

IB Business Management HL

3.2 Sources of Finance

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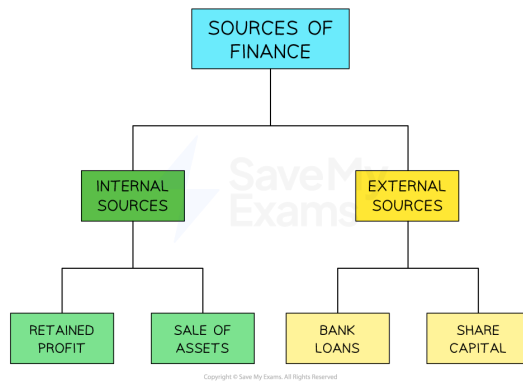


Internal Sources of Finance

YOUR NOTES

**An Introduction to Sources of Finance**

- Businesses have **different sources of finance** available to them
- When the finance comes from inside the business it is called an **internal source of finance**
- When the finance comes from outside the business it is called an **external source of finance**



The different types of internal and external sources of finance available to help businesses grow



Sources of Internal Finance

- Internal finance comes from the **owner's capital, retained profit, or the sale of assets**

Owner's capital: personal savings

- Personal savings are a key source of funds when a **business starts up**
 - Owners may introduce their savings or another lump sum e.g. money received from a redundancy payment
- Owners may invest more as the **business grows** or if there is a specific need e.g. a short-term cash flow problem

Retained profit

- The profit that has been generated in previous years and not distributed to owners is **reinvested back** into the business
- This is a cheap source of finance, as it **does not involve borrowing** and associated interest and arrangement fees
- The opportunity cost of investing the money back into the business is that shareholders **do not receive extra profit** for their investment

Sale of assets

- Selling business assets which are no longer required (e.g. machinery, land, buildings) generates a source of finance
- A **sale and leaseback arrangement** may be made if a business wants to continue to use an asset but needs cash
 - The business **sells an asset** (most likely a building) for which it receives cash
 - The business then **rents the premises** from the new owners
 - E.g. In early 2023 Sainsbury's announced that it is in talks to **sell the prime retail property** for £500m which will then be **leased back** to them by the new owners, LXI Reit

The Advantages & Disadvantages of Using Internal Finance

Advantages	Disadvantages
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- | | |
|---|---|
| <ul style="list-style-type: none">Internal finance is often free (e.g. it does not involve the payment of interest or charges) and can usually be organised very quicklyIt does not involve third parties who may want to influence business decisions | <ul style="list-style-type: none">There is a significant opportunity cost involved in the use of internal finance e.g. once retained profit has been used it is not available for other purposesInternal finance may not be sufficient to meet the needs of the business |
|---|---|



Exam Tip

Weigh up the circumstances of the business when considering the recommendation of using internal finance.

Carefully examine the financial information that is presented within the case study material (e.g. cash flow forecasts, statements of financial position and statements of comprehensive income) and look for clues in the body of the case studies text such as the personal circumstances of the business owner or the nature of the business itself.

Then make justified assumptions about the likelihood of internal finance being suitable for the intended purpose.

YOUR NOTES



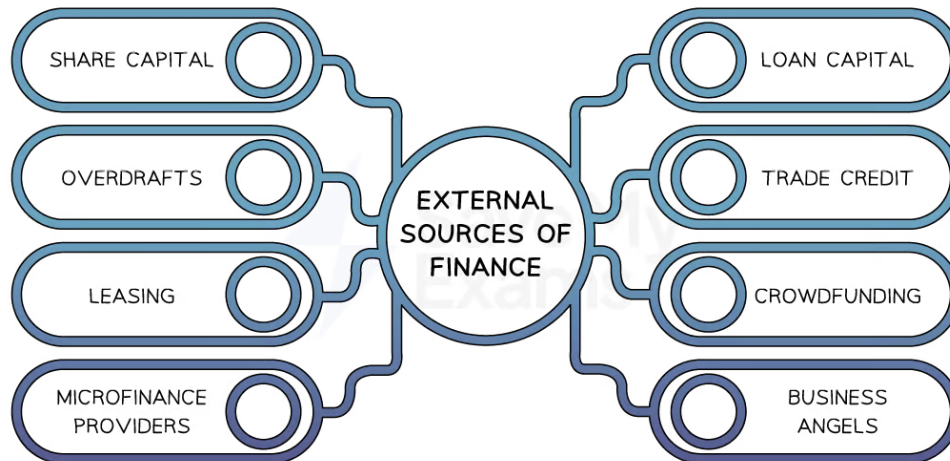
External Sources of Finance

YOUR NOTES



External Sources of Finance

- **New business startups** may seek external finance from **family and friends**
 - This is usually a very **cheap source** of funds with 'no strings attached' (e.g. a share of the business)
- As the business grows, a **more sources of finance** are available



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The external sources of finance available to businesses

- Businesses often make use of a **range of sources of finance that meet different needs**
 - For example, **long-term loans** or **share capital** are likely to be most suitable sources of finance to **fund capital expenditure** including the purchase of land, buildings or machinery whilst **overdrafts** may be used to **solve short-term cash flow** problems

An Explanation of the main External Sources of Finance

Method of Finance	Explanation
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Share Capital	<ul style="list-style-type: none">• Share capital is finance raised from the sale of shares in a limited company through flotation or a rights issue• Shareholders are the owners of shares and they are entitled to a share of the company's profit when dividends are declared• Shareholders usually have a vote at a company's Annual General Meeting (AGM) where they can have a say in the composition of the Board of Directors
Loans	<ul style="list-style-type: none">• Secured loans are more likely to be available to larger businesses and are typically repaid over five to twenty years<ul style="list-style-type: none">◦ Interest rates may vary over the term of the loan and terms may be renegotiated if needed◦ Failure to make repayments can mean a business has to convert non-current assets into cash (sell them)• Mortgages are long-term secured loans<ul style="list-style-type: none">◦ They are typically used by a business to purchase buildings, land or large items of capital equipment◦ Interest is payable and assets are at risk if the business does not make repayments as planned
Overdrafts	<ul style="list-style-type: none">• This is an arrangement between the business and their bank to spend more money than it has in its account<ul style="list-style-type: none">◦ A limit is agreed and interest is charged only when a business 'goes overdrawn'◦ It is a short-term source of finance that offers significant flexibility and aids cash flow• An overdraft may be 'called in' if the bank is concerned about a business's ability to repay what it owes• Some large businesses rely heavily on overdrafts to manage working capital
Trade Credit	<ul style="list-style-type: none">• An agreement is made with suppliers to buy raw materials, components and stock which are then paid for at a later date, typically 30 to 90 days later<ul style="list-style-type: none">◦ Trade credit is usually interest-free◦ Although trade credit may also be available for small businesses, larger businesses tend to be able to request more generous trade credit terms from suppliers

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Leasing	<ul style="list-style-type: none"> Assets such as machinery or a fleet of vehicles are made available to the business in return for regular payments (a form of rental) <ul style="list-style-type: none"> The business does not own the asset during the period of the lease and so is not responsible for maintenance or repair costs E.g. many businesses lease office equipment such as photocopiers and IT equipment Leasing is usually more expensive in the long run than buying an asset
Crowdfunding	<ul style="list-style-type: none"> Crowdfunding allows businesses to access finance provided by a large number of small investors on online platforms such as Kickstarter Businesses need to provide a persuasive business plan to convince individuals to invest in their product as they will be competing with many other projects online <ul style="list-style-type: none"> Investors are often attracted by incentives such as a sample or early access to a product E.g. In November 2022 well-known Twitter commentator Russ Jones published his long-awaited book funded via Unbound, a crowdfunding publisher
Micro-finance Providers	<ul style="list-style-type: none"> Micro-finance providers are small lenders who make finance directly available to individuals or businesses who would be unable to access finance from anywhere else (they are considered to be risky) <ul style="list-style-type: none"> These are a useful source of funds for businesses that may not qualify for other sources of funds There are usually few formalities in applying for finance though the amount available is usually very limited Many providers operate on a crowdfunding basis Examples may include credit unions and some charities such as Kiva

Business Angels

- Some individuals specialise in **making investments** in start-up or expanding businesses e.g. Dragons Den investors
- These **business angels** tend to be more willing to take a risk than banks
- Finding the 'right' business angel (e.g. **with appropriate experience**, expertise or interest) can be challenging
 - In most cases getting the support of a business angel relies on knowing the 'right people' so **networking is vital** when entrepreneurs seek this kind of investment
- As business angels own a stake in the business, they may be **involved in decision-making** and will receive a share of business profits

YOUR NOTES

**Exam Tip**

Recently, small and medium-sized businesses have found some sources of finance trickier to access. When evaluating **external sources of finance** in your answers, acknowledge that businesses may find accessing these sources more challenging and expensive than in previous years.

Peer to Peer lending, Crowdfunding and sources such as Business Angels have been able to fill some of the gaps left by changes in the banking industry.

Recognising that a business **may not be able to achieve its objectives** due to an inability to borrow can be a useful evaluative point.

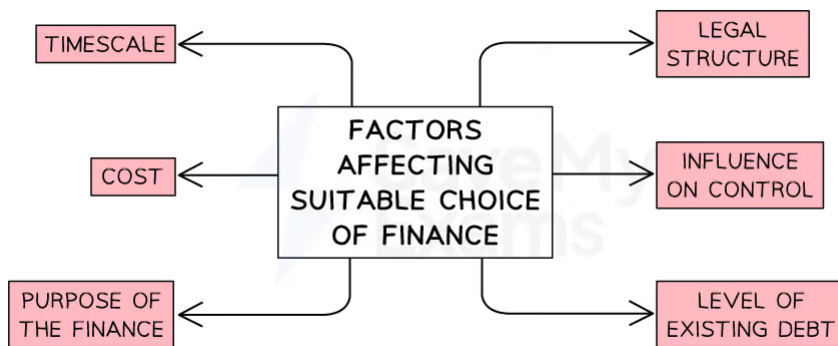
The best Choice of Finance

YOUR NOTES



Choosing the most Appropriate Source of Finance

- Businesses must investigate and select a **combination of sources of finance** that are **most suitable** for their particular needs
- Not all sources of finance are available to every business
 - A **poor credit history** may exclude a business from applying for some types of loans or using an overdraft
 - Business start ups are unlikely to be able to access sources of finance such as **trade credit**. They may not have **established a trading record** and may be viewed as too risky by suppliers

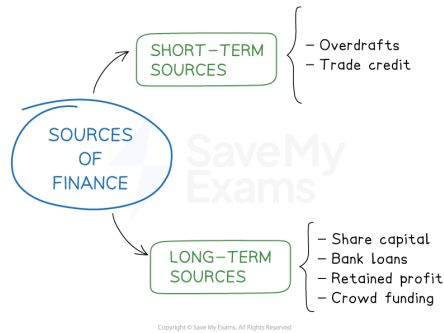


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A range of factors will affect the most suitable sources of finance for a business

Timescale

- **Short-term** sources of finance will be needed to meet **unexpected costs** or to **pay bills and suppliers**
 - These are likely to be relatively **small amounts** and are rarely needed beyond a year
- **Longer-term** sources of finance will be needed to fund the purchase of non-current assets such as buildings and other types of capital equipment
 - These are likely to be **large sums** that may be required for a significant period of time



Long-term and short-term sources of finance

YOUR NOTES



Legal structure

- **Sole traders, partnerships** and small **private limited companies** usually have a more limited range of sources of finance as they are seen as a **greater lending risk**
 - Interest rates on loans are likely to be higher as these businesses **tend to lend smaller amounts** than public limited companies and are not in a position to approach specialist lenders
- **Public limited companies** are able to access a wide selection of sources of finance and are able to provide collateral as security for lenders

Cost

- **Interest payable on loans** can add a significant cost to the use of some sources of finance
 - **Variable interest rates** change during the borrowing term which may make financial planning difficult
 - **Fixed interest rates** remain constant for the period of the loan and for this reason they are usually higher than variable rates
- **Selling shares** in public limited companies is an expensive process
 - Flotation is usually carried out by merchant banks which charge a premium price for their specialist services
 - Selling shares through a rights issue may reduce the amount of share capital raised as they are usually sold at a discount to existing shareholders

Control

- Selling shares or raising venture capital can result in some **loss of control** for business owners
 - Smaller businesses may have to **accept the terms** of more powerful suppliers or business angels as they have **little power to negotiate**



Purpose of the finance

- Certain sources of finance have narrowly focussed uses
 - A **mortgage** is the most appropriate type of lending to purchase land or property
 - Overdrafts are flexible and are best used for short-term working capital requirements

The level of existing debt

- Highly geared businesses already make use of significant amounts of debt
- Lenders and investors may be reluctant to **provide further funds due to the level of risk** the business presents
- Businesses with a poor or no borrowing history may not meet credit score requirements and would be **excluded** from most types of credit