Financing of the enterprise

Objectives of this chapter:
Time required to study this chapter:
Previous knowledge required:
Each activity in the enterprise has two sides:

- ✓ material (tangible, assets) – flow of machines, raw material, material, finished products, which is possible to divide on activities of supplying etc.
- ✓ cash (financial) – flow of income and expenses. Each activity has to be ensure by so financial means (resources).

Assets and financial flows (capital sources) has to be in concordance.
Fig. 1 Relationship between flow of financial and material means
Objectives of financial management

1) Obtain capital for common and special activities and needs and decide about its structure and changes in structure (obtain the loan, issue of shares or bonds) → side of liabilities in the balance sheet,
2) Decide about capital allocation – if it is possible to finance current activities, development of new products, invest to the land, buildings etc. → side of assets in the balance sheet
3) Decide about sharing of profit.
4) Forecasting, planning, recording, analysing, controlling and managing business activities to ensure its financial stability.

Factors influencing the activities of the enterprise
1) Factor of time – cash unit paid or gained in different time periods has got a different value.
2) Factor or risk – financial manager has to choose only one possibility, cannot be sure with the results of this possibility and usually the option with higher risk brings also higher profit and vice versa.
General rules for financial decision making

- ✓ with the same level of risk there is preferred always higher profit,
- ✓ when there is the same profit, we always prefer smaller risk,
- ✓ for the higher benefits there is required higher risk,
- ✓ there are preferred money received faster,
- ✓ motivation of all investment activities is to increase the amount of assets, profit and cash flow.

What are the possible sources of financing the business activities?
Forms of Financing
According to the origin of capital:
a) internal financing,
b) external financing.
2) According to the period of using :
a) long- term financing,
b) short-term financing.
3) According to the regularity of financing:
a) Usual financing ,
b) Unusual financing.
Figure 2 Financing of the enterprise according to the origin of capital
Internal financing of enterprise
The term means the various financial resources that are at the disposal of a company.
Sources of capital are business activities.
Result - profit, depreciation and also other resources gained by fast turn of capital.

External financing
Capital comes from external sources outside the enterprise (owner of the enterprise – contributions, shares) = financing from own sources = SHAREHOLDER´S capital
or from creditors (loans, credits, leasing etc.) = financing from outside sources = EXTERNAL CAPITAL (finance).
Other external sources are factoring, forfaiting, swaps, futures etc.
Factoring – factoring is the selling of a company's account receivables to a financial institution normally at a discounted rate. Factoring is usually performed to increase cash flow, instead of waiting for the normal terms associated with selling to customers,
Forfaiting - Forfaiting is an export financing technique where a seller of receivables (exporter of goods, service provider or contractor) sells its outstanding receivables to the bank (or some other financial institution.
New financial instruments – zero bonds, futures, swaps, options.

Long-term financing

The source is usually internal capital (own sources) and long-term external capital (e.g. long term bank credits).

Short-term financing

The sources are short-term bank credits, suppliers credits, debts to employees, state etc.
The objective of financial management is to ensure and manage the cash for the usual (normal) business operations (buying of material, energy, for paying wages, rent, transport costs, taxes and other short term obligations (duties).
It is connected mostly with current assets (short-term) assets, its summary is called as gross working capital.

Special (unusual financing)

a) Financing by the establishment of the enterprise,
b) financing by the enlargement of the enterprise and its activities,
c) Financing by the improvement or merging of the enterprise,
d) Financing of winding-up of the enterprise.

Financing and managing of current assets

Main objectives:

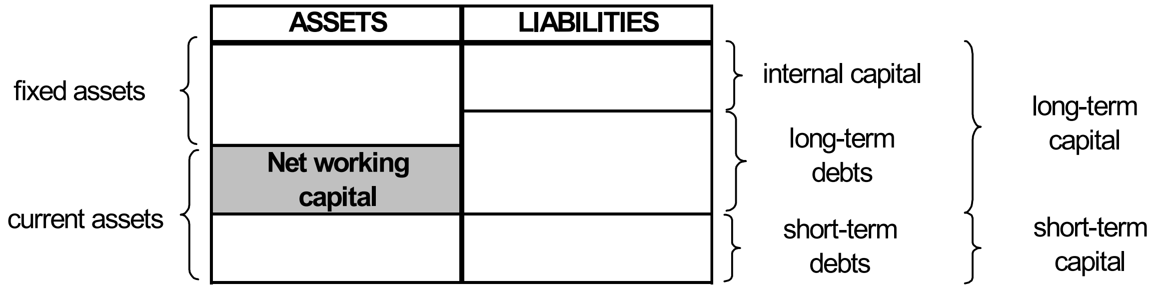
- ✓ find out the optimal level of each item of current assets and its total sum,
- ✓ find out the way, how to finance current assets.

Working capital

Working capital refers to that part of firm's capital, which is required for financing short-term or current assets such a cash marketable securities, debtors and inventories. Funds thus, invested in current assets keep revolving fast and are constantly converted into cash and this cash flow out again in exchange for other current assets.
Working capital is also known as revolving or circulating capital or short-term capital. Working capital is divided between gross working capital and net working capital
Gross working capital – the value of all current assets of the enterprise.
Net working capital = current assets – short-term external capital

Net working capital

Figure 3 Relationship between assets and capital forms



Outlines for financing of assets of the enterprise
1) Fixed assets – financed by the internal (own) capital and long-term external capital.
2) Current assets – financed by the short-term and long-term external capital.
3) Net working capital – surplus of current assets over the short-term debts. It is a part of current assets, which is financed by the long-term sources. NWC is available for the management for the business activities. It is necessary to ensure that this capital is available=liquid (available capital).

Optimum of current assets
Optimal level ≠ minimal level of current assets
The optimal level of current assets is the level, which ensures normal existence of the enterprise with the minimum total costs.
Optimal level of current assets is possible to find out through the turnover cycle of the money.
Turnover cycle of the money– the period between the payment for the purchased material and the money received from the sale of products. It is the period during which are the money fixed in current assets.

Capital need for the current assets
Capital need = turnover cycle of money * cost/day

$$\text{one day costs} = \frac{\text{total costs}}{360}$$

The shorter is the turnover cycle of the money , the less of working capital is needed (live capital).

Ways of financing of current assets
Part of current assets is fixed in the enterprise for a long time (e.g. Safety stock) permanently fixed current assets, second part is changeable (e.g. seasonal stock) fluctuating current assets.
Permanent current assets are often the minimum current assets held by companies at any given time. Example of which may include minimum inventory held by a company at any given time for precautionary purpose.
Temporary (fluctuation current assets) **are** the current assets that are used continuously by the company in its operating activities, such that before it reaches the minimum it takes action to replenish such current assets, such as inventory, cash etc.
There are 3 possible managerial approaches to the way of financing of working capital:

- ✓ moderate approach,
- ✓ aggressive approach,
- ✓ conservative approach.

Moderate approach
Balance between useful life (life cycle of assets and liabilities).
Fixed assets are covered by long-term sources (internal capital, long-term external capital).
Flexible current assets are covered by the short-term capital (debts).
Figure 4 Managerial approach - moderate

Aggregssive approach

- ✓ For the financing of fixed current assets uses short-term sources (e.g. Short-term credits).
- ✓ Short-term capital is cheaper than the long term capital, increases the profitability of the business but also the risk in case of any problems with business results, especially when the profit decreases.
- ✓ Advantages of short-term debts:
  - usually is cheaper,
  - is easier to get it from the bank,
  - is possible to get it faster.

Figure 5 Managerial approach – aggressive

Conservative approach

Principles:

- ✓ Uses long-term capital for financing both assets – fixed and flexible (seasonal assets).
- ✓ Short-term capital is used only for financing of the best seasonal current assets.
- ✓ The most expensive approach of financing but with the lowest risk.

Figure 6 Managerial approach – conservative

Cash flow

Cash flow means a change of the financial means (increase and decrease) for a given period in connection with the business activity of the enterprise.

Figure 6 Flows of Cash

Source:

Statement of Cash Flow

In financial accounting, a **cash flow statement**, also known as ***statement of cash flows*** or ***funds flow statement***, is a financial statement that shows how changes in balance sheet accounts and income affect cash and cash equivalents, and breaks the analysis down to operating, investing, and financing activities. Essentially, the cash flow statement is concerned with the flow of cash in and out of the business.

Methods of Cash Flow calculation

- Direct method
- Indirect method