3.2 Sources of finance

External sources of finance: Debt and other finance

Some entrepreneurs do not want to give up partial ownership of their business in exchange for financing. For those who want to keep full control and ownership of their business, there are other sources of finance they could use.

Debt finance

Debt finance is money that is borrowed from a bank or other financial institution. The borrowed money is made available quickly to fund investments. In exchange for the finance, the business usually pays an interest rate to the lender.

There are several forms of debt finance:

- loan capital
- overdrafts
- microfinance
- trade credit

Loan capital

A loan is a medium or long-term source of finance, often used to buy fixed assets. A mortgage is a special type of long-term loan that is used to purchase land or buildings. Other bank loans are usually considered medium-term loans and may be used to purchase capital equipment.

To receive a loan, businesses usually provide collateral. Collateral is an asset that is offered to a lender in the event that the business does not pay back the loan. Many small- and medium-sized businesses, especially in low-income countries, do not have collateral. Therefore, they may find it difficult to acquire a loan.

The key advantage of a loan is that money is available immediately for investments, but is repaid in small chunks, over a period of years. Businesses can use loans to buy profit-generating assets, such as trucks or machines, immediately and pay for them with the revenue they generate.

Overdrafts

An overdraft is a high-cost, short-term loan, attached to a bank account. An overdraft allows the account holder to withdraw an amount of money that is greater than they currently hold. An overdraft must be arranged in advance with the bank. Imagine, for example, that you have just $20 in your bank account and you want to purchase something that costs $100. An overdraft will allow you to do this. After you have paid for your $100 purchase, your account will now have –$80 in it. You are $80 into your overdraft. In effect, the bank has lent you a small amount of money, so that you can make a purchase. As money is paid into the account, the overdraft will be paid back first, before any positive balance is recorded in the account.

The overdraft allowance will be limited, and the bank will charge a very high interest rate. Overdrafts are one of the most expensive forms of borrowing. Overdrafts are useful because they enable businesses to meet day-to-day expenses while they are waiting for revenue from selling goods and services.

Microfinance

Microfinance involves providing financial services to individuals who have very limited income and assets and are not able to get services from traditional banks. Financial services can include transaction and savings accounts as well as insurance products.

Microcredit is a subset of microfinance. It refers to small loans that enable someone to start up or continue to finance a small-scale business, such as a bicycle repair service, a woodworking, sewing or knitting workshop, a kiosk, and so on. Often these loans target women, with the aim of empowering them and improving their financial independence.

Figure 1. Microcredit is often given to women, in order to finance their businesses, improving their financial independence and empowerment.

Credit: hadynyah, Getty Images

Microcredit does not usually require collateral. To make the loan more secure, microcredit is often given to small groups of borrowers in a community, so that the borrowers can support one another if one of them faces difficulties repaying the loan. Loan amounts are small and range from less than 100 dollars to several thousands of dollars when given in higher-income countries. The loan period tends to be relatively short. The interest rates are typically high, but are lower than those charged by unethical lenders (known as 'loan sharks') who take advantage of poor borrowers by charging excessively high interest rates.

Microcredit has expanded rapidly in the past few decades. There are now hundreds of millions of people who use microcredit to fund their business activities. The 2006 Nobel Peace Prize was awarded to Mohammed Yunus and the Grameen Bank (http://www.grameenbank.org/) for their role in the reduction of world poverty through microcredit.

Making connections

Microfinance and microcredit are also covered in the IBDP Economics course as an economic development strategy.

Trade credit

Figure 2. Trade credit.

Trade credit involves a business receiving goods and services from a supplier immediately, but paying for them at a later date (see **Figure 2**). This is usually for a term of 30, 60 or 90 days. No interest is charged during this credit period. It is normal business practice for suppliers to offer trade credit to their regular customers. Using trade credit gives a business time to sell the goods and services they produce; they can then use that revenue to pay their suppliers.

Both the business and the supplier benefit from trade credit. Extending credit agreements keeps suppliers' customers happy. The business that is using trade credit will have extra cash on hand for production, at least for a time. The business will want to pay for goods within a reasonable time to keep a good relationship with suppliers.

Activity

Learner profile: Knowledgeable

Approaches to learning: Thinking skills (transfer)

Complete a table in which you outline the key characteristics of sources of debt finance. You could set up your table as shown here, and you could refer to **Table 1** in Section 3.2.1 (/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/internal-sources-of-finance-id-39255) (which outlines internal sources of finance) as an example.

Source	Length	Costs	Loss of control?	Suitable for
Loan capital				
Overdrafts				

Source	Length	Costs	Loss of control?	Suitable for
Microfinance				
Trade credit				

Other forms of finance

Sometimes a business needs to increase funding but does not want to lose ownership or take on debt. Two options for doing this are:

- leasing capital equipment
- crowdfunding

Leasing

Leasing involves renting (hiring) a fixed asset over a period of time, rather than buying it.

The key advantage of leasing is that a business can use an asset without having to fully finance it up front. However, the business does not own the asset. Therefore, if the business wants to continue using the asset, it must continue to pay the leasing fee. An additional benefit of leasing equipment and not owning it is that the business can always lease the latest model and return the asset when the business no longer needs it. The business usually does not need to worry about maintaining or repairing the equipment either. This can also lower costs.

Figure 3. Expensive farm equipment may be leased if used infrequently.

Credit: Edwin Remsberg, Getty Images

Crowdfunding

Crowdfunding is a form of finance whereby many people, perhaps thousands, invest small amounts of money to fund a business or project. There are several different types of crowdfunding:

- **Peer-to-peer lending**: the many investors are providing a loan that earns interest.
- **Equity crowdfunding**: the many investors acquire a small share of ownership in the business.
- **Rewards-based crowdfunding**: the many investors receive a non-financial reward at a later date, such as a good or service produced by the business.
- **Donation-based crowdfunding**: the participants are donors rather than investors, and do not receive anything in return. This type of crowdfunding can work when the organisation seeking the funds has a strong social, environmental or ethical objective or project that donors feel passionate about.

Crowdfunding is a relatively new source of finance, made possible because of changes in technology. To facilitate crowdfunding, the business and the investors usually need a platform for the exchange. There are many such platforms globally, one of the most well-known of which is Kickstarter. As of early 2022, more than six billion USD has been pledged to more than 200 000 Kickstarter projects. Businesses that use Kickstarter must pay a fee to the platform.

Making connections

Though not covered in this syllabus section, the IBDP Economics course includes another source of finance for businesses called subsidies. Subsidies are government payments to businesses, often used to increase or stabilise production in critical industries.

A further source of finance not in the syllabus, but especially important for non-profit social enterprises is grants. These are donations, often from private foundations or from government institutions, that target specific activities.

Activity

Learner profile: Inquirers
Approaches to learning: Research skills (information literacy)

The Kickstarter crowdfunding platform (https://www.kickstarter.com/?ref=nav) works with businesses that use a rewards-based or donation-based model. Other platforms use debt or equity crowdfunding models. Carry out some quick research on the internet to see if you can find a few examples of crowdfunding platforms, perhaps in your own country.

- How do debt or equity crowdfunding platforms work?

Activity

Learner profile: Thinkers
Approaches to learning: Thinking skills (transfer)

Complete a table in which you outline the key characteristics of leasing and crowdfunding as sources of finance. You could set up your table as shown here, and you could refer to **Table 1** in Section 3.2.1 (/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/internal-sources-of-finance-id-39255) (which outlines internal sources of finance) as an example.

Source	Length	Costs	Loss of control?	Suitable for
Leasing				
Crowdfunding				