Sources of finance

Finance

Some sources of finance are short term and must be paid back within a year. Other sources of finance are long term and can be paid back over many years. Internal sources of finance are funds found inside the business. For example, profits can be kept back to finance expansion. Alternatively the business can sell assets that are no longer really needed to free up cash. External sources of finance are found outside the business. For example from creditors or banks.

Internal sources of finance

Retained profit

Profits generated by a company that are not distributed to shareholders as dividends but are either reinvested in the business or kept as a reserve for specific objectives such as to pay off a debt or purchase a capital asset.

Retained Profit Advantages:

Ready Availability: Being an internal source, these earnings are readly available to the management and directors don't have to ask outsiders for finance. Cheaper than Extermal Equity: Retained Profit is cheaper than external equity because the floatation costs, brokerage costs, underwriting commission are other issue expenses are eliminated. No Ownership Dilution: Relying on Retained Profit eliminates the fear of ownership dilution and loss of control by the existing shareholders. Positive Connotation: Retained Profits carry positive conotation as compared to equity issue as far as stock market is concerned.

Disadvantages of Retained Profit:

Limited Finance. The amount which can be raised by way of Retained Profit will be limited to an extent only. Keeping in view a stable dividend policy, the directors can't exhaust the whole balance retained. As a result, the variability of profit after tax is substantially transmitted to retained earnings.

High Opportunity Cost. The Retained Profit is nothing but sacrifice of profits made by equity shareholders. In other words, Retained Profit is dividend foregone by equity shareholders. This sacrifice increases the opportunity cost of retained earnings.

Personal Savings

Personal savings are the backbone of many small businesses. If a business doesn't have the assets to finance a project, they may still have personal finances that they can contribute to their business. This provides an alternative to seeking external investors or loans and allows you to retain control over your business. Advantages:

- Quickly available

- No interest will need to be paid Disadvantages

- The owner might not have enough savings

- It’s very risky due to unlimited liability

Decision-Making Freedom When a business finances its activities internally, they are not accountable to any outside entity. They don't need to explain their business decisions to anyone outside their company or seek their approval before making changes or expanding.

This decision-making freedom enables them to weigh personal as well as financial consideration when choosing the right course of action for their business For example, if they had financed their business internally and they find themselves feeling drained and depleted, they can make the decision to take some time off or hire someone to replace themselves temporarily, even if this is not the wisest path from a strictly financial standpoint if they looked at it like this they would care more about the business than them self’s.

External sources of finance:

Overdraft:

If a business spends more money than it has in its bank account, we say that it has become overdrawn. Businesses will often have an arrangement with the bank whereby the bank will pay the extra money provided the business will pay them back in a fairly short period of time, with interest. This is a short term source of finance and is useful for small amounts. It is often used for buying supplies / inputs.

Loan:

Bank loan is a long term source of finance and will often be for much larger sums of money. A loan is useful for a business that is starting up or looking to grow. Loans are often used to buy fixed assets (see balance sheets) such as machinery and vehicles. A business will pay the bank back each month in instalments and will also pay an interest charge.

Mortgage:

A mortgage is a long term loan specifically for the purchase of property. Most businesses might buy property through a mortgage. In many cases, mortgages are used as a security for a loan. This tends to occur with smaller businesses. A sole trader, for example, running a shop might want to move to larger premises. They find a new shop with a price of £200, 000. To raise this sort of money, the bank will want some sort of security - a guarantee that if the borrower cannot pay the money back the bank will be able to get their money back somehow.

Advantages of mortgages:

•you can keep ownership of your business and your business premises. Other investment options might involve you giving up some of your business ownership

•you can make substantial capital gain. This can be a great way of realising capital growth over a long period

• Mortgages are not subject to rental fluctuations of residential properties giving you a more stable business planning environment

•with typically lower interest rates than other unsecured loans/overdrafts, they offer lower monthly costs. Plus they can be fixed which can help you more accurately manage and forecast your finance

•tax deductible interest payments. Mortgage interest payments are tax deductible. This can contribute to reducing your business' annual tax overheads

•improved cash flow management. mortgage payment plans normally extend for a number of years letting a business focus on profit and loss and cash flow matters and

Disadvantages of commercial mortgages:

•you need a decent sized deposit. This represents money which could be used in other business operations

•it can be harder to move your business if you own the premises. With property rental, you can often negotiate ending your rent agreement or find another business to take up your tenancy

•if you have a variable rate mortgage, you can leave yourself vulnerable to interest rate increases

•you're responsible for your property including maintenance, insurance and security

•if you lose value on the property, this will reduce your capital.

Hire Purchase

Business hires the equipment for a period of time making fixed regular payments. Once payments have finished it then owns the piece of equipment. Hire purchase is different to leasing in that the business owns the equipment when it has finished making payments. With an equipment lease, the equipment is handed back to the leasing provider.

Advantages of Hire Purchase

Hire purchase is cheaper than a personal loan because the ownership of the car is retained by the finance company and if you don’t make your monthly payments then they will simply take the vehicle back. Hire purchase is relatively quick as it is offered directly by most dealers and manufacturer’s and is agreed to more easily than personal loans Deposits are lower than with personal loans.