Business Virtual Learning

Course: Intro to Business

Lesson: Introduction to Finance

May 5, 2020

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Objective/Learning Target: Students will be able to:

(1) Describe how a firm's characteristics affect its available financing sources.

Lesson Starter

From the previous lesson, which source of funding would you choose to finance a business? Why?

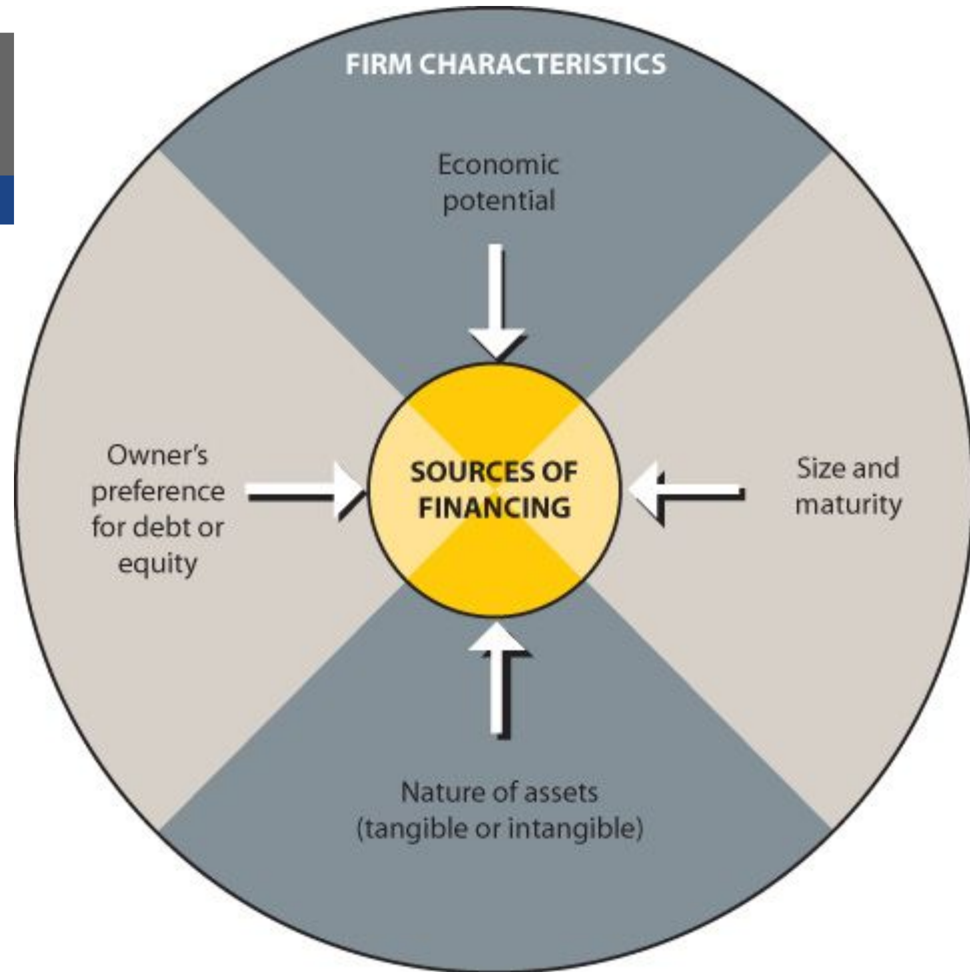
Lesson Starter Continued

The options for funding for a new or small business can vary depending on many factors. We are going to explore those factors in today's lesson.

At times, financing a business can weigh heavily on small business owners. Four basic characteristics significantly affect how a business is financed:

1. the firm's economic potential,
2. the size and maturity of the company,
3. the nature of its assets, and
4. the personal preferences of the owners with respect to the trade-offs between debt and equity.

Without understanding how these characteristics come into play in financing your business, you stand little chance of getting appropriate financing.



Firm’s Economic Potential

A firm with potential for high growth and large profits has more possible sources of financing than does a firm that provides a good lifestyle for the owner but little in the way of returns to investors. Only firms with a high rate of return on investment create value for the investor. In fact, most investors in startup companies focus on firms that offer potentially high returns within a 5- to 10-year period. Clearly, a company that provides a comfortable lifestyle for its owner but insufficient profits to attract outside investors will find its options for alternative sources of financing limited.

Company Size and Maturity

Larger and older firms have access to bank credit that may not be available to younger and smaller companies. Also, smaller firms tend to rely more on personal loans and credit cards for financing. In the early years of a business, most entrepreneurs bootstrap their financing—that is, they depend on their own initiative to come up with the necessary capital. Only after the business has an established track record will most bankers and other financial institutions be willing to provide financing.

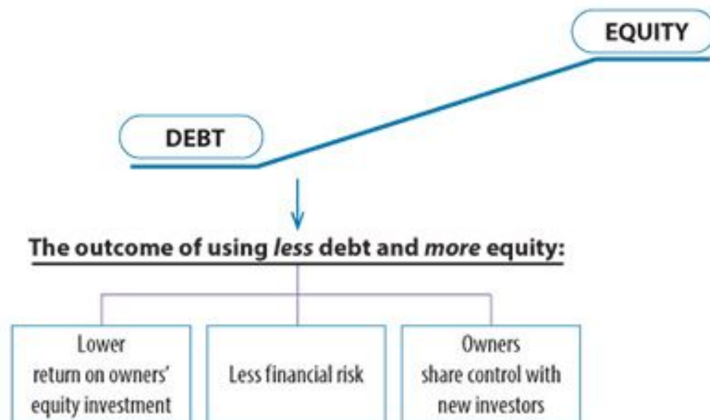
Nature of Firm’s Assets

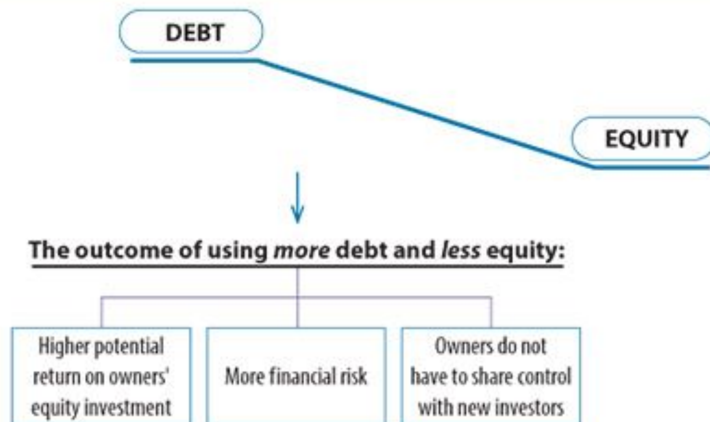
A banker specifically considers two types of assets when evaluating a firm for a loan: tangible assets and intangible assets. Tangible assets, which can be seen and touched, include inventory, equipment, and buildings. The cost of these assets appears on the firm’s balance sheet, which the banker receives as part of the firm’s financial statements. Tangible assets are great collateral when a firm is requesting a bank loan. While intangible assets, such as goodwill or past investments in research and development, are important to an investor, they have little value as collateral when it comes to getting a loan. As a result, companies with substantial tangible assets have a much easier time borrowing money than do companies with intangible assets.

Owners' Preferences for Debt or Equity

The owner of a company faces the question "Should I finance with debt or equity, or some mix of the two?" The answer depends on the situation. But in part, it is affected by trade-offs that a business owner will have to make depending on his or her personal preferences. Understand that there is no single right or wrong answer here. To make an informed decision, a small business owner needs to recognize and understand the trade-offs between debt and equity with regard to the following three factors:

- Potential profitability for the owners
- The business's financial risk
- Voting control of the business


High Equity and Low Debt Financing
EQUITY
DEBT
The outcome of using less debt and more equity:
Lower return on owners' equity investment
Less financial risk
Owners share control with new investors


High Debt and Low Equity Financing
DEBT
EQUITY
The outcome of using more debt and less equity:
Higher potential return on owners' equity investment
More financial risk
Owners do not have to share control with new investors

Activity: Review Questions

Directions: Please use the information in the previous slides and yesterday's lesson to answer the questions below. You may also need to do additional research to complete the questions. Please feel free to write your answers on a sheet of paper or type them into a Google Doc.

1. What are the four characteristics of a firm that affect how they are financed?

2 How does a firm's economic potential effect how they are financed?

3. Why do you think investors want companies that can offer high returns within a 5-10 year period?

4. Is it better to be a small and young company or a large and old company for financing opportunities?

Activity Continued: Review Questions

5. How do a majority of small companies finance their expenses?

6. What are two types of assets bankers look for in a company when deciding on giving a loan to that company? Which type of asset is better when trying to get a loan?

7. What is the main difference between debt financing and equity financing? What three factors affect a company's decision on what type of financing is right for them.

8. What are at least two outcomes of financing with more equity over debt?

9. What are at least two outcomes of financing with more debt over equity?

10. If you were starting a business, would you rather finance your company using debt or equity? Explain the advantages and disadvantages of your choice.