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The Case of the Unidentified Financial Firms


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3.1 Sources of Finance

LQ: How do firms decide on the most appropriate source of finance to meet their needs

- Define key financial terms.
- Analyse internal finance options.
- Evaluate external finance options

Role of finance for businesses:
- capital expenditure
- revenue expenditure AO2

The following internal sources of finance:
- personal funds (for sole traders)
- retained profit
- sale of assets AO2

The following external sources of finance:
- share capital
- loan capital
- overdrafts
- trade credit
- grants
- subsidies
- debt factoring
- leasing
- venture capital
- business angels AO2

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Short, medium and long-term finance AO1
The appropriateness, advantages and disadvantages of sources of finance for a given situation AO3

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Why do businesses need capital?

Finance is required for many business activities such as:

- ***Start-up capital***
- ***Working capital***
- ***Business expansion***

Key terms:

Capital expenditure is finance spent on purchasing fixed assets.

Revenue expenditure refers to payment for daily running of a business such as wages.

Liquidation/ Bankruptcy - when a firm is unable to meet its debts.

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Finance can come from two sources:

- **Internal Finance** - money raised from the businesses own assets or profits.
- **External Finance** - money raised from sources outside the business.

Finance is also divided into:

- Short-term finance - less than 1 year term
- Medium-term finance - 1 - 5 years term
- Long-term finance - 5+ years term

Internal Sources of Finance

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Retained profit/ Ploughed-back profits - any profit that remains after paying taxes and dividends.

Sale of assets - established companies often find they have assets that are no longer used.

Sale and lease back

Family and personal savings

Working capital - sale of goods and services

Investments - bond interest payments, dividends

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Evaluation - Internal sources of finance

- This type of capital may have no direct cost to the business although there may be an ***opportunity cost.***
- Internal finance does not increase the liabilities.
- There is no risk of loss of control by original owners as no shares are sold (if a plc or Ltd.)

However, it is not available for all companies, for example newly formed ones or unprofitable ones with few spare assets.

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"Companies should always choose equity finance over debt finance." Evaluate this statement from the perspective of an investor. 6 marks