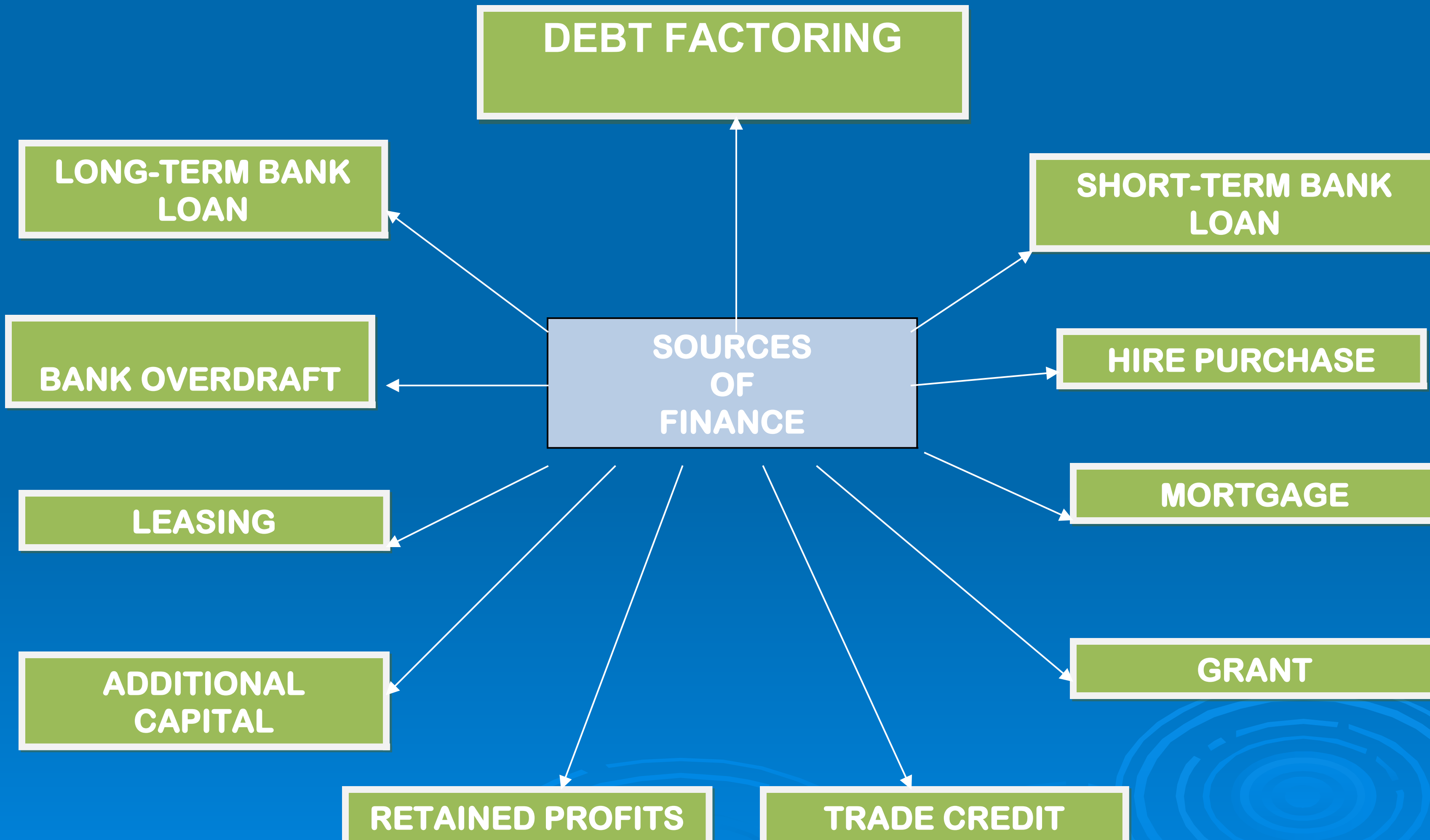
SOURCES OF FINANCE

Why do Business Need Finance?

Businesses may need to look for finance from banks or other investors for helping to start a business, keep a business going or for expanding a business.

Businesses can access many different sources of finance. The source of finance, used depends on what the finance is for and how long it is required for.

SOURCES OF FINANCE



DEBT FACTORING

FEATURES:
When customers who buy on credit fail to pay on time or attempt not to pay at all the business can use a factoring service. The factor will buy the debts of the business and they will then attempt to recover payment from the customers.

ADVANTAGE:
This saves the business time pursuing customers and ensures the business receives most of the money it is owed, thus helping with cash flow.

DISADVANTAGE:
The factor charges the business a fee for their service and so this reduces the amount of cash they will actually receive.

LONG-TERM BANK LOAN

FEATURES:
The bank may give a loan for a fixed amount, to be paid back over a fixed period of time in fixed instalments. A long-term loan might be taken out to buy a very expensive piece of machinery and be re-paid over a 5 year period.

ADVANTAGE:
- The business is able to purchase machinery now and use it in the business to start generating profit.
- Repayments are spread out over a long period of time, thus helping cash flow.

DISADVANTAGES:
- The business has now incurred debt and must ensure that all monthly payments are made on time.
- Interest is usually charged on top of the initial loan amount and so this can be a very expensive way of purchasing equipment and machinery

SHORT-TERM BANK LOAN

FEATURES:
The bank may provide a loan to the business for a fixed amount to be Paid back over a short, fixed period of time in fixed monthly instalments. The loan may be used to buy small tools and equipment.

ADVANTAGES:
Because it is a short-term loan there will be less interest payments, thus reducing the cost of the loan.

DISADVANTAGE:
Small or newly formed businesses tend to be seen as more of a risk to lend to and as such these loans can be more difficult to obtain and the interest rate to be paid tends to be much higher.

BANK OVERDRAFT

FEATURES:

A business can overdraw from their bank account, ie, spend more than they have in their bank account up to an agreed limit.

They could, for example, pay staff wages from their bank account even though they have no money in their account.

ADVANTAGE:

This allows the business to pay bills and wages on time and keep the business running smoothly.

DISADVANTAGES:

- This can work out expensive if used for a long time as interest is charged daily.
- The facility may be withdrawn immediately if the limit is exceeded.

HIRE PURCHASE

FEATURES:
Higher purchase allows a business to buy an asset such as a delivery van and pay it back over 36 months. A deposit is required followed by monthly payments over a few years.

ADVANTAGES:
This allows the business to purchase items like vehicles with only a small initial outlay of money.

DISADVANTAGES:
The business does not legally own the asset bought eg delivery van until the last payment has been made.

Interest is usually charged and so it can be an overall more expensive way of purchasing large items.

LEASING

FEATURES:

When a business uses a leasing system it never owns the asset. The business simply 'rents' the asset. For example Arnold Clark now offers a leasing system to allow small businesses to rent motor vehicles and vans.

ADVANTAGES:

The advantage is that the leasing system will replace the asset every couple of years and they are also responsible for any repairs.

DISADVANTAGE:

- The business will never actually own the asset.
- Rental charges or leasing costs can build up over a long period of time and so it may actually work out cheaper to actually purchase the asset in the first place.

MORTGAGE

FEATURES:

A common method of financing land and premises is to take out a mortgage which is a type of long-term loan secured against the title deeds of a property or piece of land. Mortgages are paid back over a long period of time (up to 25 years).

ADVANTAGES:

The business is given a long period of time (25 years) to pay the mortgage back.

DISADVANTAGES:

- Interest has to be paid on top of the initial amount borrowed.
- If the business does not pay the mortgage back or falls drastically behind with repayments, the lender (bank or building society) can claim ownership of the property or land.

ADDITIONAL CAPITAL

FEATURES:

This is where the amount of money invested in the business by the owner is increased by the owners (they take more of their own personal savings and ‘lend’ it to the business. Or they may decide to invite a partner to join the business.

ADVANTAGE:

The business does not need to pay back the money which has been invested and there is no interest to pay or any other costs involved.

DISADVANTAGES:

- The owner/s are now risking more of their own personal money as more of their private savings are ‘tied up’ in the business.
- If a partner is now involved in running the business, profits now have to be shared and so each owner gets a smaller share of the profits.

GRANT

FEATURES:
A source of finance from central government or local government, Business Gateway or the Princes Trust. Money is given to the business in return for starting a new business, creating jobs or setting up business in an area of urban decay.

ADVANTAGE:
In most cases the money does not have to be repaid.

DISADVANTAGES:

- It is usually a one-off payment and certain conditions or criteria must be met before it can be obtained.
- Usually the business is told what the money must be used for.

RETAINED PROFITS

FEATURES:

A business can keep some of its profits rather than distributing them to the owners. In this way they can re-invest the profits back into the business to help it to expand eg by buying new equipment.

ADVANTAGE:

The advantage is that there is no interest to be paid and the business is not incurring any debts. The business will own the assets straight away.

DISADVANTAGES:

When a business spends all of its profits it can run into cash flow problems. They may not be able to pay for any unexpected costs or expenses as all profit has been spent.

TRADE CREDIT

FEATURES:

Businesses can buy goods from suppliers and then arrange to pay for them at a later date eg in 30 days or 60 days.

ADVANTAGE:

This gives the business time to sell the products at a higher price, earn a profit and then pay their suppliers – hopefully before the bill or invoice arrives.

DISADVANTAGE:

- Sometimes suppliers offer a cash discount (reduction in price) for prompt payment. The firm will lose the cash discount if they take too long to pay.
- Suppliers may be reluctant to sell more goods on credit if the business struggles to pay on time.

SHORT, MEDIUM OR LONG-TERM FINANCE?

Short-term finance is covered by trade credit, bank overdraft, debt factoring or a short-term loan.

Medium-term finance is a covered by a bank loan, Hire purchase, leasing or a grant.

Long-term finance is covered by a mortgage, capital invested by owners and retained profits.

INTERNAL OR EXTERNAL FINANCE?

Internal finance comes from owner’s capital and retained profits.

External finance comes from loans, mortgages, grants, hire purchase, leasing, bank overdraft, trade credit and debt factoring

SOURCES OF FINANCE

- INTERNAL SOURCES
- OWNER'S INVESTMENT
- RETAINED PROFITS
- SALE OF STOCK
- SALE OF FIXED ASSETS
- DEBT COLLECTION

Internal Sources
Owner's investment

- This is money which comes from the owner/s own savings
- It may be in the form of start up capital - used when the business is setting up
- It may be in the form of additional capital – perhaps used for expansion
- This is a long-term source of finance

Internal Sources
Owner's investment

Advantages

- Doesn't have to be repaid
- No interest is payable

Disadvantages

- There is a limit to the amount an owner can invest

Internal Sources
Retained Profits

- This source of finance is only available for a business which has been trading for more than one year
- It is when the profits made are ploughed back into the business
- This is a medium or long-term source of finance

Internal Sources
Retained Profits

Advantages

- Doesn’t have to be repaid
- No interest is payable

Disadvantages

- Not available to a new business
- Business may not make enough profit to plough back

Internal Sources
Sale of Stock

- This money comes in from selling off unsold stock
- This is what happens in the January sales
- It is when the profits made are ploughed back into the business
- This is a short-term source of finance

Internal Sources
Sale of Stock

Advantages

- Quick way of raising finance
- By selling off stock it reduces the costs associated with holding them

Disadvantages

- Business will have to take a reduced price for the stock

Internal Sources
Sale of Fixed Assets

- This money comes in from selling off fixed assets, such as:
  - a piece of machinery that is no longer needed
- Businesses do not always have surplus fixed assets which they can sell off
- There is also a limit to the number of fixed assets a firm can sell off
- This is a medium-term source of finance

Internal Sources
Sale of Fixed Assets

Advantages

- Good way to raise finance from an asset that is no longer needed

Disadvantages

- Some businesses are unlikely to have surplus assets to sell
- Can be a slow method of raising finance

Internal Sources
Debt Collection

- A debtor is someone who owes a business money
- A business can raise finance by collecting the money owed to them (debts) from their debtors
- Not all businesses have debtors ie those who deal only in cash
- This is a short-term source of finance

Internal Sources
Debt Collection

Advantages

- No additional cost in getting this finance, it is part of the businesses' normal operations

Disadvantages

- There is a risk that debts owed can go bad and not be repaid