Business Studies Notes PDF

On

Sources of Business Finance

(Class – 11 / Chapter- 8)

CONCEPT OF BUSINESS FINANCE: The term finance means money or fund. The requirement of funds by business to carry out its various activities is called business finance. Finance is needed at every stage in the life of a business. A business cannot function unless adequate funds are made available to it.

Financing Needs of the Business:

- **Fixed Capital Requirements:** Funds required by a business to purchase land, building, plant and machinery, furniture and fixtures, etc are known as Fixed Capital Requirements. The amount of fixed capital differs from organization to organization and level of operations. The fixed capital is invested for a longer period of time.
- **Working Capital Requirement**: A business needs funds for its day to day operation. This is known as working Capital requirements. Working capital is required for purchase of raw materials, to pay salaries, wages, rent and taxes.

Classification of Sources of Funds

A. On the basis of period:

1. Short Term: These are the category of funds required for a short period of time generally one year or less than one year. For example: Trade credit, Loans from commercial banks and Commercial papers.

2. Medium Term: These funds are required for a term of one to five years. For example: Public deposits, Lease financing and Loans from financial institutions.

3. Long Term: These sources fulfill the requirements of the business for the long term or a time exceeding five years. For example: Shares, Debentures and Long-term borrowings.

B. On the basis of ownership

1. Owners' Funds: Funds provided by the owners of the organization are known as Owners' funds. It includes profits that are reinvested into the business. The important sources of owners' funds are

- Retained earnings
- Issue of equity shares.

2. Borrowed Funds: These are the funds raised through loans and borrowings. This source includes raising funds from

- Issue of debentures,
- Loans from financial institutions,
- Public deposits,
- Trade credit, etc.

C. On the basis of source of generation

1. Internal Sources: Funds generated from within the organization are known as internal sources. Though only short term or limited needs could be fulfilled by this source. For example:

- Plugging back profit,
- Disposing surplus inventory, etc.

2. External Sources: Large amounts of money requirements are fulfilled through external sources. These are more expensive sources than internal sources of financing. These are done through:

- Borrowings from commercial banks
- Acceptance of Public deposits,
- Raising debentures etc.

Sources of Finance

1. Retained Earnings:

When a company earns profit, a certain amount or percentage of those profits is retained within the business for future use and this is known as retained earnings. When the business is financed through this source it is known as ploughing back of profit or internal financing.

MERITS:

(i) Retained earnings is a permanent source of funds available to an organisation.
(ii) It does not involve any explicit cost in the form of interest, dividend or floatation cost.
(iii) As the funds are generated internally, there is a greater degree of operational freedom and flexibility.
(iv) It enhances the capacity of the business to absorb unexpected losses.
(v) It may lead to an increase in the market price of the equity shares of a company.

LIMITATIONS:

1. Uncertain Source: It is an uncertain source of funds because it is available only when profits are high.
2. Dissatisfaction among shareholders: Retained profits cause dissatisfaction among the shareholder because they get low dividends.

2. Trade Credit:

It refers to the extension and provision of credit by one trader to another for the purchase of goods and services, or other supplies without on the spot payment. This is generally used by organizations as short term financing. The terms of trade credit may vary from person to person based on past records and from industry to industry based on industry norms.

MERITS:

(i) A continuous and a convenient source of funds.
(ii) It is readily available if credit worthiness is known to the seller.
(iii) It helps in increasing the inventory levels in case of increase in sales volume.
(iv) While providing funds, It does not create a charge on assets of the firm .

LIMITATIONS:

(i) There can be chances of over-trading.
(ii) Fulfils only limited financial needs.
(iii) Costly in comparison to few other sources.

3. Factoring:

This is a financial service in which a third party, namely factor, renders various services like discounting of bills and collection of clients' debts. In this a company gives the responsibility of the collection of debts from the debtors to the factor. Also, through factoring large amounts of information can be fetched about trading history of the organization, the credit worthiness of debtors etc. There are two methods of factoring:

- **Recourse Factoring:** Factor does not assume the credit risk
- **Non-recourse factoring:** Factor assumes and takes responsibility for the entire credit risk in case the debtor defaults.

MERITS:

- A cheaper source of finance as compared to other means such as bank credit.

- The organization is relieved from the task of collection of bad debt.
- Protection against bad debts to the firm in case of non-recourse factoring.
- At times, the factor also provides finance to the company, that is he makes advance payment of the debts taken by him to the firm.
- It is flexible and does not create charge on assets of the firm.

DEMERITS:
- It can be an expensive source, if there are a number of invoices of smaller amounts.
- Customers may not feel comfortable dealing with a third party (factor).

4. Lease Financing:

A lease is a contractual agreement whereby one party i.e., the owner of an asset grants the other party the right to use the asset in return for a periodic payment. In other words it is a renting of an asset for some specified period. The owner of the assets is called the 'lessor' while the party that uses the assets is known as the 'lessee'.

MERITS:

(i) It enables the lessee to acquire the asset with a lower investment.
(ii) Simple documentation makes it easier to finance assets.
(iii) Lease rentals paid by the lessee are deductible for computing taxable profits.
(iv) Does not affect the debt raising capacity of the organization.
(v) Risk of asset wear and tear is borne by the lesser.

LIMITATIONS:

(i) The agreement may impose certain restrictions to use.
(ii) Normal course of business may be affected in case of non- renewal of the agreement.
(iii) The lessee cannot take advantage of the salvage value of the asset, as he is not the owner of the asset, and has to return it to the lessor.

4. PUBLIC DEPOSITS:

The deposits that are raised by companies directly from the public are known as public deposits. The rate of interest offered on public deposits is higher than the rate of interest on bank deposits. This is regulated by the R.B.I. and cannot exceed 25% of share capital and reserves.

MERITS:

(i) No charge on assets: The company does not have to mortgage its assets.
(ii) Tax Saving: Interest paid on public deposits is tax deductable, hence there is tax saving.
(iii) Simple procedure: The procedure for obtaining public deposits is simpler than share and Debenture.
(iv) Control: They do not have voting rights therefore the control of the company is not diluted.

LIMITATIONS:

(i) For Short Term Finance: The maturity period is short. The company cannot depend on them for the long term.
(ii) Limited fund: The quantum of public deposit is limited because of legal restrictions 25% of share capital and free reserves.
(iii) Not Suitable for New Company: New companies generally find difficulty to raise funds through public deposits.

6. Commercial Papers

A commercial paper is an unsecured promissory note which has been used in India since 1990. A Commercial Paper is used as a promissory note by corporate buyers who are highly rated. It helps them meet their short term funding requirements and can be issued for anytime between 7 days to 1 year. Non Resident Indians (NRIs), primary dealers, Foreign Institutional Investors (FIIs), All-India financial institutions can raise commercial papers.

MERITS:
- It can be sold without any restrictions
- Highly liquid
- Provides higher funds as compared to loans.
- Freely transferable
- Companies with idle funds can invest in commercial paper, and earn good returns.

LIMITATIONS:
- New firms cannot raise money using Commercial Paper.
- The amount of money depends on excess liquidity available.
- Extending the maturity of Commercial Paper is not possible.

7. Issue of Shares

A company needs huge investments to start a business; this amount is known as capital. Since, it is impossible for one individual to bring in such a huge amount of capital; the entire capital is divided into small units known as shares, where each person holding shares is referred to as a shareholder. Generally, there are two types of shares issued by the company:

(a) Equity Shares

(b) Preference Shares.

(a) Equity Share: Equity shares represent the ownership of a company. They have the right to vote and right to participate in management.

MERITS:
- It is suitable for those investors who seek to assume high risks for better returns.
- No burden to the company, as paying a dividend is not compulsory.
- It serves as permanent capital as it has to be repaid at the time of liquidation.
- Democratic control over the management of the company is given to shareholders through voting rights.

LIMITATIONS:
- The returns are fluctuating in nature so investors who need steady income may not prefer equity shares.
- Cost of raising funds from equity shares is quite high as compared to other sources.
- It is more of a complicated process and may take longer time to raise funds.

(b) Preference Share: The holders of preference shares hold a preferential position in respect to equity shareholders in two ways:
- They receive a fixed rate of dividend before any dividend for the equity shareholders.
- Their claim for receiving the capital at the time of liquidation is settled just after the creditors of the company.

MERITS:

1. Investment is safe: Preference shareholders' investment is safe. They have preferential right to claim dividend and capital.

2. No Charge on assets: The Company does not need to mortgage its assets for issue of preference shares.
3. Control: It does not affect the control of equity shareholders because they have no voting right.
4. Fixed dividend: They get a fixed dividend. So, they are useful for investors who want fixed rates of return.

LIMITATIONS /DEMERITS:
1. Costly sources of funds: Rate of preference dividend is greater than rate of interest on debenture, for a company it is a costly source of funds than Debentures.
2. No tax saving: Preference dividend is not deductible from profit for income tax. Therefore, there is no tax saving.
3. Not suitable for risk takers: Preference shares are not suitable for those who are willing to take risk for higher return.
4. As dividend on these shares is to be paid only when the company earns profit, so investors may not be very attractive to these.

8. Debentures
Debentures are the important debt sources of finance for raising long term finance. Debenture holders get fixed rate of interest on Debentures. Interest is paid after every six months or one year. They are like creditors of a company.

MERITS:
- Preferred by investors who want fixed income with lower risk.
- Non dilution of the voting rights as they do not carry voting rights.
- Less costly as compared to that of equity and preference share capital.

LIMITATIONS:
- A permanent burden on the company as they are fixed charge instruments.
- The company has to make provisions for repayment in case of issue of redeemable debentures.
- Raising finance from this source limits the borrowing ability of the firm.
- Debenture holders do not get voting rights.

9. COMMERCIAL BANKS
Commercial Banks are those banks which provide funds to organizations for many purposes as well as various time periods. They extend their loan support to organizations irrespective of their size in the form of cash, credit, overdraft facility, discounting of bills, etc.

MERITS:
1. Timely financial assistance: Commercial banks provide timely financial assistance to businesses.
2. Secrecy: Secrecy is maintained about loans taken from Commercial Banks.
3. Easier source of funds: This is the easier source of funds as there is no need to issue prospectus for raising funds.

LIMITATIONS/DEMERITS:
1. Short or Medium term finance: Funds are not available for a long time.
2. Charge on assets: Required source security of assets before a loan is sanctioned.

10. Financial Institutions

There are numerous financial institutions established by the government of India across the country. These institutions finance the businesses and are set up by both state and central governments. There are development banks especially established to promote industrial development in the country.

MERITS:

1. Long term Finance: Financial Institution provides long term finance which is not provided by Commercial Bank.
2. Managerial Advice: They provide financial, managerial and technical advice to business firms.
3. Easy installments: Loan can be made in easy installments. It does not prove to be much of a burden on business.
4. Easy availability: The funds are made available even during periods of depression.

LIMITATIONS:

1. More time Consuming: The procedure for granting loan is time consuming due to rigid criteria and many formalities.
2. Restrictions: Financial Institutions place restrictions on the company's board of Directors.

11. International Financing

a. Commercial Banks: These banks act as an important source of financing to non-trade international operations. They extend their support all over the world for foreign currency loans. For example: Standard Chartered.
b. International Agencies and Development Bank: A number of international agencies and development Banks e.g. IFC, ADB provide long term loans.
c. International Capital Markets: Various MNCs and corporate houses depend on borrowings in the form of rupees and other foreign currency. The financial instruments used for the same are:

> **(i) Global Depository Receipts:** A GDR is a negotiable instrument or an instrument that can be traded freely in various foreign capital markets. These are issued by the Indian companies to raise funds from abroad and can also be traded on foreign stock exchanges.
> **(ii) ADR**: The depository receipt issued by a company in USA is known as ADRs (American Depository Receipts)
> **Feature of ADR:**
> 1. It can be issued only to American Citizens.
> 2. It can be listed and traded on the American stock exchange.
> 3. Indian companies such as Infosys, Reliance issued ADR
>
> **(iii) Indian Depository Receipts:** IDRs are issued to Indian residents only and can be traded on Indian Stock Exchange. It is denominated in Indian Rupees. It is issued by an Indian Depository to enable foreign companies to raise funds from Indian Capital Markets. Standard Chartered PLC was the first company to issue IDRs.
> **(iv) Foreign Currency Convertible Bonds (FCCBs):** The FCCB s is issued in a foreign currency and carries a fixed interest rate. These are listed and traded in foreign stock exchanges and similar to the debenture.

Factors Affecting the Choice of the Source of Funds

The choice of source of funds greatly depends upon various factors like:

1. Cost of Finance: The source of funds generally bears two types of costs namely:

> **a.** The cost of procurement of funds
> **b.** Cost of utilization of funds.

2. Financial Position: Business should be in a sound position to repay the borrowed funds. In case when the company is not in a very good position to pay, those sources should be selected which do not become a financial burden to the company.

3. Form of Business Organization: Rising of funds strongly depends upon the form of business a company undertakes. For example, in case it is a sole-proprietorship it cannot issue equity shares.

4. Time Period: It is important for an organization or a business to choose the funds requirement as per the time period that is required for a short period of time or a longer period and then raise funds accordingly from the market.

5. Risk Factors: A strong analysis of the risk involved in each source of fund should be carefully analyzed. The source that has the least risk should be selected. For example, equity is less risky as compared to loans in respect to financial risk that arises from fixed interest payments, and repayment aspects.

6. Dilution of Control: The choice of what source from which financing has to be procured also depends upon the extent to which firm is ready for the dilution of control. Such as if existing equity shareholders aren't willing to dilute the control they enjoy, in such a case the company may issue finance from source other than equity share capital.

7. Credit Worthiness: The type of sources from which the firm raises its capital impacts its credit worthiness. Hence the firm should choose sources which do not adversely affect its creditworthiness in the market.

8. Ease of Issuance of Finance: The flexibility and ease with which the firm is able to procure finance also affects the choice of source of finance. Excessive documents, legal restrictions, heavy investigation and other reasons may discourage the company from using a particular source of finance.

9. Tax Advantages: Some sources of finance are tax deductible, and hence firms can enjoy tax advantage using those sources. For example interest on debentures is a tax deductible expense, hence firms wanting to enjoy tax benefits may go for these sources.