Financial Markets Relevant to Business Needs

1. Identify three financial markets

According to the Securities Institute of Australia, three financial markets are:
- the share or equity market
- the debt market
- the derivatives market

2. Which is the main effect of financial deregulation on businesses which borrow?

Financial deregulation has led to the increase in availability of finance from a wide range of financial institutions. Deregulation has opened the financial industry to market forces. As a result businesses have a greater selection of debt finance products from a greater number of financial institutions, often at competitive interest rates and services.

3. Outline the difference in risk on a business if it uses debt instead of equity.

There are two main differences in risk on a business if it uses debt instead of equity. Firstly, debt repayments are subject to fluctuations in interest rates. Businesses must be prepared to repay debts regardless of the level of business operations and changes in the interest rate. If the business fails to make repayments, the lenders will take legal action to reclaim the money owed to them. This will impact negatively on the image of the business. Secondly, most debt finance is attained by the creditor gaining a form of security on a business's assets. On the occasion that a business defaults on payment, the creditor has a claim over the specified assets of the business, restricting business operations.

4. When is it very appropriate for a business to increase its debt levels?

When considering using debt financing, business owners/managers must consider the ability to repay the debt; the ease of obtaining finance; the state of the economy and the benefits gained from this form of funding. Thus, it is appropriate to invest in debt finance when the interest rates are low, and therefore the debt repayments are low. When the solvency or gearing of the business is low, businesses can reduce the proportion of equity finance by acquiring debt finance. Also, in the context of strong financial position and performance, a business should consider sourcing debt finance. Strong financial records convey a stable investment for financial institutions.

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5. Why should a business use short term debt (e.g. trade credit) to purchase short term assets (e.g. stock)?

A business should use the matching principle, for instance use short term debt to purchase short term assets. Using an equivalent term of finance is an effective method of achieving liquidity and/or profitability management. For example: a business requires finance to pay a supplier's for materials, the business should use short-term finance such as trade credit or a bank bill as the funds for the materials will be generated in the short-term from the sale of the products. Similarly, if a business is experiencing a short term fluctuation in cash flow, the business should consider using short term finance because this is a short term financing requirement.

6. (a) Describe how factoring works

(b) Explain the effect of factoring on a business's: (i) cash flow and (ii) profitability.

(a) Factoring is the process of selling a business's accounts receivable to a factoring company at a discount. Factoring companies specialise in the collection of account receivable debts.

(b) Factoring improves the cash flow of the business, as the factoring company provides a large injection of cash to the business in exchange for its accounts receivable. The cash inflow received from a factoring company does not affect the sales revenue because the accounts receivable have already been incorporated in sales revenue figures of a revenue statement. However, factoring companies often charge a fee and this is an expense incurred by the business. The role of factoring is to improve working capital (liquidity) of the business, by transforming accounts receivables to a more liquid current asset, cash.

7. Outline THREE advantages and THREE disadvantages of equity as a source of finance.

The advantages of equity finance are:

- Equity finance lowers the solvency ratio of a business – lower leverage is more attractive to investors.
- Equity finance is repaid as profits to the owners. The providers of equity finance are at the discretion of management.
- The rate of return on investment paid to shareholders is generally lower than debt finance.

The disadvantages of equity finance are:

- Equity finance requires the dilution of ownership control.
- Equity finance can take longer to organise.
- Floating a company can add additional legal and administration costs to a business.

8. Outline THREE advantages and THREE disadvantages of debt as a source of finance.

The advantages of debt finance are:

- Debt financing is easier to arrange.
- Creditors do not have ownership rights. Therefore creditors do not directly influence decision-making.
- Debt repayments can act as an incentive for management to ensure adequate cash flow to service the debt finance.

The disadvantages of debt finance are:

- Increased debt finance increases the gearing of the company.
- Debt repayments are constant and regular, regardless of the business's financial performance.
- Acquiring debt finance can be a negative signal to shareholders, of inherent financial management problems.
- Debt finance is exposed to the risk of sudden interest rate rates.

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