

## Choosing the Right Source of Finance

A business needs to assess the different types of finance based on the following criteria:

- ▶ **Amount of money required** – a large amount of money is not available through some sources and the other sources of finance may not offer enough flexibility for a smaller amount.
- ▶ **How quickly the money is needed** – the longer a business can spend trying to raise the money, normally the cheaper it is. However it may need the money very quickly (say if had to pay a big wage bill which if not paid would mean the factory would close down). The business would then have to accept a higher cost.
- ▶ **The cheapest option available** – the cost of finance is normally measured in terms of the extra money that needs to be paid to secure the initial amount – the typical cost is the interest that has to be paid on the borrowed amount. The cheapest form of money to a business comes from its trading profits.
- ▶ **The amount of risk involved in the reason for the cash** – a project which has less chance of leading to a profit is deemed more risky than one that does. Potential sources of finance (especially external sources) take this into account and may not lend money to higher risk business projects, unless there is some sort of guarantee that their money will be returned.
- ▶ **The length of time of the requirement for finance** - a good entrepreneur will judge whether the finance needed is for a long-term project or short term and therefore decide what type of finance they wish to use.

## Short Term and Long Term Finance

**Short-term finance** is needed to cover the day to day running of the business. It will be paid back in a short period of time, so less risky for lenders.

**Long-term finance** tends to be spent on large projects that will pay back over a longer period of time. More risky so lenders tend to ask for some form of insurance or security if the company is unable to repay the loan. A mortgage is an example of secured long-term finance.

The main types of short-term finance are:

- ▶ Overdraft
- ▶ Suppliers credit
- ▶ Working capital

The main types of long-term finance that are available for to a business are:

- ▶ Mortgages
- ▶ Bank loans
- ▶ Share issue
- ▶ Debentures
- ▶ Retained profits
- ▶ Hire purchase

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## Internal and External Finance

**Internal finance** comes from the trading of the business.

**External finance** comes from individuals or organisations that do not trade directly with the business e.g. banks.

Internal finance tends to be the cheapest form of finance since a business does not need to pay interest on the money. However it may not be able to generate the sums of money the business is looking for, especially for larger uses of finance.

Examples of internal finance are:

- ▶ Day to day cash from sales to customers.
- ▶ Money loaned from trade suppliers through extended credit.
- ▶ Reductions in the amount of stock held by the business.
- ▶ Disposal (sale) of any surplus assets no longer needed (e.g. selling a company car).

Examples of external finance are:

- ▶ An overdraft from the bank.
- ▶ A loan from a bank or building society.
- ▶ The sale of new shares through a share issue.

The table below summarises the main types of finance that are suitable for businesses at various stages of development and/or ownership:

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