DP IB Business Management: HL

Your notes

3.2 Sources of Finance

Contents

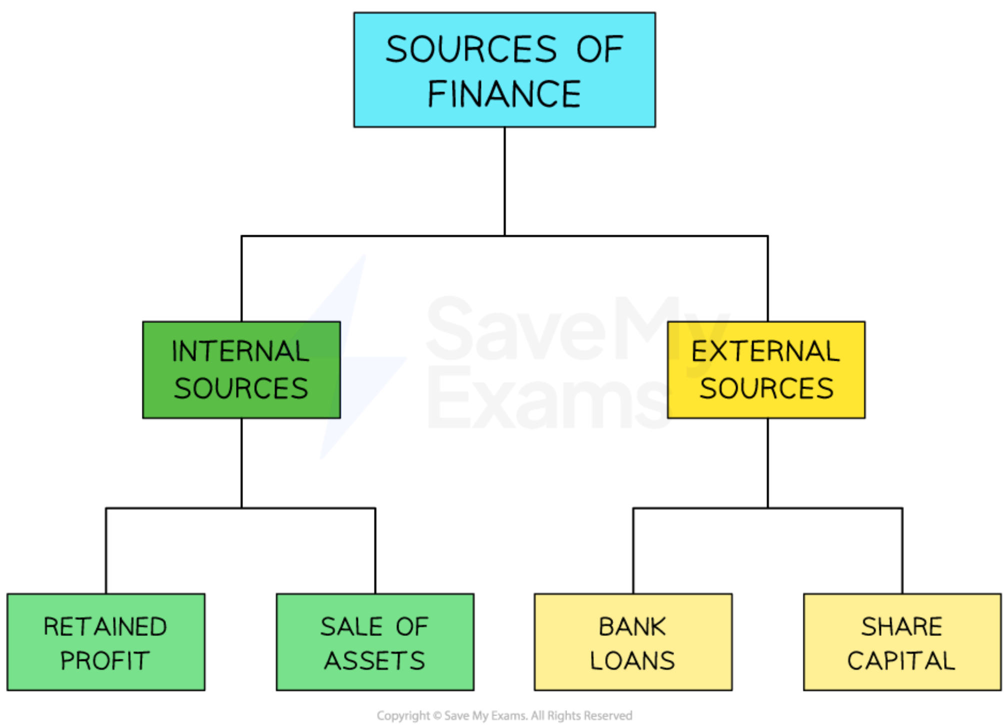
Internal Sources of Finance

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**

Diagram: sources 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

Evaluation of Internal Finance

Advantages	Disadvantages
▪ Internal finance is **often free** (e.g. it does not involve the payment of interest or charges) and can usually be organised very quickly ▪ It does not involve third parties who may want to **influence business decisions**	▪ 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 purposes ▪ Internal finance **may not be sufficient** to meet the needs of the business

Examiner Tips and Tricks

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Weighing up the circumstances of the business is very important when considering the recommendation of using internal finance.

Carefully consider 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.

External Sources of Finance

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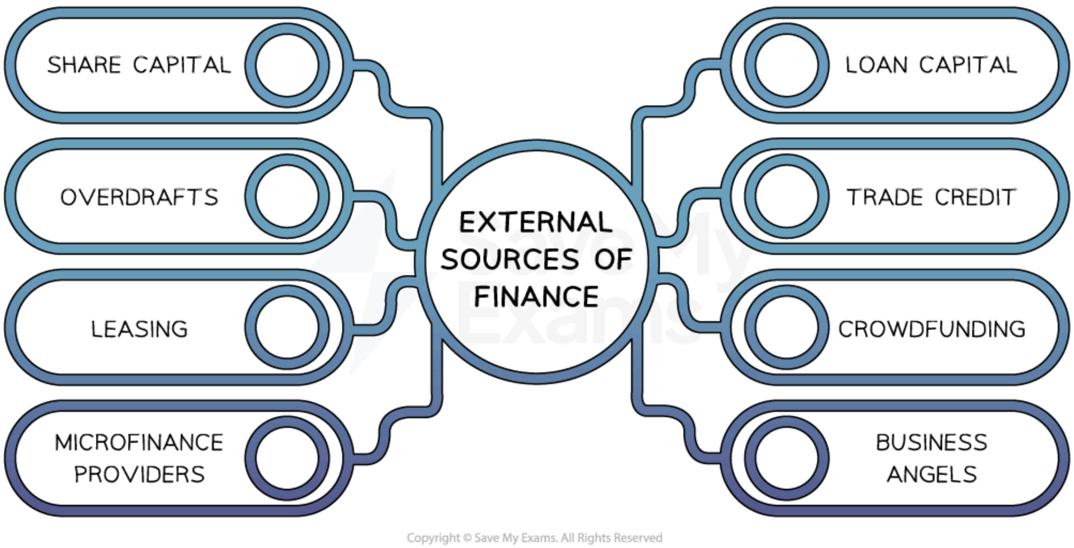
External Sources of Finance

- For **new business startups** external finance may be sought 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 **wider range of sources of finance** are available

Diagram: External Sources of Finance



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

Share Capital	▪ 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	▪ **Secured loans** are more likely to be available to larger businesses and are typically repaid over five to twenty years
	  ▪ **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**
	  ▪ 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	▪ This is an arrangement between the business and their bank to spend **more money** than it has in its account
	  ▪ A **limit** is agreed upon, 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	▪ 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 ▪ Trade credit is usually **interest-free**

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	▪ 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
Leasing	▪ Assets such as machinery or a fleet of vehicles are made available to the business in return for **regular payments** (a form of rental) ▪ The business **does not own the asset** during the period of the lease and 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	▪ 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** ▪ 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	▪ 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) ▪ These are a useful source of funds for **businesses that may not qualify for other sources of funds** ▪ There are usually **few formalities involved** 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

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Examiner Tips and Tricks

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.

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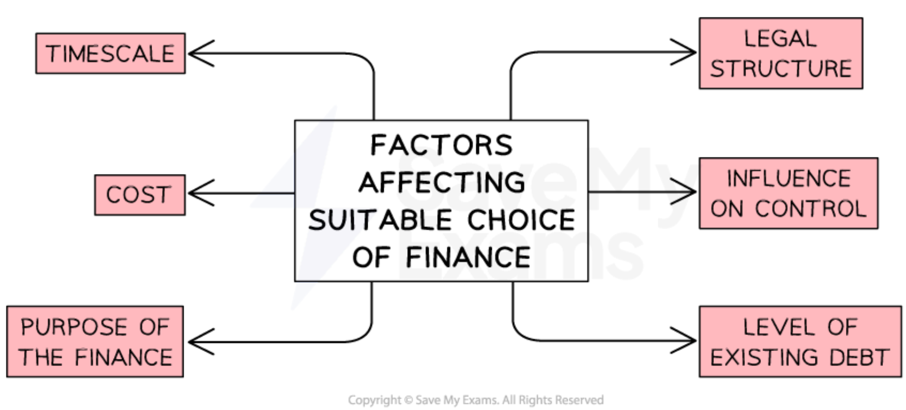
The Best Choice of Finance

Choosing the most Appropriate Source of Finance

- Businesses need to 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** as may **not have yet established a trading record** and may be viewed as too risky

Diagram: factors affecting the choice of finance



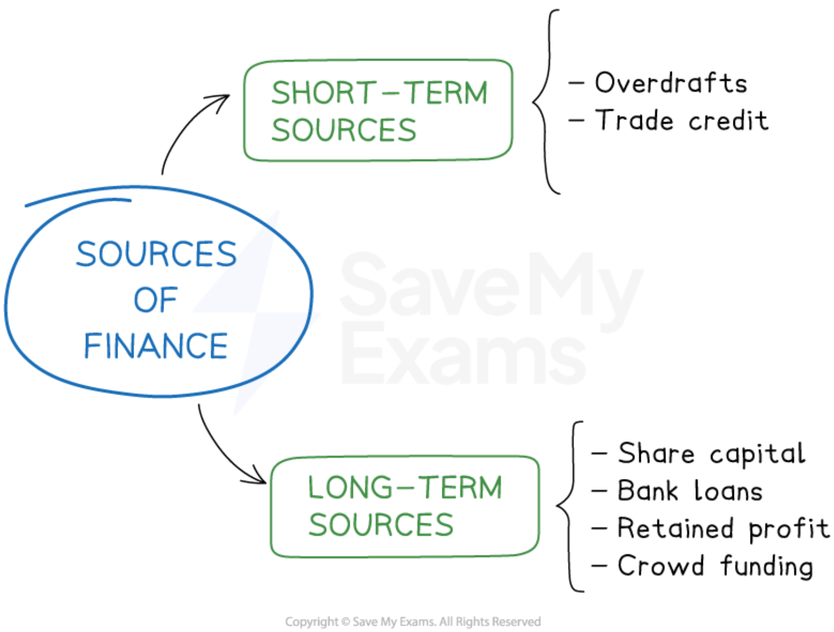
A range of factors will affect the most suitable sources of finance for a business

1. 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

Diagram: short-term and long-term sources of finance

Your notes



Long-term and short-term sources of finance

2. 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 having 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

3. 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
- **The cost of 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

4. 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**

5. Purpose of the finance

- Certain sources of finance have particular 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

6. 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

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