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3.2 Sources of finance

Internal sources of finance

An internal source of finance is money that is raised from the business's or owner's existing assets. Internal sources of finance involve using money the business or owner has previously earned. These sources do not have to be repaid, so there is less risk or cost associated with using them when compared to external sources.

There are three main internal sources of finance (**Figure 1**):

- personal funds
- retained profits
- sale of assets

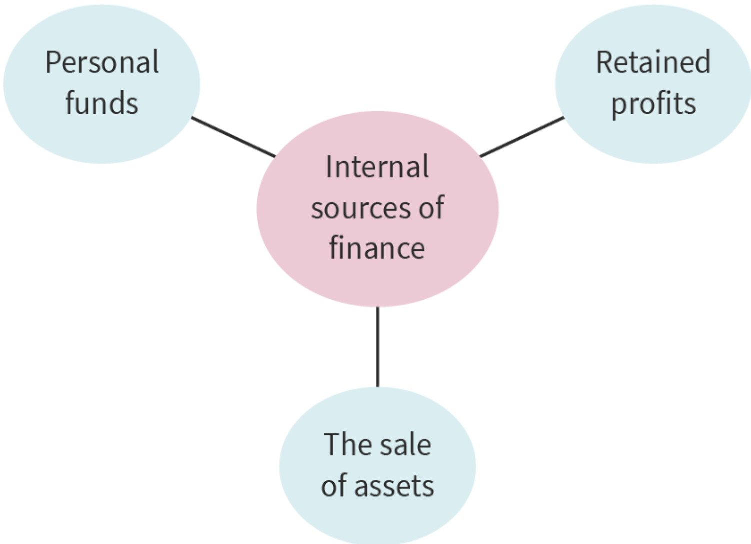

Figure 1. Internal sources of finance.

Personal funds

Personal funds refer to money invested by the owner or owners of a business. When businesses are first set up, the owners may need to invest their own money to start the business. This investment comes with a risk for the owner: if the business goes bankrupt, the money will be lost. As discussed in Subtopic 1.2 (/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/the-big-picture-id-36507), owners will receive shares in return for their investment. Share ownership comes with two significant benefits: a right to any future dividends that are paid and the power to make business decisions. In a partnership, it is likely that the partner who invests the greatest amount of personal funds will receive the most profits and greatest control over the business.

For sole traders and companies with little experience, personal funds may be the only source of finance available to them. However, even the owners of larger established companies may be forced to invest their own funds in times of crisis. During recessions and periods of falling sales, many owners are forced to risk their personal funds, just to keep their businesses going.

Retained profit

Retained profit, sometimes called accumulated profit, is money a company has left at the end of the trading year after paying all costs, expenses, dividends and taxes. It is the primary source of finance for all businesses. Retained profits are a business's savings. They are built up over time. If a business wants to invest in new capital expenditure, such as a new building, it may choose to save its retained profits each year until there is enough to pay for construction.

Figure 2. Retained profits are savings made by a business, which can be used for financing investments.

Credit: Thana Prasongsin, Getty Images

The disadvantage of this is that it may take many years before the funds are in place. Another disadvantage associated with using retained profits is the loss of dividends. Entrepreneurs may be reluctant to use retained profits as a source of finance because they may want the cash to be paid to themselves in the form of dividends. However, the advantage of using retained profits is that they do not have to be repaid. Therefore, if the new investment project is not a success, the business will not be responsible for a debt that might otherwise have been incurred and for which there would be no new income to pay.

Some businesses have very large retained profits that can be used for investments. An example of such a company is Apple, which records tens of billions of US dollars in retained profits every year. However Apple has not always used that money to invest in the business. In recent years, a proportion of the money has been used to purchase shares from shareholders. This helps increase the stock price of the company, thus increasing the wealth of the remaining shareholders.

There is some controversy around the large reserves of cash held by Apple and other technology companies. Some people see these cash reserves as an indication that the companies are not distributing value among stakeholders. Others would like to see the money used to develop the business further. Others also note that many large multinationals have large cash reserves yet avoid paying taxes in the countries in which they operate; they see ethical issues associated with the cash reserves held by some companies.

Sale of assets

An asset is something a business owns. Fixed assets are items of property that have value and are owned by a person or business, which the business plans on holding or using for longer than one year. Fixed assets usually generate income for the company. They can be tangible, such as land, building or machinery. Or they can be intangible, such as patents or brand names. When a business needs money, it may choose to sell one of its fixed assets. This can raise large amounts of money that can be reinvested into new projects.

There is, however, a cost associated with selling assets. This is called an opportunity cost. An opportunity cost is the potential cost of missing an opportunity by choosing one option over another. The opportunity cost of selling assets is that any future production or revenue from that asset will be lost. Selling assets may be appropriate if a business changes its objectives and needs money to invest in a new strategy.

A situation in which selling assets is often appropriate is when a business wants to update its technology. An example of this might be if a company wanted to replace its fleet of delivery vehicles. One option would be to sell the old vehicles in order to raise some of the money needed to pay for the new ones. However, it is unlikely that the money raised would be sufficient to cover all costs of the new vehicles. So additional sources of finance would be needed.

Another option would be to sell and lease back the equipment. This would provide a cash injection, making payments easier to manage and making it much easier to replace old equipment.

Figure 3. Businesses need to be careful with the sale of assets such as fleets of vehicles, as these may still be needed for production and distribution.

Credit: GoodLifeStudio, Getty Images

Short-term, medium-term and long-term finance

Depending on their use, sources of finance can be classified by time (see **Figure 4**).

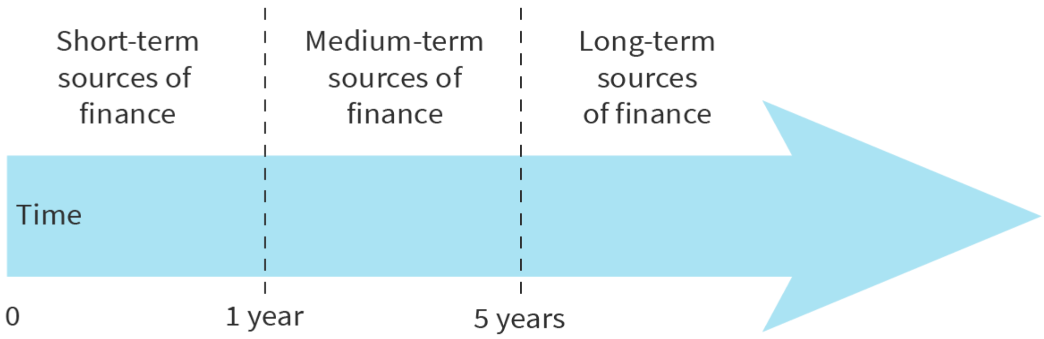

Figure 4. Short-term, medium-term and long-term sources of finance.

Short-term sources of finance

Short-term sources of finance are those that are repaid within 12 months (less than one year). These are normally used to solve cash flow problems or to pay for revenue expenditure. For example, additional cash may be needed while waiting for a customer to pay an outstanding invoice. Some external sources of short-term finance tend to be expensive, so should not be used to finance capital expenditure. Short-term finance includes trade credit and overdraft facilities on bank accounts.

Medium-term sources of finance

Medium-term sources of finance are those that last longer than one year, but less than five years. The most commonly used medium-term source of finance is a bank loan. This would normally be used to finance capital expenditure or to purchase a fixed asset. Leasing and subsidies can also be classified as medium-term sources of finance if they are used for an extended period of time.

Long-term sources of finance

Long-term sources of finance are financial products that will be used for longer than five years. All forms of equity finance are included in this category. Equity finance is essentially never-ending. Once a new shareholder has made their investment and acquired ownership, they are entitled to a share of the dividends every time they are paid. Mortgages are also long-term sources of finance. These loans, used to buy property, are typically repaid over a period of 25 years.

Table 1 summarises the characteristics of the three main internal sources of finance.

Table 1. Characteristics of internal sources of finance.

Source	Length	Costs	Loss of control?	Suitable for
Personal funds	Long, medium and short term.	Opportunity cost – other actions that could have been funded with the money.	None	Small businesses without large funding needs.
Retained profits	Long, medium and short term.	Opportunity cost. Loss of dividends to shareholders.	None	All businesses. This is the primary source of finance for almost all businesses.
Sale of assets	Depends on the size of the asset.	Opportunity cost – loss of ability to use the assets for production.	None	Potentially all businesses, when fixed assets need to be updated. Changing corporate objectives.