METHODS AND SOURCES OF FINANCE

Method of finance is the type of finance used—such as a loan or a mortgage. The source of finance would be where the money was obtained from––a loan may be obtained from a bank while the mortgage may be obtained from a credit society. From a financial statement, we can read in what form the capital is tied up (fixed assets or current assets) and how these are financed (from own capital or borrowed funds). It is necessary to notice the difference between methods and sources of finance to identify which type of asset can be bought from what source of funds. For example, fixed asset can be bought only from long-term source of funds. If you buy a long-term asset utilising funds from short-term sources, the asset has to be sold off to repay the short-term loan, in the event of pressure to repay the loan.

METHODS OF FINANCE

The following are the common methods of finance:

- Long-term finance
- Medium-term finance
- Short-term finance

Now we will discuss each of these methods identifying the sources under each method:

Sources of Finance

The following are the different sources under various methods of finance.

I. LONG-TERM FINANCE

Long-term finance refers to that finance available for a long period say three years and above. The long-term methods outlined below are used to purchase fixed assets such as land and buildings, plant and so on

Own Capital

Irrespective of the form of organisation such as soletrader, partnership or a company, the owners of the business have to invest their own finances to start with. Money invested by the owners, partners or promoters is permanent and will stay with the business throughout the life of the business.

Share Capital

Normally in the case of a company, the capital is raised by issue of shares. The capital so raised is called share capital. The liability of the shareholder is limited to the extent of his contribution to the share capital of the company. The shareholder is entitled to dividend in case the company makes profits and the directors announce dividend formally in the general body meetings. The share capital can be of two types: *Preference share capital* and *equity share capital*. The salient features of preference share capital and ordinary share capital are discussed below:

Preference Share Capital Capital raised through issue of preference shares is called preference share capital.

Preference share A preference shareholder enjoys two rights over equity shareholders: (a) right to receive fixed rate of dividend and (b) right to return of capital. After settling the claims of outsiders, preference shareholders are the first to get their dividend and then the balance will go to the equity shareholders. However, the preference shareholders do not have any voting rights in the annual general body meetings of the company. This deprives them of the right to participate in the management of the affairs of the company.

Types of preference shares Preference shares are of five types. They are:

1. *Cumulative preference share* A cumulative preference shareholder gets his right to the arrears of dividend cumulated over a period of time. If the company is not in a position to pay dividends during a particular year due to paucity of profits, it has to pay the same to the cumulative preference shareholders when it makes profits. In other words, the holders of cumulative preference shares enjoy the right to receive, when profits permit, the dividend missed in the years when the profits were nil or inadequate.
2. *Non-cumulative preference shares* The holders of these shares do not enjoy any right over the arrears of dividend. Hence the unpaid dividend in arrears cannot be claimed in future.
3. *Participating preference shares* The holder of these shares enjoys the dividend two times. They get their normal fixed rate of dividend as per their entitlement. They participate again along with the equity shareholders in the distribution of profits.
4. *Redeemable preference shares* These shares are repaid at the end of a given period. The period of repayment is stipulated on each share.
5. *Non-redeemable preference shares* These shares continue as long as the company continues. They are repaid only at the end of the lifetime of the company.

Equity Share Capital Capital raised through issue of equity share is called equity share capital. An equity share is also called ordinary share. An equity shareholder does not enjoy any priorities such as those enjoyed by a preference shareholder. But an equity shareholder is entitled to voting rights as many as the number of shares he holds. The profits after paying all the claims belong to the equity shareholders. In case tional sources may not be available. Many banks offer such finance through their merchant banking divisions, or specialist banks which offer advice and financial assistance. The financial assistance may take the form of loans and venture capital. In the case of viable or feasible projects, the merchant banks may participate in the equity also. In return, they expect one or two (depending up on the volume of funds pumped in) director positions on the board to exercise the control on the company matters. The funds, so provided by the venture capital, can be used for acquiring another company or launching a new product or financing expansion and growth.

III. SHORT-TERM FINANCE

Short-term finance is that finance which is available for a period of less than one year. The following are the sources of short-term finance:

Commercial Paper (CP)

It is a new money market instrument introduced in India in recent times. CPs are issued usually in large denominations by the leading, nationally reputed, highly rated and credit worthy, large manufacturing and finance companies in the public and private sector. The proceeds of the issue of commercial paper are used to finance current transactions and seasonal and interim needs for funds. Reliance Industries is one of the early companies which issued Commercial Paper.

Bank Overdraft

This is a special arrangement with the banker where the customer can draw more than what he has in his savings/current account subject to a maximum limit. Interest is charged on a day-to-day basis on the actual amount overdrawn. This source is utilised to meet the temporary shortage of funds.

Trade Credit

This is a short-term credit facility extended by the creditors to the debtors. Normally, it is common for the traders to buy the materials and other supplies from the suppliers on credit basis. After selling the stocks, the traders pay the cash and buy fresh stocks again on credit. Sometimes, the suppliers may insist on the buyer to sign a bill (bill of exchange). This bill is called bills payable.

Debt Factoring or Credit Factoring

Debt Factoring is the arrangement with factor where the trader agrees to sell its accounts receivable or debtors at discount to the specialised dealers called factors. In the case of Credit Factoring, the trader agrees to sell his accounts payables (at premium).

Example

For example: X sells Y goods worth Rs 5,000. Y cannot pay cash immediately. He agrees to pay after two months. X wants cash immediately. Here X enters into a debt factoring agreement with Z who agrees to pay Rs 4,500 immediately to Y and agrees to collect Rs 5,000 after two months from Y. In this example, Z is called the *factor*. In the same example, if Y enters into an agreement with the factor, the factor pays Rs 5,000 to X and collects Rs 5,500 from Y after two months. This is called *credit factoring*.

Where the business finds its financial resources tied up in the form of debtors who are not paying on time, factoring is a good relief.

A factoring company buys these debts and provides certain additional services, for example:

- It will lend up to 70–80 per cent of outstanding debts
- It will deal with all the paper work of collecting the debts
- It will insure against non-payment of debts.

Factoring frees money due to the business and the same can be utilised for growth and expansion.

Advance from Customers

It is customary to collect full or part of the order amount from the customers in advance. Such advances are useful to meet the working capital needs.

Short-term Deposits from the Customers, Sister Companies and Outsiders

It is normal to find the supermarkets and other trading organisations inviting deposits of six months to one year duration. As an incentive, such deposit holders may be given 5–10 per cent discount on the purchases.

Internal Funds

Internal funds are generated by the firm itself by way of secret reserves,* depreciation provisions, taxation provisions, retained profits and so on and these can be utilised to meet the urgencies.

Characteristics of Common Methods of Finance