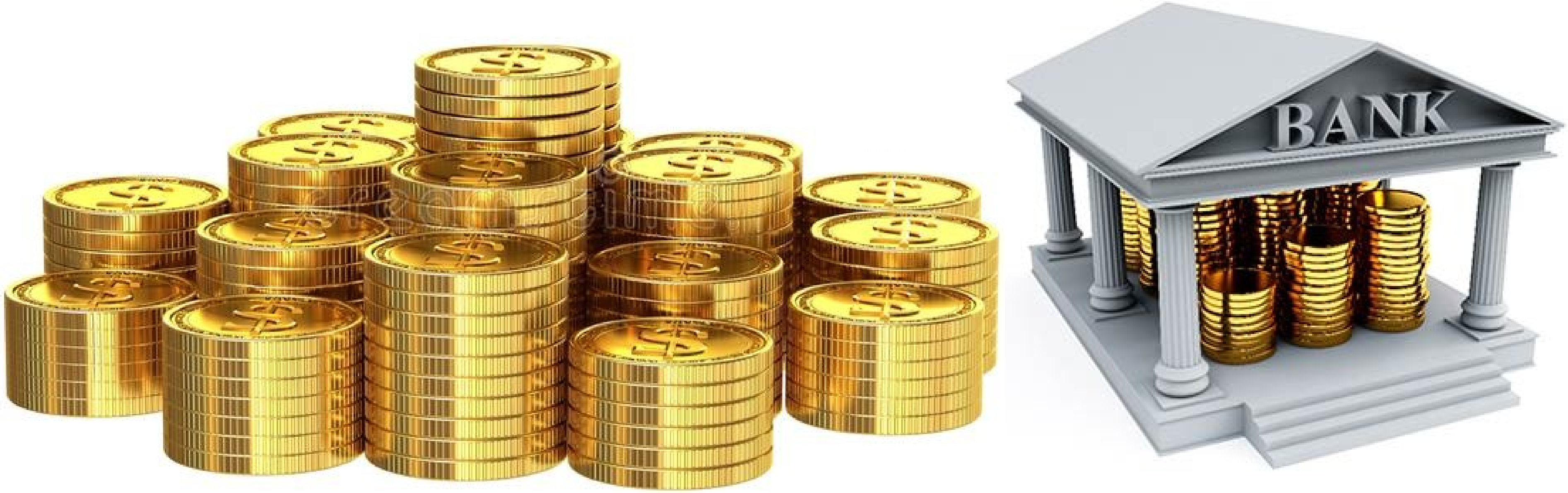
ELIZADE UNIVERSITY

SOURCES OF FINANCE



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Course Content

- Module 1: Introduction to Engineering Economics
- Module 2: Costing of Production Systems
- Module 3: Sources of Finance
- Module 4: Investment Appraisals.
- Module 5: Interest Formulas and Problems
- Module 6: Annual Costs, Present Worth and Rate of Return
- Module 7: Valuation of Assets
- Module 8: Financial Management
- Module 9: Financial Statements
- Module 10: Budget Control

Module 3: Sources of Finance

Module Learning Outcomes

At the end of this module students are expected to be able to;

- ❖**Understand and explain the various sources of finance**
- ❖**Explain differences with examples of short term and long term sources**
- ❖ **Explain differences between internal and external sources.**
- ❖**List advantages and disadvantages of the various sources of finance.**

INTRODUCTION

- To start and successfully run a business, you need funding.
- Finance is therefore a crucial part of any business
- Where do you get this funds?
- How do you source for them?
- Which sources are preferable to the others?
- These are some of the questions that needs answers when starting a business.

Source of Funds Classification

- On the basis of period
  - **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
- On the basis of ownership
  - **Owner's Funds**
    - Equity shares
    - Retained earnings
  - **Borrowed Funds**
    - Debentures
    - Loans from banks
    - Loans from financial institutions
    - Public deposits
    - Lease financing
    - Commercial Papers
- On the basis of source of generation
  - **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

Sources based on Period

- Long Term Sources: Here fund is needed 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.

- Medium Term Sources: These sources include borrowings from commercial banks, public deposits, lease financing 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.

- Short Term Sources: 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.

Sources based on Ownership

- **Owner's Fund:** 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. 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. Such capital forms the basis on which owners acquire their right of control of management.

- **Borrowed Fund:** 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. Such sources provide funds for a specified period, on certain terms and conditions and have to be repaid after the expiry of that period.

Sources based on Generation

- **Internal Sources:** Internal sources of funds are those that are generated from within 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.

- **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 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 Defined

- **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.

Advantages

1. It does not involve any explicit cost in the form of interest, dividend or floatation cost.

2. Retained earnings is a permanent source of funds available to an org.

3. As the funds are generated internally, there is a greater degree of operational freedom and flexibility

4. It may lead to increase in the market price of the equity shares of a company

Disadvantages

1. It is an uncertain source of funds as the profits of business are fluctuating.
2. Excessive ploughing back may cause dissatisfaction amongst the shareholders as they would get lower dividends;

Sources Defined

- **Trade Credit**: Trade credit is the credit extended by one trader to another for the purchase of goods and services. It is granted to those customers who have reasonable amount of financial standing and goodwill.

Advantages

1. Trade credit may be readily available in case the credit worthiness of the customers is known to the seller

2. Trade credit is a convenient and continuous source of funds.

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

Disadvantages

1. 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.

2. Only limited amount of funds can be generated through trade credit;

Sources Defined

- **Lease Financing**: 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’.

Advantages

1. It enables the lessee to acquire the asset with a lower investment

2. Simple documentation makes it easier to finance assets;

3. The lease agreement does not affect the debt raising capacity of an enterprise

Disadvantages

1. 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.

2. The normal business operations may be affected in case the lease is not renewed;

3. The lessee never becomes the owner of the asset. It deprives him of the residual value of the asset.

Sources Defined

- **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..

Advantages

1. Equity shares are suitable for investors who are willing to assume risk for higher returns

2. Payment of dividend to the equity shareholders is not compulsory. Therefore, there is no burden on the company in this respect

3. 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

Disadvantages

1. Investors who want steady income may n prefer equity shares as equity shares get fluctuating Returns

2. The cost of equity shares is generally mo as compared to the cost of raising funds through other Sources

3. Issue of additional equity shares dilutes th voting power, and earnings of existing equit shareholders

Sources Defined

- **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.

Advantages

It is preferred by investors who want fixed income at lesser risk

2. Debentures are fixed charge funds and do not participate in profits of the company

3. The issue of debentures is suitable in the situation when the sales and earnings are relatively stable;

Disadvantages

1. 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

2. In case of redeemable debentures, the company has to make provisions for repayment on the specified date, even during periods of financial difficulty

3. Each company has certain borrowing capacity. With the issue of debentures, the capacity of a company to further borrow funds

Practice Questions

1. List and Explain with examples, 3 major categorical sources of finance.
2. Explain the Following
   i. Debentures
   ii. Equity Shares
   iii. Lease Financing
3. What is Trade Credit?
4. List 2 advantages and disadvantages each of the following
   i. Trade Credit
   ii. Lease Financing
   iii. Debentures
   iv. Retained Earnings.

References

1. **Excerpts from a book; Business Studies – Sources of Business Finance.**

2. Engineering Economics by R. Panneerselvam (2001). PHI Learning Private Limited, New Delhi.

3. Contemporary Engineering Economics by Chan S. Park (2007) (4th Ed.) Pearson Education, Inc.