raise money for operations and growth through the sale of shares to the public
Debentures	Financing from the general public, which offers a fixed term and fixed rate of interest to the public. **It is secured to the firm's assets, so in the event the firm defaults (is unable to repay) holders have a way to collect their debts owed to them.** At the end of the term, the firm needs to repay the holder of the debenture. • A form of "debt financing" • Considered a long-term source of finance • No ownership stake or voting rights offered	• Finances non-current assets • Firm incurs the expense of a fixed interest rate • Safe from a holder's perspective in comparison to unsecured note etc • Considered safe to firms as well • It can be traded between holders • **Advantages**: Provides a large pool of funds and flexibility • **Disadvantages:** interest charges, increased risk if interest rates rise

	Definition	Characteristics
Trade Credit	• The provision of credit by a supplier to the merchant (firm) • Credit is defined as: *the ability of a customer to obtain goods or services before payment, based on the trust that payment will be made in the future*	• Finances current assets such as inventory and utilities • Finances expenses and short-term debt (<12-month loans, overdraft) • No additional expenses incurred by firms if the credit terms are met • **Advantages:** Cheap and easy to obtain. Typically pre-approved and on the firm's conditions • **Disadvantages:** Provides a limited pool of funds, repayments required
Venture Capital	Financing directly from investors to start-up firms and small businesses which are believed to have long-term growth potential • Seen as a form of **equity** • A long-term form of finance • Usually provide financing when banks find it too risky	• Finances non-current assets • Investors are typically considered "Angel Investors". They are very affluent people who provide capital for start-ups in exchange for debt or ownership equity of the firm • Venture capitalists usually dictate terms given the invested amounts are usually very large, they usually bring management experience to firms however • High risk for venture capitalists to lose entire investment

	Definition	Characteristics
Secured Loans (mortgages and business development loans)	Loans are a borrowed sum of money (principal) that is expected to be paid back with interest. Secured loans add onto this, with the borrower (firms) putting up collateral (assets) as a form of security in the case they are unable to pay debts. The financial institution would be able to seize said assets to pay off debts due: • Considered a medium to long term source of finance • A form of debt financing	• Finances non-current assets • It is secured against assets • Defaulting on payments (non-payment) results in the loss of the assets used to secure (cover) the debt • **Advantages:** Provides large pools of funds, interest payments can be tax deductable • **Disadvantages**: Repayments include interest
Financial Institutions	**In addition to loans/mortgages** there are the following options: **Overdraft accounts** – where banks enter into a lending agreement with firms to allow them to withdraw more than the balance of their accounts • Considered short term, debt financing **Term deposits** – a low risk investment option by banks to earn interest on lump sums of invested money at a fixed interest period and time. • Can either be short or long-term debt financing	• Finances current assets such as inventory • A form of pre-approved financing, if it is bank overdraft • No time limit for overdraft • High interest rates for both options
Government	The Government often provides targeted payments to aid the economic growth of specific industries. Two forms of payments include: **Grants**: A lump sum of money given for a specific purpose for the short term **Subsidies**: Direct contributions, tax breaks and other assistance to offset operating costs in the long term	• **Advantages:** They are not repayable and provide opportunities for growth • **Disadvantages:** There are often long application processes and are hard to obtain • Targeted at infant industries

FACTORS CONSIDERED BY FINANCIAL INSTITUTIONS

- There are various factors relating to risk and return that financial institutions will consider before providing finance to a firm:
- **Risk** – Consideration is given to the safety of an investment, whether a firm will be able to meet its payments (if applicable) as and when they fall due. In the event the business fails, how easily the funds may be recovered. Therefore, the risk factors lenders typically examine before approving finance are:

  - Collateral (assets)
  - Guarantors (who will be responsible for debt)
  - Liquidity (cash)
  - History (past financing)

- **Return** – Consideration is given as to whether the expected return is consistent with the risk being taken. The elements of return typically considered are:

  - Interest Rate
  - Future Business (potential for firms to come back for more financing)