

Section 9. Advantages & Disadvantages of Bank Loans

For some business owners, a bank loan is the best way to obtain necessary cash.

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ABSTRACT

Bank loans give you access to capital that you can re-invest and grow your business. But that opportunity comes at a cost. Bank loans are available to finance the purchase of inventory and equipment as well as to obtain operating capital and funds for business expansion. These loans are a time-honored and reliable method of financing a small business, but banks often only finance firms with substantial collateral and a long track record, and the terms they offer are often very strict. Business owners should weigh the advantages and disadvantages of bank loans against other means of finance.

Basic Advantages of Bank Loans

A bank loans money to a business based on the value of the business and its perceived ability to service the loan by making payments on time and in full. Banks do not take any ownership position in businesses. Bank personnel also do not get involved in any aspect of running a business to which a bank grants a loan. Once a business borrower has paid off a loan, there is no more obligation to or involvement with the bank lender unless the borrower wishes to take out a subsequent loan.

Tax and Financial Planning Advantages

The interest on business bank loans is tax-deductible. In addition, especially with fixed-rate loans, in which the interest rate does not change during the course of a loan, loan servicing payments remain the same throughout the life of the loan. This makes it easy for businesses to budget and plan for monthly loan payments. Even if the loan is an adjustable-rate loan, business owners can use a simple spreadsheet to compute future payments in the event of a change in rates.

Difficulties in Obtaining Loans

One of the greatest disadvantages to bank loans is that they are very difficult to obtain unless a small business has a substantial track record or valuable collateral such as real estate. Banks are careful to lend only to businesses that can clearly repay their loans, and they also make sure that they are able to cover losses in the event of default. Business borrowers can be required to provide personal guarantees, which means the borrower's personal assets can be seized in the event the business fails and is unable to repay all or part of a loan.

Cost of Bank Loans

Interest rates for small-business loans from banks can be quite high, and the amount of bank funding for which a business qualifies is often not sufficient to completely meet its needs. The high interest rate for the funding a business does receive often stunts its expansion, because the business needs to not only service the loan but also deal with additional funding to cover funds not provided by the bank. Loans guaranteed by the U.S. Small Business Administration offer better terms than other loans, but the requirements to qualify for these subsidized bank loans are very strict.

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Section 10. The Advantages of Internal Funding

Company growth results from spending money from internal or external sources.

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ABSTRACT

For your small business to grow, you have to spend money. Whether it's additional advertising, new equipment, expanded facilities, or a new department you want to add, you will need to fund your effort. You have two choices for this funding: external sources and internal sources. Learn the advantages of using internal sources to fund your expansion, and you will be on your way to a sustainable growth for your business.

Sources of Internal Funding

Internal funding comes from excess cash after expenses. This means you use profits to fund your project or advertising. You can also get extra funds from depreciation on equipment and facilities. This depreciation reduces your taxes and thus lets you keep more money to spend on the business.

Internal Funding vs. Bank Financing

When you use company funds, you do not have to pay interest to the bank. You also do not have to go through the application process, which can be costly if you have to pay someone to prepare profit and loss statements, balance sheets and other documentation required by the bank.

Internal Funding vs. Selling Stock

One way to raise money for your business projects is to sell stock to investors. This gives them part ownership of the company. Using internal funding offers the advantage of keeping control in the hands of the company's founders.

Internal Funding vs. Government Grants

A business may qualify for government grants under certain circumstances. Minority grants can help minority-owned businesses expand, and businesses can receive grants for going green, to name just two examples. However, the application process can be lengthy and expensive. The expense comes from preparing the documentation for these grants. You have to win the approval of the agency giving the grant, and this can involve many individuals and committees. With internal funding, you can start on your project immediately, with no approval required other than that of management and your stockholders.

Internal Funding vs. Selling Assets

Some businesses try to fund new expenditures by selling assets. This decreases the value of the company and can trigger transaction costs, as well as taxes. Internal funding keeps all assets in the company and incurs no additional expenses beyond the cost of the project itself.

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