Edunotes
WHERE PASSION MEETS EDUCATION

LEARN KWNIY
Where passion meets with educations

CHAPTER 8

SOURCES OF BUSINESS FINANCE

MEANING, NATURE AND SIGNIFICANCE OF BUSINESS FINANCE

Business is concerned with the production and distribution of goods and services for the satisfaction of needs of society. 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.

The need for funds arises from the stage when an entrepreneur makes a decision to start a business. Similarly, some funds are required for day-to-day operations. Also when the business expands, it needs funds.

The financial needs of a business can be categorised as follows:

(a) Fixed capital requirements: In order 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.

(b) Working capital requirements: 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 requirement for fixed and working capital increases with the growth and expansion of business. At times additional funds are required for upgrading the technology employed. Similarly, larger funds may be required for building higher inventories for the festive season or to meet current debts or expand the business or to shift to a new location. It is, therefore, important to evaluate the different sources from where funds can be raised.

CLASSIFICATION OF SOURCES OF FUNDS

In case of proprietary and partnership concerns, the funds may be raised either from personal sources or borrowings from banks, friends etc. In case of company form of organisation, the different sources of business finance.

Period Basis

On the basis of period, the different sources of funds can be categorised into three parts.These are long-term sources, medium-term sources and short-term sources.

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.

Where the funds are required for a period of more than one year but less than five years, medium-term sources of finance are used. These sources include borrowings from commercial banks, public deposits, lease financing and loans from financial institutions.

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

On the basis of ownership, the sources can be classified into 'owner's funds' and 'borrowed funds'.

Owner's funds means funds that are provided by the owners of an enterprise, which may be a sole trader or partners or shareholders of a company. Such capital forms the basis on which owners acquire their right of control of management. Issue of equity shares and retained earnings are the two important sources from where owner's funds can be obtained.

‘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.

Source of Generation Basis

Another basis of categorising the sources of funds can be whether the funds are generated from within the organisation or from external sources.

Internal sources of funds are those that are generated from within the business. The internal sources of funds can fulfill only limited needs of the business.

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 through the use of 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.

SOURCES OF FINANCE

A business can raise funds from various sources. Each of the source has unique characteristics. There is not a single best source of funds for all organisations. Depending on the situation, purpose, cost and associated risk, a choice may be made about the source to be used.

Retained Earnings

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. It is a source of internal financing or self-financing or 'ploughing back of profits'.

Merits

The merits of retained earning as a source of finance are as follows:

(i) Retained earnings is a permanent source of funds available to an organisation;

(ii) It does not involve any explicit cost;

(iii) There is a greater degree of operational freedom and flexibility;

(iv) It enhances the capacity of the business to absorb unexpected losses;

Limitations

Retained earning as a source of funds has the following 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;

Trade Credit

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. Trade credit is commonly used by business organisations as a source of short-term financing. It is

granted to those customers who have reasonable amount of financial standing and goodwill.

Merits

The important merits of trade credit are as follows:

(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) It does not create any charge on the assets of the firm while providing funds.

Limitations

Trade credit as a source of funds has certain limitations, which are given as follows:

(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.

Factoring

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. Under this, the receivables on account of sale of goods or services are sold to the factor at a certain discount. There are two methods of factoring — recourse and non-recourse. Under recourse factoring, the client is not protected against the risk of bad debts. On the other hand, the factor assumes the entire credit risk under non-recourse factoring i.e., full amount of invoice is paid to the client in the event of the debt becoming bad.

(b) Providing information about credit worthiness of prospective client's etc., Factors hold large amounts of information about the trading histories of the firms. This can be valuable to those who are using factoring services and can thereby avoid doing business with customers having poor payment record. Factors may also offer relevant consultancy services in the areas of finance, marketing, etc.

Merits

The merits of factoring as a source of finance are as follows:

(i) Obtaining funds through factoring is cheaper;

(ii) Factoring provides security for a debt that a firm might otherwise be unable to obtain;

(iii) It does not create any charge on the assets of the firm;

(iv) The client can concentrate on other functional areas of business as the responsibility of credit control is shouldered by the factor.

Limitations

The limitations of factoring as a source of finance are as follows:

(i) The advance finance provided by the factor firm is generally available at a higher interest cost than the usual rate of interest;

(ii) The factor is a third party to the customer who may not feel comfortable while dealing with it.

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. The owner of the assets is called the 'lessor' while the party that uses the assets is known as the 'lessee'. The lessee pays a fixed periodic amount called lease rental to the lessor for the use of the asset. The terms and conditions regulating the lease arrangements are given in the lease contract. At the end of the lease period, the asset goes back to the lessor.

Merits

The important merits of lease financing are as follows:

(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) The lease agreement does not affect the debt raising capacity of an enterprise;

(v) The risk of obsolescence is borne by the lesser.

Limitations

The limitations of lease financing are given as below:

(i) A lease arrangement may impose certain restrictions on the use of assets.

(ii) The normal business operations may be affected in case the lease is not renewed;

(iii) It may result in higher payout obligation in case the equipment is not found useful and

(iv) The lessee never becomes the owner of the asset.

Public Deposits

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. Companies generally invite public deposits for a period upto three years. The acceptance of public deposits is regulated by the Reserve Bank of India.

Merits

The merits of public deposits are:

(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.

Limitations

The major limitation of public deposits are as follows:

(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 deposits required is large.

Commercial Paper

Commercial Paper (CP) is an unsecured money market instrument issued in the form of a promissory note. Subsequently, primary dealers and all-India financial institutions were also permitted to issue CP to enable them to meet their short-term funding requirements for their operations. Individuals, banking companies, other corporate bodies (registered or incorporated in India) and unincorporated bodies, Non Resident Indians (NRIs) and Foreign Institutional Investors (FIIs) etc. can invest in CPs. CP can be issued for maturities between a minimum of 7 days and a maximum of up to one year from the date of issue in denominations of Rs.5 lakh or multiples thereof. However, the maturity date of the CP should not go beyond the date up to which the credit rating of the issuer is valid.

Merits

(i) A commercial paper is sold on an unsecured basis;

(ii) As it is a freely transferable instrument, it has high liquidity;

(iii) It provides more funds compared to other sources.

Limitations

(i) New and moderately rated firms are not in a position 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 particular time;

(iii) Extension of maturity of a CP is not possible.

Issue of Shares

The capital obtained by issue of shares is known as share capital. The capital of a company is divided into small units called shares. Each share has its nominal value. The person holding the share is known as shareholder. There are two types of shares normally issued by a company. These are equity shares and preference shares. The money raised by issue of equity shares is called equity share capital, while the money raised by issue of preference shares is called preference share capital.

(a) Equity Shares

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. Equity shareholders do not get a fixed dividend but are paid on the basis of earnings by the company. They are referred to as ‘residual owners’ since they receive what is left after all other claims on the company’s income and assets have been settled. They enjoy the reward as well as bear the risk of ownership. Their liability, however, is limited to the extent of capital contributed by them in the company. Further, through their right to vote, these shareholders have a right to participate in the management of the company.

Merits

The important merits of raising funds through issuing equity shares are given as below:

(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.

(iii) Equity capital serves as permanent capital as it is to be repaid only at the time of liquidation of a company.

(iv) 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 the purpose of borrowings, if the need be;

(v) Control over management of the company due to voting rights of equity shareholders.

Limitations

The major limitations of raising funds through issue of equity shares are as follows:

(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) More formalities and procedural delays are involved while raising funds through issue of equity share.

(b) Preference Shares

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; and (ii) receiving their capital after the claims of the company's creditors have been settled, at the time of liquidation. Preference shareholders generally do not enjoy any voting rights.

Merits

The merits of preference shares are given as follows:

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

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

Limitations

The major limitations of preference shares as source of business finance are as follows:

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

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

(iii) As the dividend on these shares is to be paid only when the company earns profit, there is no assured return for the investors.

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

TYPES OF PREFERENCE SHARES

1. Cumulative and Non-Cumulative: **The preference shares which enjoy the right to accumulate unpaid dividends in the future years are known as cumulative preference shares. On the other hand, on non-cumulative shares, dividend is not accumulated if it is not paid in a particular year.**

2. Participating and Non-Participating: **Preference shares which have a right to participate in the further surplus of a company shares which after dividend at a certain rate has been paid on equity shares are called participating preference shares. The non-participating preference are such which do not enjoy such rights of participation in the profits of the company.**

3. Convertible and Non-Convertible: **Preference shares that can be converted into equity shares within a specified period of time are known as convertible preference shares. On the other hand, non-convertible shares are such that cannot be converted into equity shares.**

Debentures

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, therefore, termed as creditors of the company.

Merits

The merits of raising funds through debentures are given as follows:

(i) It is preferred by investors who want fixed income at lesser risk;

(ii) The issue of debentures is suitable in the situation when the sales and earnings are relatively stable;

(iii) As debentures do not carry voting rights, financing through debentures does not dilute control of equity shareholders on management;

(iv) 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

Debentures as source of funds has certain limitations. These are given as follows:

(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 has to make provisions for repayment on the specified date.

(iii) With the issue of debentures, the capacity of a company to further borrow funds reduces.

<u>Types of Debentures</u>

1. Secured and Unsecured: Secured debentures are such which create a charge on the assets of the company. Unsecured debentures

on the other hand do not carry any charge or security on the assets of the company.

2. Registered and Bearer: Registered debentures are those which are duly recorded in the register of debenture holders maintained by the company. The debentures which are transferable by mere delivery are called bearer debentures.

3. Convertible and Non-Convertible: Convertible debentures are those debentures that can be converted into equity shares after the expiry of a specified period. On the other hand, non-convertible debentures are those which cannot be converted into equity shares.

4. First and Second: Debentures that are repaid before other debentures are repaid are known as first debentures. The second debentures are those which are paid after the first debentures have been paid back.

Commercial Banks

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

The merits of raising funds from a commercial bank are as follows:

(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) 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

The major limitations of commercial banks as a source of finance are as follows:

(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. 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.

Financial Institutions

The government has established a number of financial institutions all over the country to provide finance to business organisations. These institutions are established by the central as well as state governments. This source of financing is considered suitable when large funds for longer duration are required for expansion, reorganisation and modernisation of an enterprise.

Merits

The merits of raising funds through financial institutions are as follows:

(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) As repayment of loan can be made in easy instalments, it does not prove to be much of a burden on the business;

(iv) The funds are made available even during periods of depression, when other sources of finance are not available.

Limitations

The major limitations of raising funds from financial institutions are as given below:

(i) Financial institutions follow rigid criteria for grant of loans. Too many formalities make the procedure time consuming and expensive;

(ii) Financial institutions may have their nominees on the Board of Directors of the borrowing company thereby restricting the powers of the company.

International Financing

With the opening up of an economy and the operations of the business organisations becoming global, Indian companies have an access to funds in global capital market. Various international sources from where funds may be generated include:

(i) Commercial Banks: Commercial banks all over the world extend foreign currency loans for business purposes. For example, Standard

Chartered emerged as a major source of foreign currency loans to the Indian industry.

(ii) International Agencies and Development Banks: A number of 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. It include International Finance Corporation (IFC), EXIM Bank and Asian Development Bank.

(iii) International Capital Markets: Modern organisations including multinational companies depend upon sizeable borrowings in rupees as well as in foreign currency. Prominent financial instruments used for this purpose are:

(a) Global Depository Receipts (GDR's): 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. A holder of GDR can at any time convert it into the number of shares it represents. The holders of GDRs do not carry any voting rights but only dividends and capital appreciation.

(b) American Depository Receipts (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.

(c) Indian Depository Receipt (IDRs): An Indian Depository Receipt is a financial instrument denominated in Indian Rupees in the form of a Depository Receipt. It is created by an Indian Depository to enable a foreign company to raise funds from the Indian securities market.

According to SEBI guidelines, IDRs are issued to Indian residents in the same way as domestic shares are issued. The issuer company makes a public offer in India, and residents can bid in exactly the same format and method as they bid for Indian shares.

(d) Foreign Currency Convertible Bonds (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 non-convertible debt instrument. FCCB's are listed and traded in foreign stock exchanges. FCCB's are very similar to the convertible debentures issued in India.

FACTORS AFFECTING THE CHOICE OF THE SOURCE OF FUNDS

Financial needs of a business are of different types — long term, short term, fixed and fluctuating. Therefore, business firms resort to different types of sources for raising funds. Short-term borrowings offer the benefit of reduced cost due to reduction of idle capital, but long – term borrowings are considered a necessity on many grounds. Similarly equity capital has a role to play in the scheme for raising funds in the corporate sector.

As no source of funds is devoid of limitations, it is advisable to use a combination of sources, instead of relying only on a single source. A number of factors affect the choice of this combination:

(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 taken into account 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 so as to be able to repay the principal amount and interest on the borrowed amount.

(iii) Form of organisation and legal status: The form of business organisation and status influences the choice of a source for raising money.

(iv) Purpose and time period: Business should plan according to the time 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.

(v) Risk profile: Business should evaluate each of the source of finance in terms of the risk involved.

(vi) Control: A particular 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. Thus, business firm should choose a source keeping in mind the extent to which they are willing to share their control over business.