Sources of finance for business: pros and cons

Sources of Finance

Finance is essential for a business's, development and expansion. Finance is the core factor for most businesses and therefore it is crucial for businesses tomanage and maintain their financial resources better. Finance is available to a business from avariety of sources both internal and external. It is also crucial for businesses to choose the most appropriate source of finance for its several needs as different sources have its own benefits and costs. Sources of finance can be classified based on a number of factors and the can be classified as Internal and External, Short-term and Long-term.

Identify the sources of finance available to a business

Working capital – owners finding that are invested into business from the beginning to finance operation. Liability will be created in shape of capital.

Advantages	Disadvantages
• Since it is an internal source offinance there are no costs involved and no repayment is	• Opportunity costs are involved. • Is not suitable forlong term investments. • Working capital

	cannot raise large amounts of funds. • Total risk is undertaken by the company.
needed.	• Using working capital as a source offinance will affect the current ratio of the business.

Bank Overdraft – occurs when money is withdrawn from the bank account and the available balance goes below zero. There are different bank charges which are depending on the agreement.

Advantages	Disadvantages
• This is a	• Interest is

good way to cover the period between money going out of and coming into a business. • If used in the short-term it is usually cheaper than a bank loan.	repayable on the amount overdrawn • Can be expensive if used over a longer period of time.

Mortgage – this is a loan secured on property repaid in instalments over a long time around 25 years. The business will own the property once the final payment has been made. This is a long-term source of finance.

Advantages	Disadvantages
• Business has the	• This is an expensive

use of the property. • Payments are spread over a period of time which is good for budgeting. • Once all repayments are made the business will own the asset.	method compared to buying with cash. • If business does not keep up with repayments the property could be repossessed.

<u>Bank loan – </u>This is a fixed amount for a fixed short time with fixed repayment. The interest on this loan can be expensive.

Advantages	Disadvantages

• Set repayments are spread over a period of time which is good for budgeting.	• Can be expensive due to interest payments. • Bank may require security on the loan.

<u>Hire purchase – </u>occurs when buyer is paying for things or items in fixed instalments while using the item.

Advantages	Disadvantages
• Businesses can have the use of up to date equipment immediately • Payments are spread	• This is an expensive method compared to buying with cash.

over a period of time which is good for budgeting

- Once all repayment s are made the business will own the asset.

<u>Trade Credit – </u>it is a system that allows buying something now and paying letter. For many business trade credit it is essential for business to growth.

Advantages	Disadvantages
• Busines s can sell the goods first and pay for them later • Good	• Discount given for cash payment would be lost • Businesses need to carefully

for cash flow • No interest charged if money is paid within agreed time.	manage their cash flow to ensure they will have money available when the debt is due to be paid.

Government Grants – this organisations offer grants to businesses, both established and new and normally there are some conditions apply.

Advantages	Disadvantages
• Don't have to be repaid.	• Certain conditions may apply • Not all businesses may be eligible for a grant.

Factoring – is a financial transaction that occurs whereby a business sells its accounts receivable to a third part at a discount.

Advantages	Disadvantages
- A large proportion of money isreceived within a short time-frame. - The sales ledger of the business can be outsourced to the factor. - The money collections from debtors are undertaken by the factoring company.	- The business has to pay interests and fees for the factor for its services. - The cost will be areduction on the company's profit margin.

- Helps a business tohave a smooth cash flow operation.
- Non-recourse factoring protects the client company from bad debts.

Analyse the costs of different sources of finance

Working capital

- Tangible cost: They do not have any costs as it owner money that will be invested to start a business.
- Opportunity costs: Could have borrowed extra if the working capital is not enough from relatives, friend.
- Tax effects: This can be repay when the profit will rise.

Bank Overdraft

- Tangible cost: Interest is a little higher than forbank loans and interest is calculated on a daily basis. This is short term and quick source of finance which is not pay on time extra and large interest charges will apply.

- Opportunity costs: Could have borrowed from relatives or friend to avoid extra charges or to feel into debts.
- Tax effects: It can be deducted when the business is increasing asset.

Mortgage

- Tangible cost: Interest rates apply as agreed in monthly instalments over a long time usually for 25 years.
- Opportunity costs: Could have borrowed from family to avoid the interest fees.
- Tax effects: The property will be possessed by the organisation if monthly payments are not meet.

Bank loan

- Tangible cost: Interest to be paid on the sum borrowed at agreed rate. Interest is usually fixed forshort term loans, and long-term loans usually have a variable rate of interest. Interest rates are lower than for bank overdrafts.
- Opportunity costs: Could have borrowed cheaply from relatives or friends.
- Tax effects: Interest is tax deductible from profit before we arrive at profit figure for tax purpose.

Hire purchase

- Tangible cost: The business ends up paying more than the original value of the asset for its purchase and the interest has been paid in equal instalments.
- Opportunity costs:
- Tax effects: Interest charges can be offset against profits for taxation.

Trade Credit

- Tangible cost: If paid on time there is no financial cost involved, however if not paid on time the interest will apply automatically.
- Opportunity costs: Working capital and friends.
- Tax effects: own possession of goods can be removed by the debt organisation or sale or rent to cover the interest cost.

Government Grants

- Tangible cost: Government grants are free and have nofinancial costs.
- Opportunity costs: Could have borrowed from relatives or friend as there are no legal agreements involved.
- Tax effects: No financial costs are involved.

Factoring

- Tangible cost: The business must pay interests and fees for the factor for its services the interest is calculated on a dailybasis, credit management and administrative fee are also chargedand ranges.
- Opportunity costs: Working Capital will be a better alternative or relatives and friends.

- Tax effects : The business must pay interests and fees for the factor for its services and the cost will be areduction on the company’s profit margin.

Evaluate appropriate sources of finance for a business project

There are several sources of finance available to a business on the market. Finances are needed for many and different purposes need sources offinance which are most suitable. When choosing a most appropriate source of finance some conditions have to be considered. The conditions that need tobe considered when choosing an appropriate source of finance are:

- The amount of money needed
- The urgency of funds
- The cost of source of finance
- The risk involved
- The duration of finance
- The gearing ratio of thebusiness
- The control of the business

Project

Hair and Beauty Business Project

“ Inspiration” aims are to be the first beauty salon in the local area which will deliver unique and quality service by offering high standard beauty products which will quickly gain market share.

“ Inspiration” will provide customers with a relaxing and comforting atmosphere which will help them to enjoy the service provided to gained high reputation.

- Building– Mortgage – long term which will be payable for 25 years.
- Personnel – Bank Loan – short time with fixed repayment 3-5 years.
- Furnitureand stationary etc.– Working Capital – owners finding that are invested into business.
- Brochures– Overdraft – short-term it is usually cheaper than a bank loan.
- Advertisement– Bank Loan – Set repayments, spread over a period of time, interest high.
- Others– Relatives or friends.

These loans will be paid from the cash flow from the business and will be collateralized by the assets of the company on short-term or long-term agreements with the lenders.