1.10 RAISING FINANCE

Capital expenditure or revenue expenditure?

This section of Unit 1 deals with ways of providing finance for a business. To help explain, I have illustrated parts of the section with the story of Chris Cole and his plan for a recording studio.

Chris Cole runs a small business managing various bands. He now wants to create a recording studio in an old stone barn. He will have to spend some money on buying the building and adapting it. In other words, he will need to raise capital for a long-term investment. This kind of spending is known as **capital expenditure**. It is just the same for any entrepreneur. They need a lump sum of capital to fund the start-up. Pause for a moment and think about other capital expenditure there would be for Chris in this instance.

You may have thought that it would require capital expenditure to buy all the recording equipment that Chris needs, and you would be right. If, on the other hand, you felt that Chris would need capital expenditure to pay for things such as wages, the electricity bill or any other fairly day to day expenses, then you are missing the point a little. These are on-going expenses, not one-off payments. This short-term finance is known as **revenue expenditure**. The money needed for revenue expenditure is called working capital.

So capital expenditure involves big one-off costs. Capital expenditure requires long-term finance. The sources of long-term finance for a business include:

- Personal capital
- Ordinary share capital
- Loan capital

Businesses are in fact likely to use a combination of these different sources.

Revenue expenditure, on the other hand, requires short-term finance. So only short-term methods of financing are used. The different types of short-term finance include:

- A bank overdraft
- A short term loan
- Trade credit

ACTIVITY 20 : The new studio

Which of the following can be regarded as capital expenditure and which as revenue expenditure?

- 32 Channel, 14 Bus mixer desk £2081
- Telephone line rental £50 (per quarter)
- Cleaning services £200 (monthly)
- Drum machine £432
- Instant coffee (500g) £16.99

Capital expenditure: Personal capital

Personal capital is the capital that the entrepreneur brings to start the business. It may come from savings, inheritance or the sale of a house or other property. Personal capital can also be called internal finance.

Advantages of using personal capital

One advantage of using your own money to start a business is that it will cost you less. If you borrow from a bank, the bank will require interest to be paid as part of the regular repayments. In other words, you will end up paying a lot more back to the bank than you borrowed.

Another advantage of personal capital is that nobody will suddenly ask for their money back. This can happen when a bank decides that a business may not be able to repay a loan. All bank loans are subject to this possibility. Many now successful entrepreneurs struggled in their early days to reassure anxious bank managers that a business running at a loss would make a profit in due course.

Disadvantages of using personal capital

If the only source of capital is personal finance, the entrepreneur carries all of the risk. This is particularly an issue where the business is a sole trader. As explained in sectioon 1.9, the sole trader has unlimited liability for debts.

There is a clear opportunity cost in using your own savings rather than borrowing. If you borrowed capital, you might have been able to use your own capital for other purposes. For example, some people starting up small businesses using their own savings will not be able to purchase the consumer goods that they might otherwise have done.

Capital expenditure: ordinary share capital

Share capital is sometimes known as **equity**. Ordinary shares are those that carry full voting rights (in a general meeting of shareholders) and where shareholders only receive a dividend if the directors decide to give them one in a given year. There are other sorts of shares known as preference shares, but you need not know about these for AS Business.

Where the founders of a company bring their own capital to start-up a business in return for shares in the company they have created, the share capital can in effect be regarded as internal finance.

On the other hand, if the entrepreneurs running a new business attract capital from other people by selling them shares, the finance is a type of external capital. “Outside” capital is being brought in to help finance the creation of the business. Two particular kinds of shareholder are venture capital companies and business angels. Venture capital companies provide finance in return for shares to start-up business entrepreneurs with little or no track record but the potential for significant growth in profits. (In fact, venture capital companies may also provide loans or a combination of loans and equity finance.) Business angels have a similar role but angels are individuals rather than companies. Business angels will tend to provide relatively small amounts of capital and are likely to be actively involved in advising the business and monitoring its progress, to help safeguard their investment. Venture capital companies and angels provide capital when others may see the risks as too high.

Advantages of share capital

The risk of losing capital is spread between a number of people, when shares are created, not just the founders of the company. A further advantage is that shareholders are much more likely to regard their investment as a long-term one than the banks do, and are more likely to stick with the company through good times and bad.

Disadvantages of share capital

The price of having shareholders, from the viewpoint of those running the business, is that they do not have as much control. Shareholders have a say in the running of the company and if the majority of the shares are held by external investors, they will have a great deal of influence over many important decisions, such as expansion, diversification into new markets and the removal of directors. Where the shareholders are supportive of the company directors this may not matter too much. But where they have different priorities and concerns, there is obviously the potential for conflict between managers and owners.

Capital expenditure: loan capital

Bank loans provide a fixed sum of money for a fixed period of time, repaid according to the terms of the loan agreement, which usually requires regular repayments of an equal amount. The lender can also be called a creditor. The recipient of a loan is the debtor. Repayments will include interest. The rate of interest varies according to a number of factors, including the level of risk perceived by the lender. The greater the chance that the debtor will not be able to make payment, the higher the rate of interest will be.

A bank loan is not the same as a bank overdraft. (Bank overdrafts are explained below under revenue expenditure.) Bank loans of any size are likely to be secured. This means that the debtor has agreed to forfeit property to the value of the loan if they are unable to keep up with repayments. It may be that banks require small business entrepreneurs to secure loans to their houses. This means that if the debtor is unable to keep up with payments, the bank can sell the house to recover the value of the loan.

Advantages of loan capital

One advantage of borrowing from a bank is that although the bank will monitor the performance of the business from time to time, so as to ensure that the business is still safe to lend to, a bank does not have the same degree of influence in the running of a business as shareholders in general meeting.

Another advantage is that the business knows how much it will have to have to pay to the bank, and when the payments will have to be made. If a business raises the finance for capital expenditure through a bank loan it may benefit from being able to retain extra profit once the loan has been repaid. Shareholders, on the other hand, will continue to expect a share of profits.

Disadvantages of loan capital

In some situations, the fact that loan repayments are fixed may turn out to be a disadvantage. Supposing a business does not perform as well as expected? Loan repayments have to be made regardless of whether the business is making a profit or not. Shareholders on the other hand do not receive a dividend unless there is sufficient profit and the company directors agree.

Where a loan is secured, entrepreneurs risk losing personal assets (often their homes) if the business falls behind with repayments.

Because business start-ups involve a high level of risk, loans will carry a higher rate of interest. For this reason, borrowing from a bank will tend to be more expensive than share capital or personal capital at the start-up stage.

Revenue expenditure: overdrafts

Once the recording studio has opened for business, it will probably take quite a while to become busy enough to make a profit. This is the case with most start-ups. Monthly revenue will not exceed monthly expenditure for months, possibly even years. In the mean time, there will be various costs to be paid on a regular basis. Staff will need paying every month, there will be heating and electricity bills to pay, and so on. Chris will need to find a way of financing all of this, even if it is only a short-term problem.

One way of dealing with the need for revenue expenditure is to ask his bank for an overdraft arrangement. This means that the bank will give Chris the option of having a negative balance on his bank statements. (He can spend more than there is in the account.) An overdraft limit will be set by the bank and the arrangement will only last for a defined period. A percentage interest rate is charged if the bank account becomes overdrawn.

Advantages of an overdraft

The great advantage of an overdraft is its flexibility. By managing money carefully the entrepreneur may be able to avoid having a very big overdraft, attracting big interest payments. But if there is unexpected expenditure, having an overdraft facility acts as a safety net.

Disadvantages of an overdraft

The rate of interest charged by banks on overdrafts tends to be fairly high. Not only that, a business might face serious difficulties if a bank suddenly decides to withdraw an overdraft facility because they feel that the business has become unacceptably risky. If the business has been reliant on the overdraft, this represents a big problem.

Revenue expenditure: short-term bank loans

Short-term loans can be seen as an alternative to an overdraft. The advantages and disadvantages of loans are discussed under loan capital above.

Revenue expenditure: trade credit

The use of trade credit to manage working capital is explained in the Unit 2 section on improving cash flow. (See section 2.2)

Self Check Questions

1. Explain what is meant by capital expenditure.
2. What is meant by personal capital?
3. Give one advantage of using personal capital.
4. State another name for share capital.
5. Explain one disadvantage of raising capital through issuing shares.
6. State three types of revenue expenditure.
7. Give one advantage of loan capital.
8. Give one disadvantage of loan capital.
9. What is a bank overdraft?
10. State one disadvantage of raising finance through an overdraft.

ACTIVITY 21 : Choosing finance methods

For each of the scenarios below, suggest the most suitable way of raising finance. Explain your answers.

1. Dennis has finally found suitable premises for his new day care nursery. With 20 years of successful management experience in this type of business he believes he has a winning formula for creating a quality, profitable operation. In time, David hopes to expand the business through a chain of franchised nurseries. David plans to have 8 nurseries up and running over a 6 year period. The only problem is that he has insufficient personal capital to purchase the property he has found and the banks seem uninterested. (6)

2. Jane is able to fund the start-up of her tool hire shop from significant personal savings and a small bank loan. However, she has recognised in her business plan that the business will not break even for at least one year. She needs to keep the business afloat during that first year. (6)

3. Nikki and Len are planning to run a mobile catering van. They will work at music festivals, sporting events and so on. They live in a four bedroom house with a large garden which Nikki inherited from her parents. They are considering whether to borrow from the bank and/or seek other sources of finance. (6)