**Activity 1 – Internal finance**

1. What is the importance of business finance? (2 marks)
2. What are the sources of internal finance? (2 marks)
3. Explain and define retained profit and its importance? (2 marks)
4. What is working capital and how can it be used as a source of finance? (2 marks)
5. What is the sale of assets? (2 marks)

**Activity 1 – Internal finance**

1. **What is the importance of business finance? (2 marks)**

Businesses cannot survive without finance, whether in the form of initial funds to start the business, working capital to run the business day-to-day, or investment capital to help the business grow. For a new business starting out it is unlikely that external forms of finance will be available. Apart from capital provided by the entrepreneur and friends and family, sources of finance are likely to be severely limited. These new sole traders and microbusinesses are likely to continue to struggle to find external sources of finance until they establish an effective trading record.

1. **What are the sources of internal finance? (2 marks)**

Retained profit, Working capital and sale of assets.

1. Explain and define retained profit and its importance? (2 marks)

This is regarded as the single most important source of finance and is also the cheapest source of finance. As a business becomes more profitable, it makes sense to build up and retain some profit (reserves). This will provide a liquidity buffer and potential funds for growth. Reserves, reinvested profits, come with only one cost – the loss of profit distribution to owners. Short-term pressures to pay profits to owners (normally shareholders) can, however, restrict the availability of this form of finance.

1. **What is working capital and how can it be used as a source of finance? (2 marks)**

By reducing their trade credit period and collecting debts more efficiently, a business may receive money from customers more quickly. However, this is likely to drive customers away and may have the opposite effect on making finance available. Reducing stock holdings is another way to release finance but a sudden surge in demand could result in lost sales if the business is unable to meet delivery dates.

1. **What is the sale of assets? (2 marks)**

Established businesses are able to sell off assets that are no longer required, such as buildings and machinery. Smaller businesses are unlikely to have such unwanted assets and, if growth is an objective, they are much more likely to want to acquire assets as opposed to losing them.