Business Finance

Chapter Outline :

Definition of Finance, Scope and Functions of Business Finance, Principles of Business Finance, Classification of Business Finance, Sources of Business Finance.Managing the Finances of the Firm, Specialized financial institutions of Bangladesh, Problems of Financial, Institution of Bangladesh, Questions to Answer, Multiple Choice Questions, Idicate True or False & Reference.

10.1 Definition of Finance

Finance can be defined as the art and science of managing money. Virtually all individuals and organizations earn or raise and spend or invest money. Finance is concerned with the processes, institutions, markets and instruments involved in the transfer of money between individuals, businesses and governments.

Financial management is concerned with the acquisition, finance and management of assets with some overall goals in mind.

According to B. O. Wheeler, "Business finance is that activities which is concerned with the acquisition and conservation of capital funds in meeting the financial need and over all objective of business enterprise."

According to Dr. R. E. Gloss & Dr. H. Baker, "Business finance is concerned with the sources of funds available to enterprise of all sizes and the proper use of money or credit obtained from such sources"

At last we can say that, the study of money within the firm; the business function responsible for finding funds, managing them, and determining their best use is business finance.

10.2 Scope and Functions of Business Finance

Business finance is that activities which is concerned with the acquisition and conservation of capital funds in meeting the financial needs and over all objective of business enterprise. Overall financial functions can be divided into two groups:

1. **Managerial Functions :** It includes two important decisions of a finance manager.

(a) **Investment decision:** Investment decision is taken by valuing different projects where expected return and risk are considered. Investment project or assets can be divided into two categories:

⊃ **Short-term investment:** in this case investment is made in current assets for one or less than one year.

⊃ **Long-term investment:** Capital budgeting is concerned for investing in long term project where the following things are considered: overall assets and cost, expected future return, risk of expected return, cost of capital.

(b) **Financing decision:** The second function of financial manager is to decide about the allocation of dividend among its stakeholders. In this case retained earnings are also considered.

2. Routine or incidental functions: Some other functions are also accomplished financial managers. These are commonly known as routine works :

- Fund collection
- Reserve maintenance
- Information collection
- Preparing financial statements, etc.

10.3 Principles of Business Finance

Business finance is concerned with the sources of funds available to enterprises of all s and the proper use of money or credit obtained from such source. For achieving goal, so principles should be followed:

1. **Principles of risk and return :** Higher the risk, higher the return. So there should b trade off between risk and return.
2. **Principles of time value of money :** This principle states that a dollar in hand toda worth more than a dollar to be received in the future because the dollar in hand toc can be invested to earn interest to yield more than a dollar in the future.
3. **Principles of cash flow :** A financial manager places importance on cash flows rath than on profit.
4. **Principles of profitability and liquidity :** This principle states that there should be trade off between profitability and liquidity.
5. **Hedging principle :** This principle states that current assets should be met up b current liabilities and long-term assets should be met up by long-term liabilities.
6. **Principles of diversity :** This principle states that all the money should not be investe in a project, rather investment should be diversified.
7. **Principles of business cycle :** According to this principle, all the financial decision should consider the business cycle.

10.4 Classification of Business Finance

Business finance is that activities which is concerned with the acquisition and conservatio of capital funds in meeting the financial need and over all objective of business enterprise Business finance can be divided into the following two types. Such as:

(a) Short Term Finance :

Funds available for a period of one year or less are called short term finance. Short term finance is mainly used for purchasing current assets. Current assets are cash, inventories, sundry debtors, bills receivables, etc. For purchasing these assets, current liabilities are used. Current liabilities are sundry creditors, accounts payable, trade credit, commercial paper, etc. In a financial year the difference between total current assets and total liabilities is called working capital.

Characteristics of short term finance :

1. **Time :** This financing is made available for a period of one year or less. The funds may be used for procuring raw materials either in cash or credit. In purchasing the raw materials in cash any bank or financial institution may provide the loan for a short period of time.

2. **Purpose :** This financing is generally used to meet the working capital requirements of the organization like procuring raw materials, paying the wages of the workers, etc.

3. **Costly and risky :** Since this fund is made available for short period of time, it is considered as costly and risky.

4. **Security :** In obtaining short term financing no security is generally required. Sometimes bank loans are offered without any security based on relationships of the clients with the banks.

5. **Recycling:** Short term financing can be recycled. That is if we buy raw materials on credit, bill payable is created. If we pay the bill in time, creditors remain satisfied and they sanction this again.

(b) Long Term Finance:

An organization requires long-term financing to meet its long-term capital asset requirements. Thus the funds raised for long-term investment is termed as long-term financing.

❑ **Characteristics of long-term finance:**

1. **Size of the fund:** It is generally very large and is usually invested in immoveable property.

2. **Use of fund:** The fund is used to procure land, machineries and equipments, preparing office building and residential building.

3. **Nature of the fund:** This fund can be either in domestic or foreign currencies.

4. **Repayment method:** Depends upon the contractual relationship between the lenders and the borrowers.

5. **Security:** Requires sufficient security against this loan. Generally the fixed assets of the business are used in this regard.

6. **Claim on income :** The creditors get first priority over the income of the borrowers.

7. **Cost of Capital:** Generally less than on short-term financing since the fund is used for a long-term and the expected income is generally low.

8. **Participation in management :** Shareholders can actively participate in management if the fund is raised through issuing shares. But if it is raised through the creditors, they can influence management indirectly.

10.5 Sources of Business Finance.

The assets of a company indicate the uses of fund while the liabilities of a company indicate the sources of fund. There are two sources of fund :

(A) Internal sources of fund:

The fund that is collected from the owners or internal revenue or cash flow of firm, is called internal sources of fund or internal financing. For example, share capital, retained earnings, depreciation fund, etc. The following are the sources of internal financing:

1. Promoters' initial capital : The first and the foremost source of fund is promoters' initial capital. At the initiation of business, promoters accumulate capital. But the amount of capital, change of capital, accounting system etc. are different according to the nature of business.

2. Retained earnings : The portion of net profit which is not distributed among the owners, instead is retained, is called retained earnings. Retained earning is an important source of internal financing of a firm. Retained earnings may be of five types:

➲ **General reserve :** The portion of net profit that is kept reserved instead of seeing distributed to owners with the objective of meeting future uncertainties is called general serve.

➲ **Dividend equalization fund :** Most of the shareholders expect a consistent return every year. But a firm does not earn consistent return every year. To provide consistent return, every firm retains some portion of profit each year. This is called dividend equalization fund. This is another important source of fund.

➲ **Credit balance of profit and loss account:** The remaining balance of net profit after deducting dividend and general reserve is used as a source of internal financing.

➲ **Sinking fund:** When a firm takes long-term loan, it retains some portion of profit as collateral. This fund is called sinking fund and is used as a source of internal financing.

➲ **Workmen's Compensation and Welfare Fund:** This fund is formed to compensate any injured or diseased employee. This fund can temporarily be used as a short-term fund.

3. Provision for depreciation: Every firm maintains some provisions for depreciation of assets every year. This depreciation can be used as a source of internal fund.

4. Outstanding expenses: Every firm carries some outstanding expenses in its account every year. This fund can be used as a source of internal financing until and unless it is paid.

5. Provident fund of officers and employees: Almost all of the firms have provision of provident fund for its officers and employees. This fund can be used as a source of internal financing.

6. Sale of fixed asset: Sometimes fund can be collected by selling fixed asset when the asset becomes obsolete.

7. Over use of fixed assets: Every asset has an estimated life. But after the estimated period, the asset can be used for some additional years. The accumulated depreciation for the asset can be used as a source of internal financing.

(B) External sources of fund:

The fund that is collected from any sources outside the firm is called external sources of fund or external financing.

Sources of External Financing:

There are two types of external financing sources :

Institutional Sources	Non-institutional Sources
Commercial Banks	Trade Credit
Investment Banks	Outstanding Expenses
Insurance Companies	Mortgage
Development Banks	Bond and Debenture
Leasing Companies	Friends and Relatives
Capital Market	Money Lenders
Specialized Financial Institutions	

1. Institutional Sources:

➲ **Commercial Banks :** There are more than 50 commercial banks in our country. These banks can be used as institutional sources of fund. Banks provide both secured and unsecured loans to borrowers.

➲ **Investment Banks :** The main function of investment bank is to underwrite the newly issued shares of public limited companies and provide bridge financing to them. Investment Corporation of Bangladesh (ICB) acts as an investment bank in Bangladesh.

➲ **Insurance Companies :** Insurance companies gather a lot of idle cash for a long time. These idle cash can be used as institutional sources of fund. There are more than 30 general insurance companies and more than 30 life insurance companies in Bangladesh.

➲ **Development Financing Institutions :** To promote industrialization, some institutions act as sources of fund. These are Bangladesh Shilpa Bank (BSB) and Bangladesh Shilpa Rin Sangstha (BSRS).

➲ **Leasing Company :** Leasing companies play important role in mid-term financing. Industrial Development Leasing Company (IDLC) and United Leasing Company (ULC) play a vital role in this regard. Besides there are more than 30 leasing companies to provide fund.

➲ **Owners' Capital from Capital Market :** One of the external sources of fund is owner's capital. This capital can be collected from initial public offering (IPO) or seasoned public offering (SPO).

➲ **Specialized Financial Institutions :** Specialized financial institutions provide loan for special purposes. These institutions include Bangladesh House Building Finance Corporation (BHBFC), Bangladesh Krishi Bank (BKB)

2. Non-institutional Sources :

➲ **Trade Credit:** Trade credit refers to the credit that a customer gets from suppliers of goods in the normal course of business. It is an interim debt arising from credit sales and recorded as an account receivable by the seller and as an account payable by the buyers.

➲ **Outstanding Expenses:** Some expenses like telephone bill, electricity bill, etc are not paid on a cash basis. These outstanding expenses act as non-institutional sources of fund.

➲ **Mortgage:** Business firms can take loan by putting mortgage against the loan. The mortgage is a non-institutional source of fund.

➲ **Bond and Debenture:** Large and blue chip companies can raise fund by selling bonds to general investors. The difference between share and bond or debenture is that investors earn fixed income against bond and debentures.

➲ **Friends and Relatives:** Generally sole proprietorship and partnership businesses raise fund from friends and relatives.

➲ **Money Lenders:** Money lenders are another non-institutional source of fund, generally sole proprietorship and partnership businesses raise fund from this source.

10.6 Managing the Finances of the firm

Financial managers are responsible for the proper flow of funds. They help the company for the proper uses of funds and also to find appropriate sources of funds. They also invest excess cash to earn additional income of the company. In performing these duties, the financial manager has to manage the company's working capital, develop capital budgets, and develop appropriate controls.

1. Managing Working Capital: If a firm's current liabilities are subtracted from its current assets, the result is the value of working capital. Working capital represents the amount of capital available for the day-to-day running of the firm. Sufficient working capital is obviously important to the effective management of a firm's operations.

2. Develop Capital Budgets: Capital budgets represent the funds allocated for future investments of the firm's cash. These may be for the development of the factory installation of machinery etc. The process of capital budgeting involves comparing and evaluating alternative investments.

3. Developing Financial Control : Financial controls mean that once cash flow projections, capital budgets, and so on are established, they must be reviewed to make sure that the actual results match projected ones.

10.7 Specialized Financial Institutions of Bangladesh

➲ Bangladesh Shilpa Bank (BSB)
➲ Bangladesh Shilpa Rin Sangstha (BSRS)
➲ Investment Corporation of Bangladesh(ICB)
➲ Bangladesh House Building Finance Corporation (BHBFC)
➲ Bangladesh Small and Cottage Industries Corporation (BSCIC)
➲ Bank of Small Industry and Commerce (BSIC)
➲ Industrial Development Leasing Company of Bangladesh (IDLC)

- Saudia-Bangladesh Industrial and Agriculture Investment Company Limited (SABINCO)
- Industrial Promotion and Development Company of Bangladesh (IPDCB)
- United Leasing Company limited (ULC)

10.8 Problems of Financial Institutions of Bangladesh

- Political instability
- Lack of awareness
- Lack of investment climate
- Lack of investment company and merchant banks
- Lack of information about the loaners
- Failure to produce collateral
- Legal problem to realize loan
- Complex and time consuming procedure to sanction loans
- Government interference
- Lack of supervision
- Default cutlture
- Rate of interest
- Failure to reach the loan to the needy
- Problem of determining priority
- Problem of determining the amount of credit

Question to Answers :

1. What is business finance?
2. Simplify the scope and functions of business finance
3. What are the principles of business finance? Explain.
4. Discuss in brief, the classification of business finance
5. What are the sources of business finance? Discuss in details.
6. How to manage the finances of the firm?
7. Mention some specialized financial institutions in Bangladesh.
8. What are the problems of financial institutions in Bangladesh?

Multiple Choice Questions (MCQ)

1. The art and science of managing money means—

(a) economics defined (b) finance can be described
(c) source of income (d) finance can not be described

2. Over-all objective of business enterprise is related :

(a) profit from business (b) finance
(c) economies (d) economics

3. All the economical decisions should consider the business cycle concerned with.

(a) risk and return (b) hedging
(c) business cycle principle (d) principles of cach flow