Unit IB08: Sources of Business Finance

Name: ____________________

Date: __/__/__

Meaning

For carrying out various activities, business requires money. Finance, therefore, is called the life blood of any business. The requirements of funds by business to carry out its various activities is called business finance.

Need for Business Finance

A business cannot function unless adequate funds are made available to it. The initial capital contributed by the entrepreneur is not always sufficient to take care of all financial requirements of the business. A business person, therefore, must look for different other sources from where the need for funds can be met.

A clear assessment of the financial needs and the identification of various sources of finance, therefore, is a significant aspect of running a business organisation. The need for funds arises from the stage when an entrepreneur decides to start a business.

Some funds are needed for procuring assets like land, building and machinery while some funds are needed for running the business operations daily.

Fixed Capital Requirement

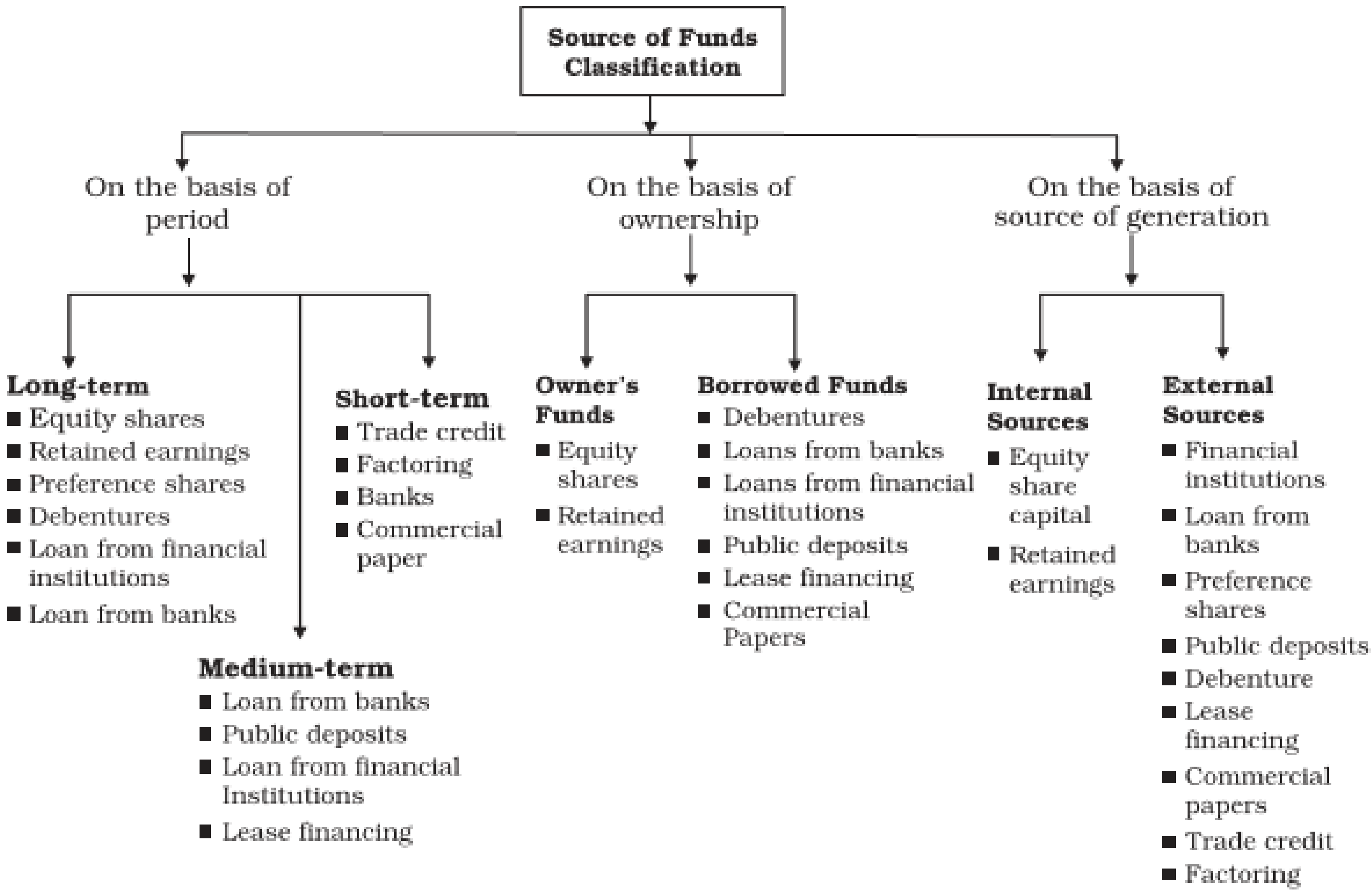
To start business, funds are required to purchase fixed assets like land and building, plant and machinery, and furniture and fixtures. This is known as fixed capital requirements of the enterprise. The funds required in fixed assets remain invested in the business for a long period of time.

Different business units need varying amount of fixed capital depending on various factors such as the nature of business, etc. A trading concern for example, may require small amount of fixed capital as compared to a manufacturing concern. Likewise, the need for fixed capital investment would be greater for a large enterprise, as compared to that of a small enterprise.

Working Capital Requirement

The financial requirements of an enterprise do not end with the procurement of fixed assets. No matter how small or large a business is, it needs funds for its day-to-day operations. This is known as working capital of an enterprise, which is used for holding current assets such as stock of material, bills receivables and for meeting current expenses like salaries, wages, taxes, and rent.

The amount of working capital required varies from one business concern to another depending on various factors. A business unit selling goods on credit, or having a slow sales turnover, for example, would require more working capital as compared to a concern selling its goods and services on cash basis or having a speedier turnover.



Source of Funds Classification
On the basis of period
On the basis of ownership
On the basis of source of generation
Long-term
Equity shares
Retained earnings
Preference shares
Debentures
Loan from financial institutions
Loan from banks
Medium-term
Loan from banks
Public deposits
Loan from financial Institutions
Lease financing
Short-term
Trade credit
Factoring
Banks
Commercial paper
Owner's Funds
Equity shares
Retained earnings
Borrowed Funds
Debentures
Loans from banks
Loans from financial institutions
Public deposits
Lease financing
Commercial Papers
Internal Sources
Equity share capital
Retained earnings
External Sources
Financial institutions
Loan from banks
Preference shares
Public deposits
Debenture
Lease financing
Commercial papers
Trade credit
Factoring

Period Basis

The long-term sources fulfil the financial requirements of an enterprise for a period exceeding 5 years and include sources such as shares and debentures, long-term borrowings, and loans from financial institutions. Such financing is generally required for the acquisition of fixed assets such as equipment, plant, etc.

Short-term funds are those which are required for a period not exceeding one year. Trade credit, loans from commercial banks and commercial papers are some of the examples of the sources that provide funds for short duration.

Ownership Basis

Based on ownership, the sources can be classified into 'owner's funds' and 'borrowed funds'

1) Owner's funds: Owner's funds mean funds that are provided by the owners of an enterprise, which may be a sole trader or partners or shareholders of a company. Apart from capital, it also includes profits reinvested in the business. The owner's capital remains invested in the business for a longer duration and is not required to be refunded during the life period of the business. A business, for example, can generate funds internally by accelerating collection of receivables, disposing of surplus inventories and ploughing back its profit. The internal sources of funds can fulfill only limited needs of the business.
2) Borrowed funds: 'Borrowed funds' on the other hand, refer to the funds raised through loans or borrowings. The sources for raising borrowed funds include loans from commercial banks, loans from financial institutions, issue of debentures, public deposits, and trade credit. In some cases, business is required to mortgage its assets as security while obtaining funds from external sources. Issue of debentures, borrowing from commercial banks and financial institutions and accepting public deposits are some of the examples of external sources of funds commonly used by business organisations.

Source of Generation Basis

1) Internal Sources: A business, for example, can generate funds internally by accelerating collection of receivables, disposing of surplus inventories, and ploughing back its profit. The internal sources of funds can fulfil only limited needs of the business.
2) External Sources: External sources of funds include those sources that lie outside an organisation, such as suppliers, lenders, and investors. When large amount of money is required to be raised, it is generally done using external sources. External funds may be costly as compared to those raised through internal sources.

Retained Earnings

Meaning

A company generally does not distribute all its earnings amongst the shareholders as dividends. A portion of the net earnings may be retained in the business for use in the future. This is known as retained earnings.

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 more operational freedom and flexibility;
(iv) It enhances the capacity of the business to absorb unexpected losses;
(v) It may lead to increase in the market price of the equity shares of a company.

Limitations

(i) Excessive ploughing back may cause dissatisfaction amongst the shareholders as they would get lower dividends;
(ii) It is an uncertain source of funds as the profits of business are fluctuating;
(iii) The opportunity cost associated with these funds is not recognised by many firms. This may lead to sub-optimal use of the funds.

Trade Credit

Meaning

Trade credit is the credit extended by one trader to another for the purchase of goods and services. Trade credit facilitates the purchase of supplies without immediate payment. Such credit appears in the records of the buyer of goods as 'sundry creditors' or 'accounts payable'.

Merits

(i) Trade credit is a convenient and continuous source of funds;
(ii) Trade credit may be readily available in case the credit worthiness of the customers is known to the seller;
(iii) Trade credit needs to promote the sales of an organisation;
(iv) If an organisation wants to increase its inventory level in order to meet expected rise in the sales volume in the near future, it may use trade credit to, finance the same;
(v) It does not create any charge on the assets of the firm while providing funds.

Limitations

(i) Availability of easy and flexible trade credit facilities may induce a firm to indulge in overtrading, which may add to the risks of the firm;
(ii) Only limited amount of funds can be generated through trade credit;
(iii) It is generally a costly source of funds as compared to most other sources of raising money.

Factoring

Meaning

Factoring is a financial service under which the 'factor' renders various services which includes:

(a) Discounting of bills (with or without recourse) and collection of the client's debts.
(b) Providing information about credit worthiness of prospective client's etc.,

Merits

(i) Obtaining funds through factoring is cheaper than financing through other means such as bank credit;
(ii) With cash flow accelerated by factoring, the client can meet his/her liabilities promptly as and when these arise;
(iii) Factoring as a source of funds is flexible and ensures a definite pattern of cash inflows from credit sales. It provides security for a debt that a firm might otherwise be unable to obtain;
(iv) It does not create any charge on the assets of the firm;
(v) The client can concentrate on other functional areas of business as the responsibility of credit control is shouldered by the factor

Limitations

(i) This source is expensive when the invoices are numerous and smaller in amount;
(ii) The advance finance provided by the factor firm is generally available at a higher interest cost than the usual rate of interest;
(iii) The factor is a third party to the customer who may not feel comfortable while dealing with it.

Lease Financing

Meaning

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) It provides finance without diluting the ownership or control of business;
(v) The lease agreement does not affect the debt raising capacity of an enterprise;
(vi) The risk of obsolescence is borne by the lesser. This allows greater flexibility to the lessee to replace the asset.

Demerits

(i) A lease arrangement may impose certain restrictions on the use of assets. For example, it may not allow the lessee to make any alteration or modification in the asset;
(ii) The normal business operations may be affected in case the lease is not renewed;
(iii) It may result in higher pay-out obligation in case the equipment is not found useful and the lessee opts for premature termination of the lease agreement;
(iv) The lessee never becomes the owner of the asset. It deprives him of the residual value of the asset.

Public Deposits

Meaning

The deposits that are raised by organisations directly from the public are known as public deposits. Rates of interest offered on public deposits are usually higher than that offered on bank deposits.

Merits

(i) The procedure of obtaining deposits is simple and does not contain restrictive conditions as are generally there in a loan agreement;

(ii) Cost of public deposits is generally lower than the cost of borrowings from banks and financial institutions;

(iii) Public deposits do not usually create any charge on the assets of the company. The assets can be used as security for raising loans from other sources;

(iv) As the depositors do not have voting rights, the control of the company is not diluted.

Limitations

(i) New companies generally find it difficult to raise funds through public deposits;

(ii) It is an unreliable source of finance as the public may not respond when the company needs money;

(iii) Collection of public deposits may prove difficult, particularly when the size of

Commercial Paper

Meaning

Commercial Paper emerged as a source of short term finance in our country in the early nineties. Commercial paper is an unsecured promissory note issued by a firm to raise funds for a short period, varying from 90 days to 364 days.

Merits

- (i) A commercial paper is sold on an unsecured basis and does not contain any restrictive conditions;
- (ii) As it is a freely transferable instrument, it has high liquidity;
- (iii) It provides more funds compared to other sources. Generally, the cost of CP to the issuing firm is lower than the cost of commercial bank loans;
- (iv) A commercial paper provides a continuous source of funds. This is because their maturity can be tailored to suit the requirements of the issuing firm. Further, maturing commercial paper can be repaid by selling new commercial paper;
- (v) Companies can park their excess funds in commercial paper thereby earning some

Limitations

- (i) Only financially sound and highly rated firms can raise money through commercial papers. New and moderately rated firms are not able to raise funds by this method;
- (ii) The size of money that can be raised through commercial paper is limited to the excess liquidity available with the suppliers of funds at a time;
- (iii) Commercial paper is an impersonal method of financing. As such if a firm is not able to redeem its paper due to financial difficulties, extending the maturity of a CP is not possible.

Issue of Equity Shares

Meaning

Equity shares is the most important source of raising long term capital by a company. Equity shares represent the ownership of a company and thus the capital raised by issue of such shares is known as ownership capital or owner's funds. Equity share capital is a prerequisite to the creation of a company

Merits

(i) Equity shares are suitable for investors who are willing to assume risk for higher returns;
(ii) Payment of dividend to the equity shareholders is not compulsory. Therefore, there is no burden on the company in this respect;
(iii) Equity capital serves as permanent capital as it is to be repaid only at the time of liquidation of a company. As it stands last in the list of claims, it provides a cushion for creditors, in the event of winding up of a company;
(iv) Equity capital provides credit worthiness to the company and confidence to prospective loan providers;
(v) Funds can be raised through equity issue without creating any charge on the assets of the company. The assets of a company are, therefore, free to be mortgaged for borrowings, if the need be;
(vi) Democratic control over management of the company is assured due to voting rights of equity shareholders.

Limitations

(i) Investors who want steady income may not prefer equity shares as equity shares get fluctuating returns;
(ii) The cost of equity shares is generally more as compared to the cost of raising funds through other sources;
(iii) Issue of additional equity shares dilutes the voting power, and earnings of existing equity shareholders;
(iv) More formalities and procedural delays are involved while raising funds through issue of equity share.

Issue of Preference Shares

Meaning

The capital raised by issue of preference shares is called preference share capital. The preference shareholders enjoy a preferential position over equity shareholders in two ways:

(i) Receiving a fixed rate of dividend, out of the net profits of the company, before any dividend is declared for equity shareholders;

(ii) Receiving their capital after the claims of the company's creditors have been settled, at the time of liquidation. In other words, as compared to the equity shareholders, the preference shareholders have a preferential claim over dividend and repayment of capital.

Merits

(i) Preference shares provide reasonably steady income in the form of fixed rate of return and safety of investment;

(ii) Preference shares are useful for those investors who want fixed rate of return with comparatively low risk;

(iii) It does not affect the control of equity shareholders over the management as preference shareholders don't have voting rights;

(iv) Payment of fixed rate of dividend to preference shares may enable a company to declare higher rates of dividend for the equity shareholders in good times;

(v) Preference shareholders have a preferential right of repayment over equity shareholders in the event of liquidation of a company;

(vi) Preference capital does not create any sort of charge against the assets of a company.

Limitations

(i) Preference shares are not suitable for those investors who are willing to take risk and are interested in higher returns;

(ii) Preference capital dilutes the claims of equity shareholders over assets of the company;

(iii) The rate of dividend on preference shares is generally higher than the rate of interest on debentures;

(iv) As the dividend on these shares is to be paid only when the company earns profit, there is no assured return for the investors. Thus, these shares may not be very attractive to the investors;

(v) The dividend paid is not deductible from profits as expense. Thus, there is no tax saving as in the case of interest on loans.

Debentures

Meaning

Debentures are an important instrument for raising long term debt capital. A company can raise funds through issue of debentures, which bear a fixed rate of interest. The debenture issued by a company is an acknowledgment that the company has borrowed a certain amount of money, which it promises to repay at a future date. Debenture holders are,

Merits

(i) It is preferred by investors who want fixed income at lesser risk;
(ii) Debentures are fixed charge funds and do not participate in profits of the company;
(iii) The issue of debentures is suitable in the situation when the sales and earnings are relatively stable;
(iv) As debentures do not carry voting rights, financing through debentures does not dilute control of equity shareholders on management;
(v) Financing through debentures is less costly as compared to cost of preference or equity capital as the interest payment on debentures is tax deductible.

Limitations

(i) As fixed charge instruments, debentures put a permanent burden on the earnings of a company. There is a greater risk when earnings of the company fluctuate;
(ii) In case of redeemable debentures, the company must make provisions for repayment on the specified date, even during periods of financial difficulty;
(iii) Each company has certain borrowing capacity. With the issue of debentures, the capacity of a company to further borrow funds reduces.

Commercial Banks

Meaning

Commercial banks occupy a vital position as they provide funds for different purposes as well as for different time periods. Banks extend loans to firms of all sizes and in many ways, like, cash credits, overdrafts, term loans, purchase/discounting of bills, and issue of letter of credit

Merits

(i) Banks provide timely assistance to business by providing funds as and when needed by it.

(ii) Secrecy of business can be maintained as the information supplied to the bank by the borrowers is kept confidential;

(iii) Formalities such as issue of prospectus and underwriting are not required for raising loans from a bank. This, therefore, is an easier source of funds;

(iv) Loan from a bank is a flexible source of finance as the loan amount can be increased according to business needs and can be repaid in advance when funds are not needed.

Limitations

(i) Funds are generally available for short periods and its extension or renewal is uncertain and difficult;

(ii) Banks make detailed investigation of the company's affairs, financial structure etc., and may also ask for security of assets and personal sureties. This makes the procedure of obtaining funds slightly difficult;

(iii) In some cases, difficult terms and conditions are imposed by banks. for the grant of loan. For example, restrictions may be imposed on the sale of mortgaged goods, thus making normal business working difficult.

Financial Institutions

Meaning

These institutions are established by the central as well as state governments. They provide both owned capital and loan capital for long and medium-term requirements and supplement the traditional financial agencies like commercial banks. As these institutions aim at promoting the industrial development of a country, these are also called 'development banks'.

Merits

(i) Financial institutions provide long-term finance, which are not provided by commercial banks;
(ii) Besides providing funds, many of these institutions provide financial, managerial, and technical advice and consultancy to business firms;
(iii) Obtaining loan from financial institutions increases the goodwill of the borrowing company in the capital market. Consequently, such a company can raise funds easily from other sources as well;
(iv) As repayment of loan can be made in easy instalments, it does not prove to be much of a burden on the business;
(v) The funds are made available even during periods of depression

Limitations

(i) Financial institutions follow rigid criteria for grant of loans. Too many formalities make the procedure time consuming and expensive;
(ii) Certain restrictions such as restriction on dividend payment are imposed on the powers of the borrowing company by the financial institutions;
(iii) Financial institutions may have their nominees on the Board of Directors of the borrowing company thereby restricting the powers of the company

International Financing

Commercial Banks

Commercial banks all over the world extend foreign currency loans for business purposes. They are an important source of financing non-trade international operations. The types of loans and services provided by banks vary from country to country. For example, Standard Chartered emerged as a major source of foreign currency loans to the Indian industry.

International Agencies and Development Banks

Many international agencies and development banks have emerged over the years to finance international trade and business. These bodies provide long and medium-term loans and grants to promote the development of economically backward areas in the world. These bodies were set up by the Governments of developed countries of the world at national, regional, and international levels for funding various projects. The more notable among them include International Finance Corporation (IFC), EXIM Bank and Asian Development Bank.

International Capital Markets

GDRs

The local currency shares of a company are delivered to the depository bank. The depository bank issues depository receipts against these shares. Such depository receipts denominated in US dollars are known as Global Depository Receipts (GDR). GDR is a negotiable instrument and can be traded freely like any other security. In the Indian context, a GDR is an instrument issued abroad by an Indian company to raise funds in some foreign currency and is listed and traded on a foreign stock exchange.

ADRs

The depository receipts issued by a company in the USA are known as American Depository Receipts. ADRs are bought and sold in American markets like regular stocks. It is like a GDR except that it can be issued only to American citizens and can be listed and traded on a stock exchange of USA.

FCCBs

Foreign currency convertible bonds are equity linked debt securities that are to be converted into equity or depository receipts after a specific period. Thus, a holder of FCCB has the option of either converting them into equity shares at a predetermined price or exchange rate, or retaining the bonds.

The FCCB’s are issued in a foreign currency and carry a fixed interest rate which is lower than the rate of any other similar nonconvertible debt instrument. FCCB’s are listed and traded in foreign stock exchanges. FCCB’s are very like the convertible debentures issued in India.

Factors Affecting Source of Funds

(i) Cost: There are two types of cost viz., the cost of procurement of funds and cost of utilising the funds. Both these costs should be considered while deciding about the source of funds that will be used by an organisation.

(ii) Financial strength and stability of operations: The financial strength of a business is also a key determinant. In the choice of source of funds business should be in a sound financial position to be able to repay the principal amount and interest on the borrowed amount. When the earnings of the organisation are not stable, fixed charged funds like preference shares and debentures should be carefully selected as these add to the financial burden of the organisation.

(iii) Form of organisation and legal status: The form of business organisation and status influences the choice of a source for raising money. A partnership firm, for example, cannot raise money by issue of equity shares as these can be issued only by a joint stock company.

(iv) Purpose and time: Business should plan according to the period for which the funds are required. A short-term need for example can be met through borrowing funds at low rate of interest through trade credit, commercial paper, etc. For long term finance, sources such as issue of shares and debentures are more appropriate.

(v) Risk profile: Business should evaluate each of the source of finance in terms of the risk involved. For example, there is a least risk in equity as the share capital must be repaid only at the time of winding up and dividends need not be paid if no profits are available. A loan on the other hand, has a repayment schedule for both the principal and the interest. The interest is required to be paid irrespective of the firm earning a profit or incurring a loss.

(vi) Control: A source of fund may affect the control and power of the owners on the management of a firm. Issue of equity shares may mean dilution of the control. For example, as equity shareholders enjoy voting rights, financial institutions may take control of the assets or impose conditions as part of the loan agreement.

(vii) Effect on credit worthiness: The dependence of business on certain sources may affect its credit worthiness in the market. For example, issue of secured debentures may affect the interest of unsecured creditors of the company and may adversely affect their willingness to extend further loans as credit to the company.

(viii) Flexibility and ease: Another aspect affecting the choice of a source of finance is the flexibility and ease of obtaining funds. Restrictive provisions, detailed investigation, and documentation in case of borrowings from banks and financial institutions for example may be the reason that a business organisation may not prefer it, if other options are readily available.

(ix) Tax benefits: Various sources may also be weighed in terms of their tax benefits. For example, while the dividend on preference shares is not tax deductible, interest paid on debentures and loan is tax deductible and may, therefore, be preferred by organisations seeking tax advantage.