CHAPTER 10

Influences on financial management

OVERVIEW

10.1 Introduction
10.2 Sources of finance — internal and external
10.3 Financial institutions
10.4 Influence of government
10.5 Global market influences

10.1 Introduction

The influences on the financial management of a business include a range of external factors such as the domestic government's economic decisions and legislation, and the global economy, which has become a major influence on not just the financial function but all aspects of business operations. Internal factors also have an impact on the financial management of a business and these are more directly controlled and monitored by management through its short- and long-term planning. Figure 10.1 outlines the main influences on the financial management of a business.

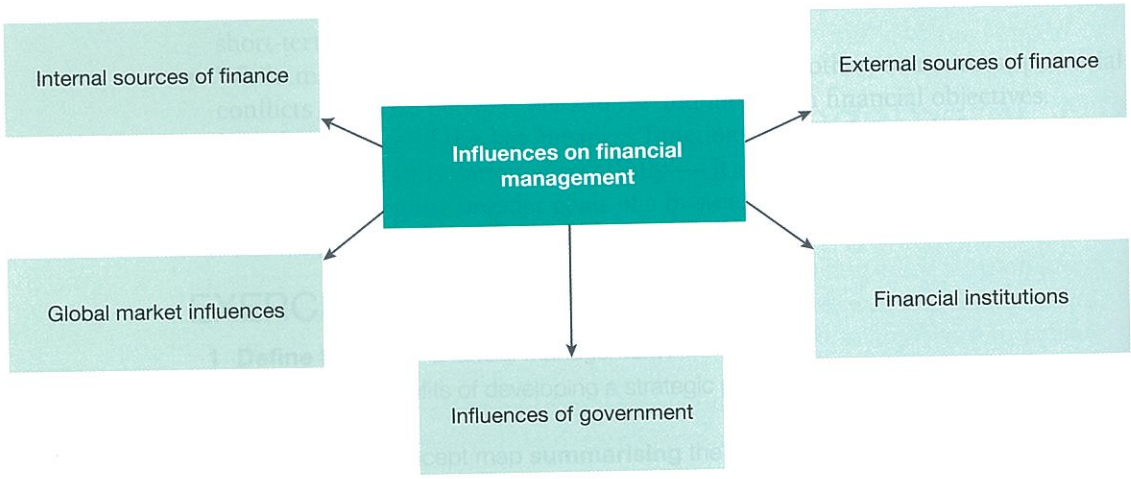


FIGURE 10.1 Influences on financial management

10.2 Sources of finance — internal and external

A business cannot establish itself and thrive without funds to enable it to pursue its activities. The range of activities in which a business is involved during its life cycle includes the initial set-up — whether establishing a new business or buying one that is already established — and might include expanding its range of products,

introducing a new product, expanding the number of outlets, upgrading its systems and technology, employing more staff and building a new warehouse.

In the establishment phase of a business, owners and/or shareholders usually contribute funds. In later years, when a business is in the growth stage, a number of options can be considered regarding sources of funds and how those sources will be used. Sources of funds may be internal or external (see figure 10.2). Finding the appropriate source of funds for the business's needs involves **financial decision making**, which means that relevant information must be identified, collected and analysed to determine an appropriate course of action.

BizWORD

Financial decision making *requires relevant information to be identified, collected and analysed to determine an appropriate course of action.*

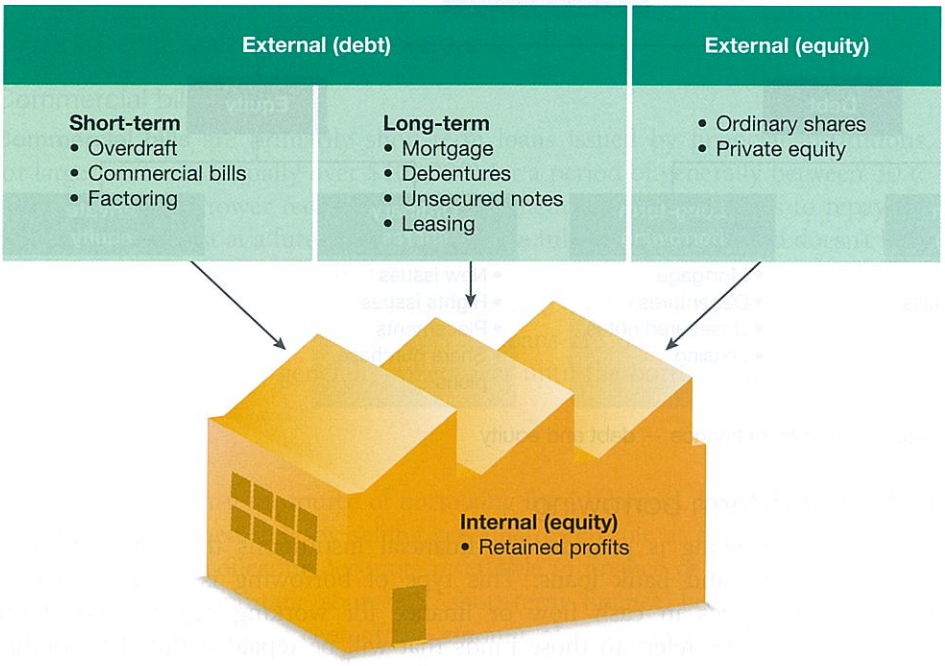


FIGURE 10.2 Internal and external sources of funds

studyon

Syllabus area 3
Topic 2
Concept 1

Internal sources of finance
Summary screen and practice questions

10.2.1 Internal sources

Internal finance refers to funds generated from inside the business. For example, profits can be retained to finance expansion.

BizWORD

Internal finance *refers to funds generated from inside the business. For example, profits can be retained to finance expansion.*

Retained profits

The most common source of internal finance is retained earnings or profits in which all profits are not distributed, but are kept in the business as a cheap and accessible source of finance for future activities. Most businesses keep some of their profit in the form of retained earnings. In Australian businesses, approximately 50 per cent of profits on average are retained to be reinvested.

10.2.2 External sources

External finance refers to the funds provided by sources outside the business, including banks, other financial institutions, government, suppliers or financial intermediaries. Finance provided from external sources through creditors or lenders is known as **debt finance**.

BizWORD

External finance *is the funds provided by sources outside the business, including banks, other financial institutions, government, suppliers or financial intermediaries.*

Debt finance *relates to the short-term and long-term borrowing from external sources by a business.*

Using debt as a source of finance means that the business relies on outside sources rather than the owners to finance the business. The increased funds for the business should mean increases in earnings and hence profits. Regular repayments on the borrowings must be made so firms have to generate sufficient earnings to make the payments. There is an increase in risk for businesses using debt as the

interest and bank and government charges have to be paid on top of the principal borrowed. However, Australia's tax system has promoted debt financing for businesses by providing tax deductions for interest payments.

Types of external debt include short- and long-term borrowing (see figure 10.3). The advantages and disadvantages of debt and equity financing, as well as matching the terms and sources of finance to business purpose, will be examined in more detail in chapter 11.

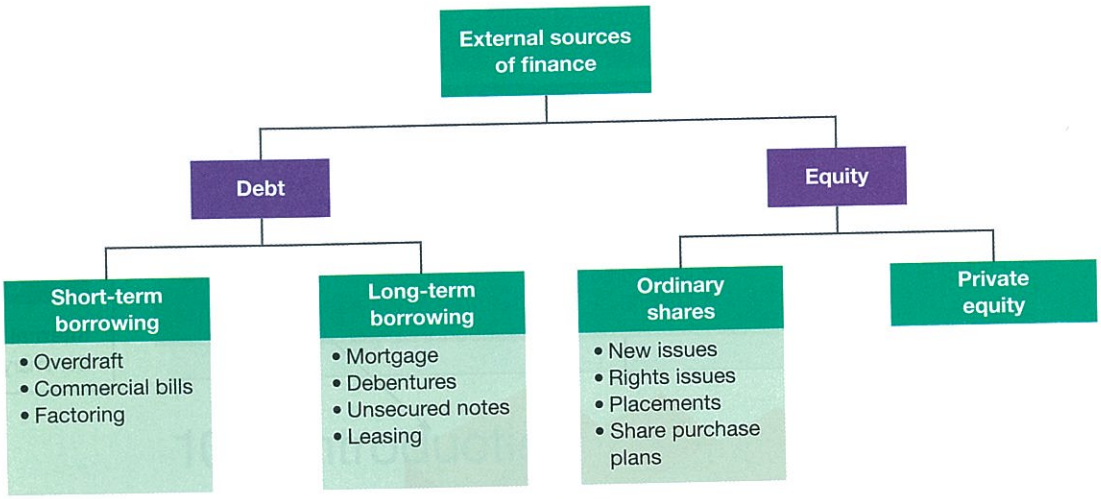


FIGURE 10.3 External sources of finance — debt and equity

Debt: short-term borrowing

Short-term borrowing is provided by financial institutions through overdrafts, commercial bills and bank loans. This type of borrowing is used to finance temporary shortages in cash flow or finance for working capital. Short-term borrowing generally refers to those funds that will be repaid within 12 months. Short-term debts are recorded as current liabilities on the balance sheet.

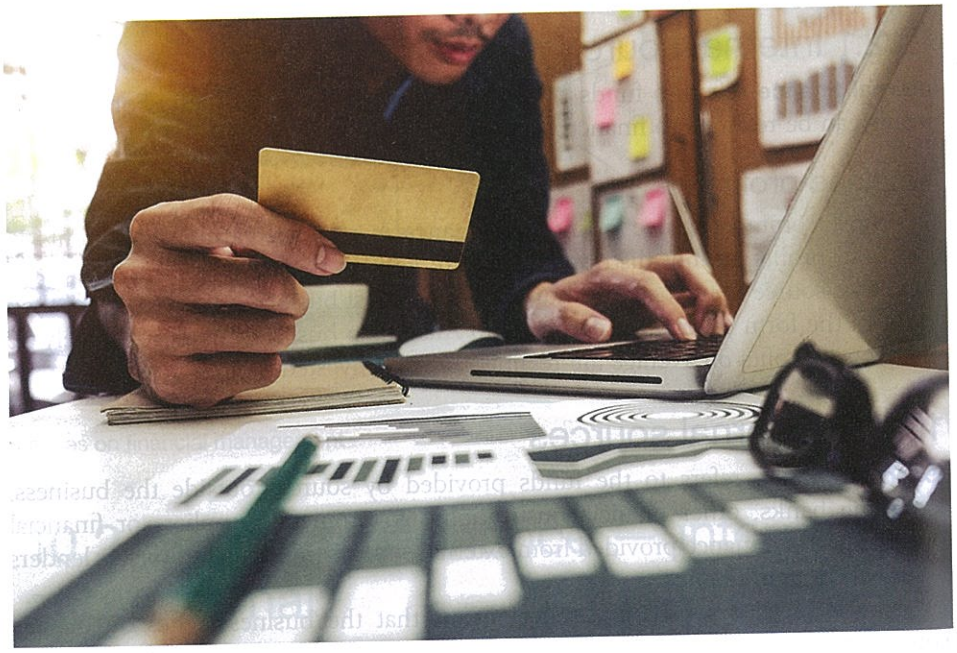


FIGURE 10.4 Credit cards are another form of short-term debt finance that many businesses use to meet their short-term obligations. Seventy-nine per cent of small business owners use credit cards as a source of financing.

Overdraft

An **overdraft** is one of the most common types of short-term borrowing. A bank allows a business or individual to overdraw their account up to an agreed limit and for a specified time, to help overcome a temporary cash shortfall. Overdrafts assist businesses with short-term liquidity problems, for example a seasonal decrease in sales. Costs for overdrafts are minimal, and interest rates are lower than on other forms of borrowing. As interest rates are usually variable, interest is paid on the daily outstanding balance of the account. Banks usually require the agreed limits to the overdraft to be maintained at a high level and require some security. Overdrafts are repayable on demand, although this is not common.

Many businesses prefer overdrafts to short-term bank loans because bank loans do not have the same flexibility as overdrafts.

BizWORD

*With an **overdraft**, the bank allows a business or individual to overdraw their account up to an agreed limit and for a specified time, to help overcome a temporary cash shortfall.*

Commercial bills

Commercial bills are primarily short-term loans issued by financial institutions, for larger amounts (usually over $100 000) for a period of generally between 30 to 180 days. The borrower receives the sum immediately and promises to repay the money with interest at a future time; that is, the full amount borrowed doesn't have to be repaid until the end of the term.

Commercial bills are flexible both in relation to the interest that needs to be paid and the repayment period. These types of loans are usually secured against the business's assets and are generally rolled over until the borrower has the funds to repay the loan in full.

BizWORD

***Commercial bills** are primarily short-term loans issued by financial institutions, for larger amounts (usually over $100 000) for a period of generally between 30 to 180 days.*

Factoring

Factoring is a short-term source of borrowing for a business. It enables a business to raise funds immediately by selling accounts receivable at a discount to a firm that specialises in collecting accounts receivable (a finance or factoring business). Factoring is an important source of short-term finance because the business will receive up to 90 per cent of the amount of receivables within 48 hours of submitting its invoices to the factoring company. By having immediate access to funds, the business will improve its cash flow and gearing. The business does not have to worry about the collection of accounts or the costs involved in this process. However, it must be remembered that the full amount will not be received for accounts.

A factoring company may offer its services with or without recourse.

- 'Without recourse' means that the business transfers responsibility for non-collection to the factoring company.
- 'With recourse' means that bad debts will still be the responsibility of the business.

Factoring involves greater risk than other sources of short-term borrowing such as overdrafts and commercial bills because of the likelihood of unpaid debts. It is a relatively expensive source of finance because the business is usually responsible for debts that remain unpaid, and commission is paid on the debt. In the past, factoring was used as a last resort but this attitude has changed in the last decade, and factoring is seen as a legitimate means of financing the activities of a business.

BizWORD

***Factoring** is the selling of accounts receivable for a discounted price to a finance or factoring company.*

SNAPSHOT





'SMEs are increasingly using factoring as a source of finance...'

Case study: OSCAR Natural — factoring and invoice discounting

Small and medium-sized enterprises (SMEs) increasingly use factoring as a source of finance despite the fact it costs more than traditional forms of funding. Factoring is particularly appealing to the construction, manufacturing, agriculture and mining, transport and storage, wholesale trade and labour hire markets as they have traditionally extended longer payment cycles to their clients, which ties up funds.

OSCAR Natural is a company that produces natural shaving products. The owner, Oscar de Vreis, used factoring from the outset to fund his business.

> Without factoring stockists pay your invoice on 60 or 90 days. A factoring firm will advance you between 70 per cent and 85 per cent of the value of the invoice as soon as it's issued so you can keep in sync with your cash flow. The more successful you are the more you need it because you need the funds to order stock.

While Oscar admits that factoring is more expensive than an overdraft, he prefers this type of funding because, unlike some other forms of debt finance, he doesn't need to provide security or give up any equity in the business.

There are some drawbacks with factoring, however.

> The biggest headache with factoring is that the admin team at the factoring company reconcile the payments and inevitably they make errors and have occasionally applied payments to the wrong invoices.

Once Oscar's company became more profitable, he was offered invoice discounting. This is very similar to factoring but it is only offered to more established companies that have a high turnover rate.The main difference between factoring and invoice discounting is that the business, not the lender, collects payments from customers, which means that their customers will not be aware that they have taken on cash flow finance. With invoice discounting, the finance company pay a certain percentage of the invoice amount (generally 80–90 per cent of the total) but it's up to the business to collect the payments as normal and then repay the lender (with fees and interest charges). Oscar prefers this method of finance as it enables him to maintain his standards of customer service and keep a direct relationship with his debtors.

SNAPSHOT QUESTIONS

1. **Discuss** factoring.
2. **Describe** invoice discounting.
3. **Explain** why Oscar prefers invoice discounting over factoring.

study on

Syllabus area 3
Topic 2
Concept 2

External sources of finance: short-term debt
Summary screen and practice questions

Debt: long-term borrowing

Long-term borrowing relates to funds borrowed for periods longer than 12 months. Long-term borrowing is usually used to purchase major assets such as buildings and equipment, and the assets often serve as security on the loan. Despite some risks, long-term borrowing is a common source of financing for businesses.

Long-term debts are recorded as non-current liabilities on the balance sheet.

Mortgage

BizWORD

*A **mortgage** is a loan secured by the property of the borrower (business).*

A **mortgage** is a loan secured by the property of the borrower (business). The property that is mortgaged cannot be sold or used as security for further borrowing until the mortgage is repaid. Mortgage loans are used to finance property purchases, such as new premises, a factory or office. They are repaid with interest, usually through regular repayments, over an agreed period of time.

Debentures

BizWORD

***Debentures** are issued by a company for a fixed rate of interest and for a fixed period of time.*

Debentures are issued by a company for a fixed rate of interest and for a fixed period of time. Companies provide them as a way to raise funds from investors, as opposed to financial institutions. A debenture is a promise made by a company to

repay money that has been lent to the business. An investor lends money to a company and in return the company issues a debenture with a promise to make regular interest payments for a defined term and then repay the loan at a particular date in the future.

Companies that borrow offer security to the lender usually over the company's assets. On maturity, the company repays the amount of the debenture by buying back the debenture. The amount of profit made by a company has no effect on the rate of interest because debentures carry a fixed rate of interest. Debenture products must have a prospectus. This will tell investors everything they need to know about the company, how they will use the funds and the terms of the investment. Finance companies raise much of their funds through debenture issues to the public.

Unsecured notes

An **unsecured note** is a loan from investors for a set period of time. Unsecured notes are not secured against the business's assets and therefore present the most risk to the investors in the note (the lender). For this reason it attracts a higher rate of interest than a secured note. Companies sell unsecured notes to generate money for their initiatives, such as share repurchases and acquisitions.

BizWORD

*An **unsecured note** is a loan from investors for a set period of time. Unsecured notes are not secured against the business's assets.*



FIGURE 10.5 In 2006 Fincorp, a property investment group, wanted to raise $500 million dollars by issuing debentures and unsecured notes to public investors. They offered investors 9.75 per cent a year. Some people ended up losing hundreds of thousands of dollars when the company collapsed in 2007 owing $200 million to 8000 investors. Those who invested in secured debentures got some of their money back but those who invested in unsecured notes have so far not received a cent.

Leasing

Leasing is usually a long-term source of borrowing for businesses. It involves the payment of money for the use of equipment that is owned by another party. A variety of business assets are suitable for leasing, including business cars, plant and machinery, equipment, computers and software.

BizWORD

Leasing *involves the payment of money for the use of equipment that is owned by another party.*

BizFACT

A motor vehicle leased for two weeks would be leased as an operating lease. The leasing firm would be responsible for repairs to the motor vehicle; and if the vehicle was returned earlier than two weeks, there would be an adjustment to the lease payment.

A motor vehicle leased for three years would be leased as a financial lease. The firm leasing the motor vehicle would be responsible for insurance and maintenance of the vehicle, and the term of the lease would be close to the economic life of the vehicle.

Leasing enables an enterprise to borrow funds and use the equipment without the large capital outlay required. Costs and benefits of the financial asset are transferred from the lessor to the lessee. The lessee uses the equipment and the lessor owns and leases the equipment for an agreed period of time. A long-term lease cannot usually be cancelled.

Since the 1960s, leasing as a source of finance has been used widely in Australia. The main participants in lease finance have been finance companies. Businesses choose the equipment, arrange for the finance company to purchase it, then lease it from the finance company, which retains ownership for the period of the lease. There are two types of leases, operating and financial (see the BizFact).

- Operating leases are assets leased for short periods, usually shorter than the life of the asset. The owner carries out the maintenance on the asset. Operating leases can be cancelled, often without penalty.
- Under the conditions of a financial lease, the lessor purchases the asset on behalf of the lessee. Financial leases are usually for the life of the asset. Lease repayments are fixed for the economic life of the asset, usually between three and five years. Plant, vehicles, equipment, furniture and fittings are leased as financial leases. There are usually penalties for cancellation of financial leases. Leasing assets for long periods as financial leases is cheaper than leasing them as operating leases.

Some of the advantages of leasing as a source of finance include:

- It assists a business with their cash flow; this is because the cash outflows or payments related to leasing are spread out over several years, hence saving the burden of a one-off significant cash payment.
- The costs of establishing leases may be lower than other methods of financing.
- If some assets are leased a business may be in a better position to borrow funds.
- It provides long-term financing without reducing control of ownership.
- It permits 100 per cent financing of assets.
- Repayments of the lease are fixed for a period so cash flow can be monitored easily.
- Lease payments are a tax deduction.
- Payment usually includes maintenance, insurance and finance costs.

However, a disadvantage of leasing is that interest charges may be higher than for other forms of borrowing.

studyon

Syllabus area 3
Topic 2
Concept 3

External sources of finance: long-term debt
Summary screen and practice questions



FIGURE 10.6 Small business owners often don't have the funds available to purchase business assets outright without affecting their cash flow. This is why leasing has become an attractive source of finance. According to the Alleasing Equipment Demand Index, Australia's SMEs have an estimated $91.8 billion in leased plant and equipment assets, excluding real estate.

Corporations are required by law to reveal significant leases in their published financial statements or in notes to the financial statements.

Equity

Equity as an external source of funds refers to the finance raised by a company through inviting new owners. For example, this can be done by issuing shares to the public through the Australian Securities Exchange (ASX). This is used as an alternative to debt funding. Equity as a source of external finance includes:

- ordinary shares (new issue, rights issue, placements, share purchase plan)
- private equity.

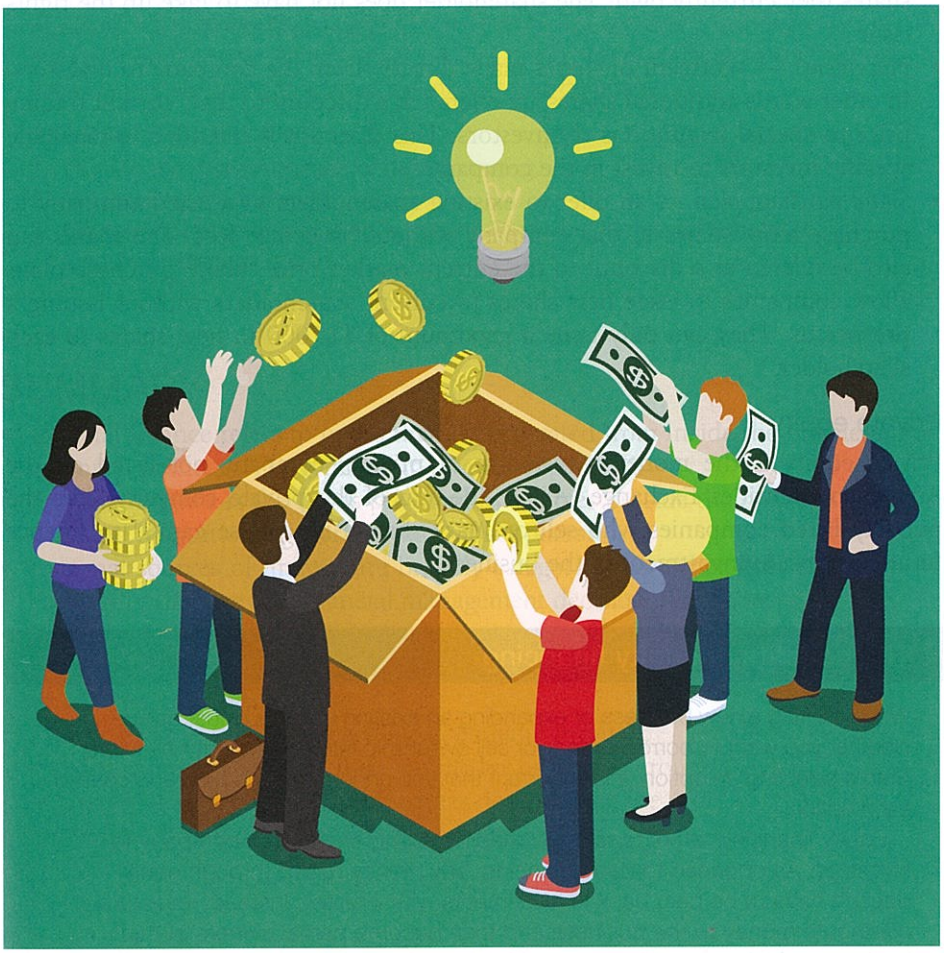


FIGURE 10.7 In 2017, the Australian Government amended the *Corporations Act 2001* allowing companies to access crowd-sourced equity funding (CSEF) (refer to BizFACT). The government introduced these changes to make it easier and less expensive for small businesses to raise equity and to remedy the shortage of finance options available for SMEs and start-ups.

Ordinary shares

Ordinary shares are the most commonly traded shares in Australia. The purchase of ordinary shares by individuals means they have become part-owners of a publicly listed company. This means they get voting rights according to the number of shares that they have as well as payments called **dividends**. When shareholders purchase shares in a company, they are providing a source of finance (equity) for that business. The value of the share is determined by a company's current or future performance.

BizWORD

Equity *as an external source of funds refers to the finance raised by a company through inviting new owners.*

BizFACT

Crowd-sourced equity funding (CSEF) is an innovative type of fundraising that allows a large number of individuals to make small financial investments (up to $10 000) in exchange for an equity stake in the company. CSEF is similar to other forms of crowdfunding in that it enables companies to raise funds through an online portal. The difference is that investors receive a share of the company rather than a product or service. Eligible companies will be able to raise up to $5 million a year this way.

BizWORD

A **dividend** *is a distribution of a company's profits (either yearly or half-yearly) to shareholders and is calculated as a number of cents per share.*

The following terms refer to variations in the type or issue of ordinary shares.

- *New issue* — a security that has been issued and sold for the first time on a public market e.g. the Australian Securities Exchange. New issues are sometimes referred to as primary shares or new offerings. An initial public offering (IPO) is when a company issues shares to the public for the first time. Usually, businesses will be required to issue a prospectus, which is a document that contains relevant details about the company so that investors can make informed decisions.
- *Rights issue* — the privilege granted to shareholders to buy new shares in the same company. This occurs after the IPO and provides existing shareholders with the opportunity to purchase more shares. Usually the current shareholders will have the right to purchase new shares in proportion to the number of shares they currently own. The shareholder does not have to take up the rights issue.
- *Placements* — allotment of shares made directly from the company to investors. In other words additional shares are offered at a discount to their current trading price to special institutions or investors. This discount is intended to persuade specific investors to invest in the company.
- *Share purchase plan* — an offer to existing shareholders in a listed company to purchase more shares in that company without brokerage fees. The shares can also be offered at a discount to the current market price. Share purchase plans allow companies to issue new shares to current shareholders without issuing a prospectus. They can only issue a maximum of $15 000 in new shares to each shareholder.

Private equity

Private equity is the money invested in a (private) company not listed on the Australian Securities Exchange (ASX). The aim of the private company (like the publicly listed companies who sell ordinary shares) is to raise capital to finance future expansion/investment of the business.

SNAPSHOT



'the float... will enable them to achieve their long-term strategic plans.'

The benefits of equity financing

When starting a new business or expanding an existing one, you must decide whether you want to borrow money or sell ownership interest to equity investors. Before selecting an option, it is important that you understand the pros and cons of each option.

Equity financing refers to raising funds by selling shares in a company to investors. As opposed to debt financing, any money raised through equity doesn't have to be paid back in instalments with interest. Instead, investors contribute money to the business and then become partial owners of that business, which means they are entitled to a share of the company's profits over time.

For small businesses, however, the most common source of equity is friends and family. Unlike debt, investments made by friends and family can be paid back after the business starts to make money. This may not be until after a number of years. These investments are usually made when businesses are starting out because the owners may experience difficulties obtaining debt finance since they don't have a track record and there is a high risk of business failure.

Daniel Tartak is the chief executive of Bingo Industries, a waste management and recycling company that has its corporate headquarters in the western Sydney suburb of Auburn. In 2005, Tony Tartak, Daniel's father, bought the business for less than $1 million dollars. At that time it was just a small skip bin collection company with four trucks, 100 skip bins and six employees. Five family trusts owned by various members of the extended Tartak family each

owned 20 per cent of the company. Over twelve years, the family gradually built the company up into a large family business with 158 trucks and 10 recycling centres.

Daniel Tartak, who has always been involved with the family business, began running Bingo in 2015 after his parents retired. To achieve his aim of expanding the company into a national firm within five years, Daniel listed his company on the ASX in 2017. The company raised $420 million in proceeds from the float. The Tartak family will retain 104.7 million shares worth $188 million at the issue price, which means they retain only 30 per cent of the company. However, they will collect $348 million in cash from the float, which will enable them to achieve their long-term strategic objectives.

The type of financing businesses seek depends largely on the nature of the business. If a business is just getting started, they may consider a loan from family, friends or even a bank. As they grow, equity funding may become an option, but only if the owners are willing to give up a portion of their company.

SNAPSHOT QUESTIONS

1. **Outline** the disadvantages of debt financing.
2. **Discuss** equity financing.
3. **Explain** how equity financing is helping Bingo Industries achieve their long-term strategic plans.

SUMMARY

- Internal finance refers to funds that are generated from inside the business. For example, profits can be retained to finance expansion.
- External finance is the funds provided by sources outside the business, such as financial institutions, governments and suppliers.
- External sources of finance are broadly categorised as either debt or equity — each will influence the financial management decision of a business.
- Debt finance can be short-term borrowings such as overdrafts, commercial bills and factoring; or long-term borrowings such as mortgages, debentures, unsecured notes and leasing.
- Equity refers to the cash raised by a company through:
  - issuing ordinary shares to the public for purchase through the ASX
  - private shares (equity) in companies not listed on the ASX.
- Different types of ordinary shares include:
  - new issue
  - rights issue
  - placements
  - share purchase plan.

studyon

Syllabus area 3
Topic 2
Concept 4

External sources of finance: equity
Summary screen and practice questions

EXERCISE 10.1 REVISION

1 **Outline** the difference between internal sources and external sources of finance.
2 **Define** the term 'retained profits'.
3 **Explain** why equity finance can be the most difficult type of finance to obtain.
4 **Why** do you think most businesses keep approximately half of their profit in the form of retained earnings?
5 Thomas, who owns a hairdressing business, prefers to use retained earnings to expand his business rather than taking on a new partner. **Interpret** the reasons for this.
6 **Identify** the main sources of external finance.
7 **Discuss** the use of an overdraft to meet short-term financial commitments.
8 **Clarify** the main features of commercial bills.

9 **Identify** and **explain** the sources of finance from the following balance sheet.

Current Assets		
Cash	$33 000	
Receivables	12 000	
Inventories	4 700	$49 700
Non-current Assets		
Land and buildings	98 000	
Plant and equipment	18 000	116 000
Total Assets		165 700
Current Liabilities		
Creditors	8 700	
Non-current Liabilities		
Borrowings	12 000	20 700
Net Assets		145 000
Owners' Equity		
Capital	140 000	
Profits	5 000	145 000

10 (a) **Define** the term 'factoring'.
(b) **Why** has factoring become an important source of finance for business?
(c) **Discuss** factoring.

11 **Distinguish** between a debenture and an unsecured note.

12 **Define** the term 'leasing'.

13 'Leasing is a cheap, flexible and important source of finance for businesses'. **Discuss** this statement, **outlining** the uses, advantages and disadvantages of leasing.

14 BJs Supermarket is considering whether to purchase or lease a new supermarket. The lease requires that BJs pays for maintenance, insurance and rates if the store is leased. The annual lease payment is $100 000 (payable in advance) for four years. The purchase price of the supermarket is $350 000 and funds would need to be borrowed if the store was purchased. **Construct** a report for BJs supermarket on the best alternative for the business, **outlining** the advantages and disadvantages of both leasing and purchasing the supermarket.

15 Leo has purchased a number of computers and new software for his photographic equipment business in anticipation of increasing sales on the internet. This has not occurred and Leo is having difficulties paying bills on time. **Recommend** to Leo the best sources of finance for the business to overcome the problems. **Justify** your answers.

16 **Construct** a concept map **summarising** the variations in the type or issue of ordinary shares.

on Resources

Weblink: Austrade

Weblink: Australia Private Equity and Venture Capital Association (AVCAL)

EXERCISE 10.1 EXTENSION

1 **Examine** the sources of funds provided by Austrade and Australia Private Equity and Venture Capital Association (AVCAL) that are available to businesses.

2 **Analyse** a range of annual reports of businesses to determine their sources and applications of funds. **Construct** a table to **summarise** your findings.

10.3 Financial institutions

Financial institutions collect funds and invest them in financial assets. They provide financial services and focus on dealing with financial transactions such as investments, loans and deposits. While most businesses acquire funds from a bank, finance is also available from a variety of other institutions, such as investment banks, finance companies, superannuation funds, life insurance companies, unit trusts and the Australian Securities Exchange.

10.3.1 Banks

Banks are the major operators in financial markets and are the most important source of funds for businesses. Banks receive savings as deposits from individuals, businesses and governments, and, in turn, make investments and loans to borrowers.



FIGURE 10.8 There is intense competition between banks. To entice businesses to bank with them, banks now offer a wide variety of products and services for businesses; for example, low fees, merchant facilities such as EFTPOS and BPay, debit and credit cards, business loans, internet banking, business insurance, overdraft facilities and advice.

Most of the funds provided through financial markets come from banks that operate on their own behalf or on behalf of other corporations, although other financial institutions also operate in the financial market.

Banks are the largest form of financial institution in Australia, although their share has declined as the financial markets have become deregulated. They perform an increasingly wide range of roles rather than specialising in one area, and have subsidiaries in superannuation and mutual, and other funds. Banks are supervised by the Reserve Bank of Australia.

BizFACT

There are currently 54 banks operating in Australia. The four largest banks are ANZ Banking Group, Commonwealth Bank of Australia, National Australia Bank and Westpac Banking Corporation.

10.3.2 Investment banks

Investment banks provide services in both borrowing and lending, primarily to the business sector, for example, Macquarie Bank. They provide a wide variety of different types of loans for businesses and can therefore customise loans to suit the business's specific needs. Investment banks sometimes impose conditions when providing loans. For example, they may require some equity in the business borrowing the funds. Investment banks:

- trade in money, securities and financial futures
- arrange long-term finance for company expansion
- provide working capital
- arrange project finance
- advise clients on foreign exchange cover
- advise on mergers and takeovers

- provide portfolio investment management services
- underwrite corporate and semi-government issues of securities
- operate unit trusts including cash management trusts, property trusts and equity trusts
- arrange overseas finance.

10.3.3 Finance companies

BizFACT

There are currently 105 registered finance companies in Australia. However, their share of business loans has been shrinking in recent years.

Finance companies are non-bank financial intermediaries that specialise in smaller commercial finance. They provide mainly short-term and medium-term loans to businesses through consumer hire-purchase loans, personal loans and secured loans. They are also the major providers of lease finance to businesses. Some finance companies specialise in factoring or cash flow financing.

Finance companies raise money through share issues (debentures). Debentures are for a fixed term and carry a fixed rate of interest. Lenders have the security of priority over the firm's assets in the event of liquidation. In other words, the finance company is entitled to sell the assets of the business to recover the initial loan if the business fails. Finance companies can provide businesses with quick access to funds, although the interest rate will usually be higher. Finance companies (and insurance companies) are regulated by the Australian Prudential Regulation Authority (APRA) (see figure 10.9).

FIGURE 10.9 The Australian Prudential Regulation Authority (APRA) is the prudential regulator of the Australian financial services industry. It oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies and most members of the superannuation industry. APRA is funded largely by the industries that it supervises.

10.3.4 Life Insurance companies

Life insurance companies are also non-bank financial intermediaries who provide cover and a lump sum payment in the event of death. Policy holders pay regular premiums and the insurer guarantees to pay the designated beneficiary a sum of money upon death of the insured person or under other circumstances specified in the contract.

Life insurance companies provide both equity and loans to the corporate sector through receipts of insurance premiums, which provide funds for investment. The funds received in premiums, called reserves, are invested in financial assets.

10.3.5 Superannuation funds

BizWORD

Superannuation *is a scheme set up by the federal government, which requires all employers to make a financial contribution to a fund which will provide benefits to an employee when they retire.*

Superannuation funds have grown rapidly in Australia over the past 25 years due to tax incentives and compulsory superannuation, which was introduced by the government in 1992. **Superannuation** is a scheme set up by the federal government, which requires all employers to make a financial contribution to a fund that will provide benefits to an employee when they retire.

Employers are required by the government to make superannuation contributions for all employees aged between 18 and 69 who are paid more than $450 before tax in a calendar month. They are also obligated to make contributions for people under 18 who work more than 30 hours a week (and still earn more than $450 in the calendar month). Employers must pay an amount equal to 9.5 per cent

of their employee's salary into a super fund account. This is on top of the employee's salary or wages. Over the course of their working life, these contributions add up.

Superannuation funds invest the money received from superannuation contributions in many things, such as company shares, property and managed funds. They do this so that their members will earn investment returns on the money.

Superannuation guarantee — future plans

There are laws about how much superannuation employers must contribute to their employees' superannuation fund. This is called the superannuation guarantee. The superannuation guarantee began in 1992 with the passing of the *Superannuation Guarantee (Administration) Act 1992*. When this law was first introduced, the superannuation guarantee was only 3 per cent (4 per cent for employers who had an annual payroll greater than $1 million). Over the next ten years, higher levels of contributions were phased in, until it reached 9 per cent in 2002–03.

In 2010, the Australian Labor Party (ALP) announced that they planned to gradually increase the superannuation guarantee contributions from 9 per cent to 12 per cent by 2019. Under new laws passed by the Liberal government, the planned rate of increase will slow. The superannuation guarantee rate will remain at 9.5 per cent for another five years, increasing to 10 per cent from July 2021. It will not reach 12 per cent until July 2025, another seven years from what was set out in the previous laws.

The table below details the planned gradual increase to the SG rate over a period of 10 years.

Financial year	SG rate
2012–13	9%
2013–14	9.25%
2014–15	9.5%
2015–16	9.5%
2016–17	9.5%
2017–18	9.5%
2018–19	9.5%
2019–20	9.5%
2020–21	9.5%
2021–22	10%
2022–23	10.5%
2023–24	11%
2024–25	11.5%
2025–26	12%

This planned increase was originally introduced to address issues raised by Australia's ageing population: the number of Australians aged over 65 is projected to increase from 3 million to 8.1 million by 2050. In addition, those people approaching retirement will spend more time in retirement than past generations. These reforms will therefore boost the retirement incomes for Australian workers.

SNAPSHOT QUESTIONS

1. **Define** 'superannuation guarantee'.
2. **Justify** why the government introduced a reform to the superannuation guarantee.
3. **Assess** the impacts of this reform on individuals, employers and the government.

SNAPSHOT



'There will be a phased increase in superannuation guarantee contributions.'

10.3.6 Unit trusts

Unit trusts (also known as mutual funds) take funds from a large number of small investors and invest them in specific types of financial assets. Unit trusts invest in any mixture of cash, Australian or international shares, fixed interest securities (such as government bonds) or property. In recent years some unit trusts have also invested in gold, silver, oil and gas. Unit trusts are usually connected to a management firm that manages a diversified investment portfolio for its investors.

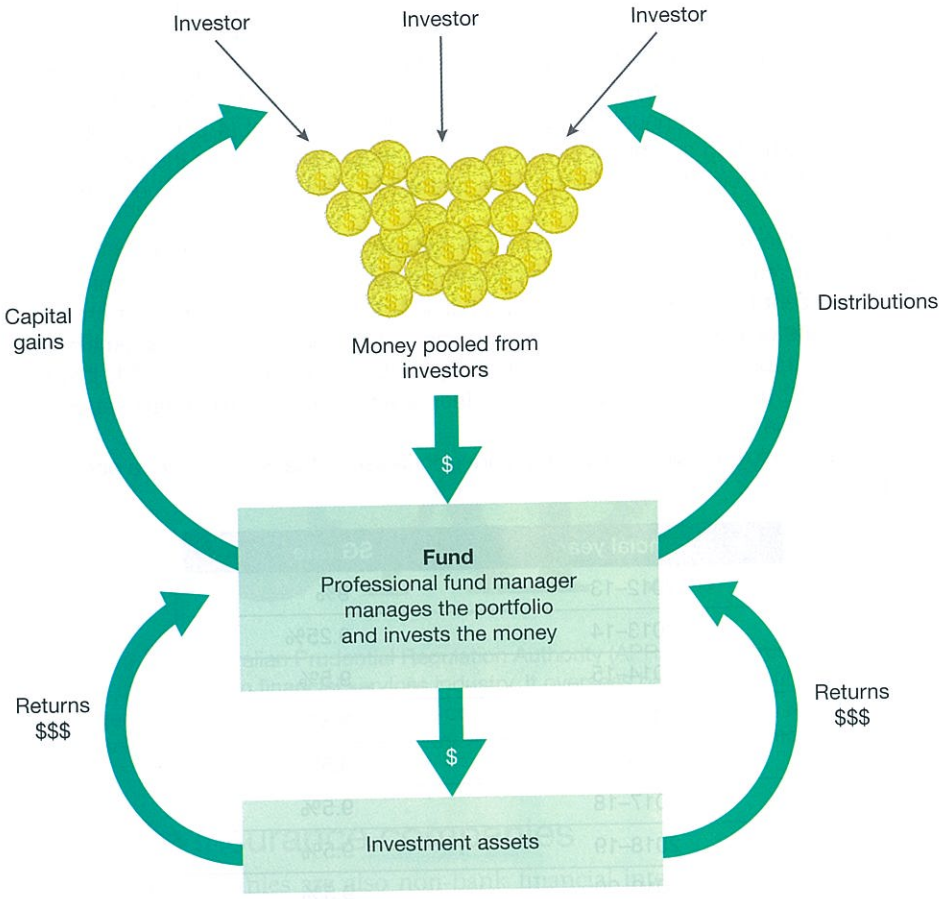


FIGURE 10.10 How unit trust funds work

BizWORD

The **Australian Securities Exchange (ASX)** *is the primary stock exchange group in Australia.*

10.3.7 Australian Securities Exchange

The **Australian Securities Exchange (ASX)** was created by the merger of the Australian Stock Exchange and the Sydney Futures Exchange in July 2006 and is the primary stock exchange group in Australia. The ASX is a market where shares are bought and sold.

The ASX functions as a market operator, clearing house and payments system facilitator. It oversees compliance with its operating rules and promotes standards of corporate governance among Australia's listed companies. The ASX offers products and services including:

- shares
- futures
- exchange traded options
- warrants
- contracts for difference
- exchange traded funds
- real estate investment trusts
- listed investment companies
- interest rate securities.

The biggest stocks traded on the ASX include BHP Billiton, CBA, Rio Tinto, Suncorp and Telstra.

Importantly for businesses, the ASX acts as a **primary market**. This primary market enables a company to raise new capital through the issue of shares and through the receipt of proceeds from the sale of securities.

The ASX also operates as a **secondary market**. The secondary market is where pre-owned or second-hand securities, such as shares, are traded between investors who may be individuals, businesses, governments or financial institutions. Transactions in this market do not increase the total amount of financial assets — the secondary market increases the liquidity of financial assets and, therefore, influences the primary market for securities.

BizWORD

Primary markets *deal with the new issue of debt instruments by the borrower of funds.*

Secondary markets *deal with the purchase and sale of existing securities.*

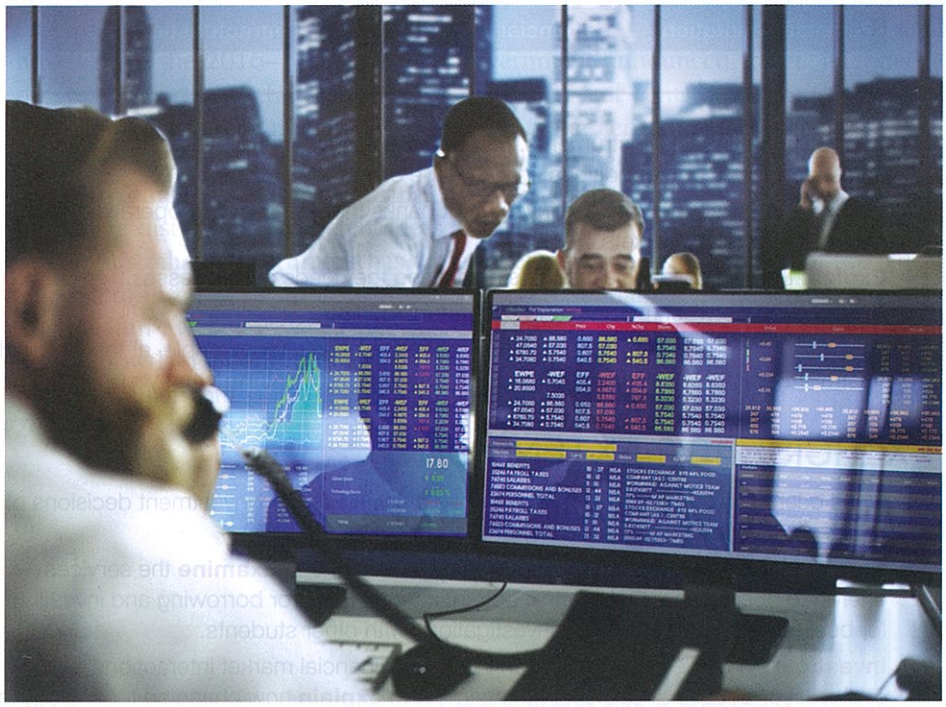


FIGURE 10.11 The most common ways to buy and sell shares is on the share market using a full service broker, an online trading account or from the company itself when it offers shares through a public float. An online broking service allows investors to make their own investment decisions for lower fees. A full service broker will charge more; however, they can also give advice on what to buy and sell.

SUMMARY

- The main financial institutions are:
  - banks
  - investment banks
  - finance companies
  - life insurance companies
  - superannuation funds
  - unit trusts
  - Australian Securities Exchange.
- Banks are the major operators in financial markets and are the most important source of funds for business.
- Investment banks provide services in both borrowing and lending, primarily to the business sector.
- Finance companies are non-bank financial intermediaries that specialise in smaller commercial finance.
- Life insurance companies are also non-bank financial intermediaries who provide cover and a lump sum payment in the event of death.

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Syllabus area 3 | Topic 2 | Concept 5

Financial institutions
Summary screen and practice questions

- Superannuation funds are able to invest the contributions of members into a range of short- and long-term investments with the aim of maximising a return.
- The business sector increasingly uses superannuation funds for long-term investment in growth and development.
- The ASX acts as both a primary and secondary market for the sale of shares to the public.

EXERCISE 10.2 REVISION

1 Draw a table, as indicated below, to **summarise** the major participants in financial markets.

Financial institution	Financial instruments	Characteristics

2 Choose three financial instruments. **Investigate** current interest rates, maturity dates, and terms and conditions from a range of four institutions.

3 Using the internet, **identify** five investment banks that are currently operating in Australian financial markets.

4 **Explain** the role of financial markets in meeting the needs of businesses.

5 **Distinguish** between primary and secondary markets.

6 **Examine** an area of business banking that interests you, for example, at the National Australia Bank (NAB). Prepare a list of five points **summarising** what you learnt.

on Resources

Weblink: National Australia Bank (NAB)

EXERCISE 10.2 EXTENSION

1 It has been said that financial markets drive the financial and investment decisions of businesses. **Analyse** the accuracy of this statement.

2 Choose one of the major participants in financial markets. **Examine** the services offered to businesses. **Determine** current interest rates for borrowing and investing for businesses. **Compare** your investigations with other students.

3 **Investigate** the role of technology in improving financial market interactions for businesses. **Create** a report to management to **explain** how changing technology in financial markets can improve financial and investment decisions.

10.4 Influence of government

The government influences a business's financial management decision making with economic policies such as those relating to the monetary and fiscal policy, legislation and the various roles of government bodies or departments who are responsible for monitoring and administration. The following outlines the importance of two governmental influences on financial management for businesses.

10.4.1 The Australian Securities and Investments Commission (ASIC)

ASIC is an independent statutory commission accountable to the Commonwealth parliament. It enforces and administers the *Corporations Act 2001* and protects consumers in the areas of investments, life and general insurance, superannuation and banking (except lending) in Australia.

The aim of ASIC is to assist in reducing fraud and unfair practices in financial markets and financial products. ASIC ensures that companies adhere to the law, collects information about companies and makes it available to the public. This includes the financial information that companies must disclose in their annual reports.

ASIC have been given a wide range of powers to enforce the Corporations Act. If a business breaches the law, ASIC will investigate the matter and determine an appropriate remedy. They are able to pursue a variety of remedies depending on the seriousness of the misconduct, such as imprisonment and monetary penalties. Failure to comply with the Corporations Act also generates negative publicity for the business.

10.4.2 Company taxation

All Australian businesses that have been incorporated — that is, all private and public companies — are required to pay company tax on profits. This tax is levied at a flat rate of 30 per cent of net profit, unlike personal income taxes, which use a progressive scale. Prior to 2017, the company tax rate was 30 per cent, however, in the 2016–17 Budget, the government announced that it intended to progressively reduce the corporate tax rate to 25 per cent. From the 2016/17 tax year, the company tax rate was reduced to 27.5 per cent for small businesses with a turnover less than $10 million. The company tax rate will remain at 30 per cent for all other companies that are not small business entities. Company tax is paid before profits are distributed to shareholders as dividends.

The Australian Government has undertaken this process of reform of the federal tax system in order to improve Australia's international competitiveness and make Australia an even more attractive place to invest, thereby driving long-term economic growth. This will mean more jobs and higher wages for working Australians. The Australian company tax rate was previously reduced from 36 to 34 per cent in 2000/01 and then to 30 per cent in 2001/02.

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BizFACT

The federal Liberal government has been trying to pass legislation to lower the tax rate from 30 per cent to 25 per cent for companies with a turnover of more than $50 million.

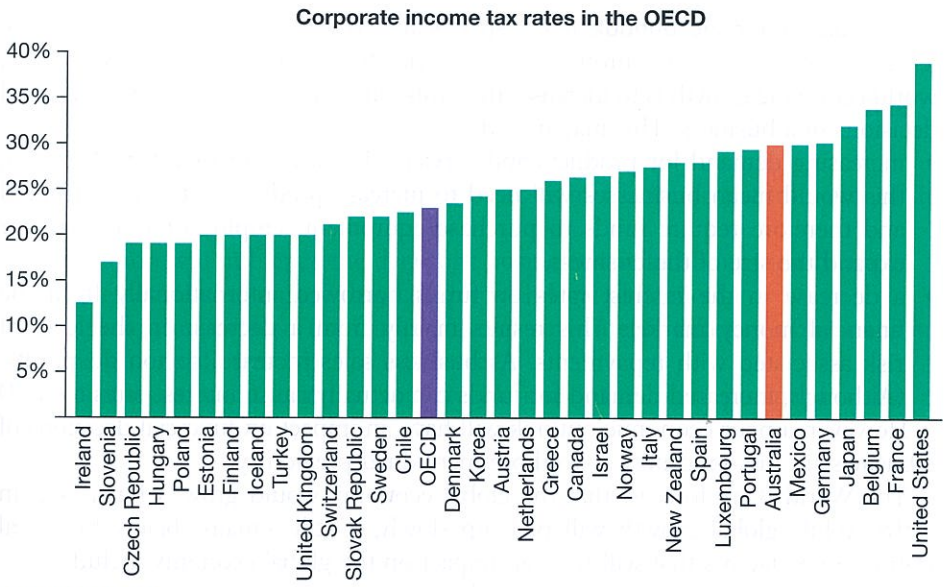


FIGURE 10.12 Australia's company tax rate in relation to other OECD countries

Source: The Organisation for Economic Co-operation and Development (OECD), https://stats.oecd.org/Index.aspx?DataSetCode=TABLE_II1

10.5 Global market influences

Financial risks associated with global markets are greater than those encountered domestically, but such risk-taking is necessary to implement a business strategy.

Largely uncontrollable financial influences include the availability of funds, interest rates and the global economic outlook. 'Uncontrollable' means that

these influences are part of the external business environment and may not be significantly controlled by the business. However, a business can put in place appropriate financial management strategies to minimise the negative effects.

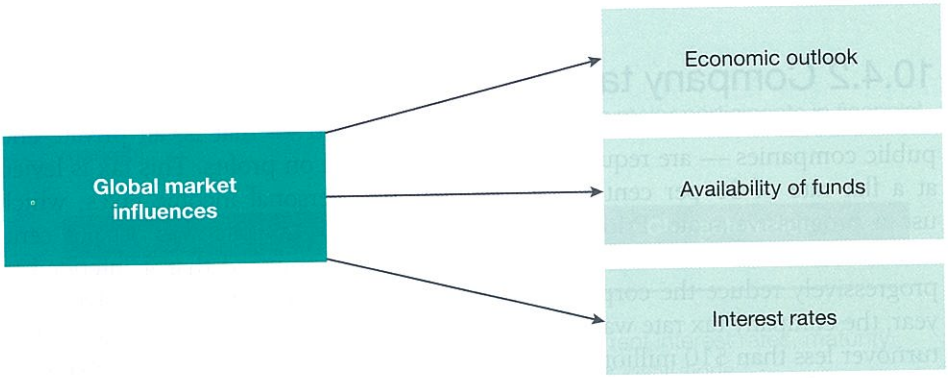


FIGURE 10.13 Global influences on financial management

One very significant influence in the past two decades is the impact of globalisation on world financial markets. Globalisation has created more interdependence between economies and their business (and financial) sector which relies on trade for expansion and increased profits.

10.5.1 Global economic outlook

BizWORD

The **global economic outlook** *refers specifically to the projected changes to the level of economic growth throughout the world.*

The **global economic outlook** refers specifically to the projected changes to the level of economic growth throughout the world. If the outlook is positive (that is, world economic growth is to increase) then this will have an impact on the financial decisions of a business. This may include:

- increasing demand for products and services. For a country such as Australia, this would mean businesses will need to increase production to meet demand and therefore require funds to purchase equipment, employ or train staff, or expand the size of the business.
- a decrease in the interest rates on funds borrowed internationally from the financial money market. This results mainly from a decrease in the level of risk associated with repayments. As business sales increase, so too do profits. (Although, increased demand for funds can actually cause interest rates to rise!)

However, a poor economic outlook will have an impact on financial decisions of a business in the opposite way to those mentioned previously.

The World Bank forecast that the global economy would grow 3.1 per cent in 2018. While global growth will pick up slowly, it still remains below historical norms. Some factors that will have an impact on the global economy include:

- an increase in manufacturing and trade
- increasing consumer confidence
- increased investment spending
- uncertainty surrounding the economic policies of the US administration and their global ramifications
- uncertainty resulting from the Brexit referendum resulting in the United Kingdom withdrawing from the European Union
- expected slowing in the growth in the Chinese economy
- increase in commodity and oil prices
- financial risks from high and rising credit growth and house price increases.

BizFACT

Research from the McKinsey Global Institute in 2017 found that global cross-border capital flows — including lending, purchases of equities and bonds, and foreign direct investment — have fallen by 65 per cent since the global financial crisis in 2007, from $12.4 trillion to $4.3 trillion. Half of that decline reflects a sharp reduction in cross-border lending and other banking activities.

10.5.2 Availability of funds

BizWORD

Availability of funds *refers to the ease with which a business can access funds (for borrowing) on the international financial markets.*

The **availability of funds** refers to the ease with which a business can access funds (for borrowing) on the international financial markets. The international financial markets are made up of a range of institutions, companies and governments that are prepared to lend money to individuals, companies or governments who may need to raise capital. Various conditions and rates apply and these will be based primarily on:

- risk
- demand and supply
- domestic economic conditions.

The global financial crisis that occurred in 2008–09 had a major impact on the availability of funds for all companies and institutions. It caused a sharp increase in interest rates that was a reflection of the high level of risk in lending.

10.5.3 Interest rates

BizWORD

Interest rates *are the cost of borrowing money.*

Interest rates are the cost of borrowing money. The higher the level of risk involved in lending to a business, the higher the interest rates. A business that plans to either relocate offshore or expand domestic production facilities to increase direct exporting will normally need to raise finance to undertake these activities. Traditionally, Australian interest rates tend to be above those of other countries, such as the United States and Japan. Therefore, Australian businesses could be tempted to borrow the necessary finance from an overseas source to gain the advantage of lower interest rates. However, the real risk here is exchange rate movements. Any adverse currency fluctuation could see the advantage of cheaper overseas interest rates quickly eliminated. In the long term, the 'cheap' interest rates may end up costing more.

10.5.4 Analyse the influence of government and the global market on financial management

There are a variety of implications for businesses in relation to the influence of the government:

- Legislation will influence the decisions businesses make about their finances.
- Businesses need to ensure they comply with legal obligations.
- Legislation impacts on the choice of legal structure as different obligations are imposed on different types of businesses.
- If businesses don't comply with regulations, ASIC can pursue a range of remedies, which will influence a business's finances.
- Negative publicity could result for businesses who do not comply with government regulations.
- Taxation regulations will affect business's financial decisions as some decisions might be better for taxation purposes.
- Taxation regulations require sound financial management so the business will have adequate financial resources available for when their taxation obligations are due.

There are also various implications for businesses in relation to the influences of the global market:

- The global economic outlook will have a direct effect on the demand for Australian exports; that is, a positive outlook will increase demand for Australian products whereas a negative outlook will decrease demand.
- The availability of funds will impact on whether Australian businesses can access the money they need to expand.

- Overseas interest rates will also affect Australian businesses who borrow funds from overseas. If interest rates and/or exchange rates change, then this could lead to an increase in repayments and therefore a reduction in profits.

SUMMARY

- The government influences the financial management of business through the implementation of economic policies (fiscal and monetary), and through the implementation of current and changing legislation.
- The Australian Securities and Investments Commission (ASIC) aims to reduce fraud and unfair practices in financial markets and financial products.
- Companies and corporations in Australia pay company tax on profits.
- Globalisation has created more interdependence between economies and their business (and finance) sectors, which relies on trade for expansion and increased profits.
- Global market influences increasingly affect business financial decisions, and this is specifically evident in the availability of funds for loans and the interest rates charged for these loans.
- The changes to the global economic outlook relate specifically to changes in the economic growth rates of individual economies throughout the world.
- The need to maximise profits and the capacity to source funds internationally will affect financial management decisions.

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Syllabus area 3
Topic 2
Concept 7

Global market influences
Summary screen and practice questions

EXERCISE 10.3 REVISION

1 **Describe** the role of ASIC and briefly **discuss** its importance as a regulator of financial markets.
2 **Explain** the influence of company tax on financial management.
3 (a) **Identify** three global market influences.
(b) **Why** are these influences considered 'uncontrollable'?
4 **How** could a negative global outlook affect the financial decisions of a business?
5 **Outline** factors that will affect a business's ability to access funds globally.
6 **Outline** the risk to Australian businesses of borrowing finance from an overseas source to gain the advantage of lower interest rates.
7 **Explain** the impact of the global market on the financial management decisions of businesses throughout the world. Use examples in your response.
8 **Summarise** the implications for businesses in relation to the influences of government and the global market.
9 Answer the following questions by referring to the graph in figure 10.12.
(a) **Identify** which OECD country has the lowest company tax rate.
(b) **Identify** which country has the highest company tax rate. What is the tax rate?
(c) **Compare** Australia's tax rate to other OECD countries.

on Resources

- **Digital doc:** Chapter summary (doc-24812)
- **Interactivity:** Chapter crossword (int-7167)
- **Interactivity:** Multiple choice quiz (int-7168)
- **eLesson:** Floating Intrepid Travel (eles-1045)
- **Weblink:** Australian Securities and Investments Commission (ASIC)

EXERCISE 10.3 EXTENSION

1 Use the internet to **determine** three financial impacts of the global financial crisis on business.
2 Using information from the **Australian Securities and Investments Commission (ASIC)** website, **construct** a concept map that **summarises** the roles and powers of ASIC.

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CHAPTER 11

Processes of financial management