CHAPTER - 8

SOURCES OF BUSINESS FINANCE

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

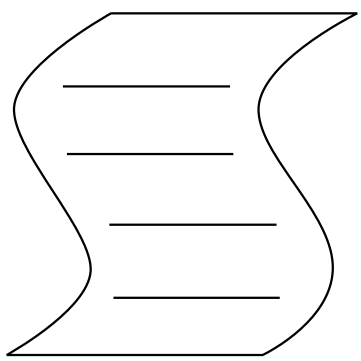
A business needs fund at the time of its formation for purchasing plant and machinery, furniture, and other fixed assets. Similarly, some funds are required for day-to-day operations, say to purchase raw materials, pay salaries to employees, etc. Also when the business expands, it needs funds.

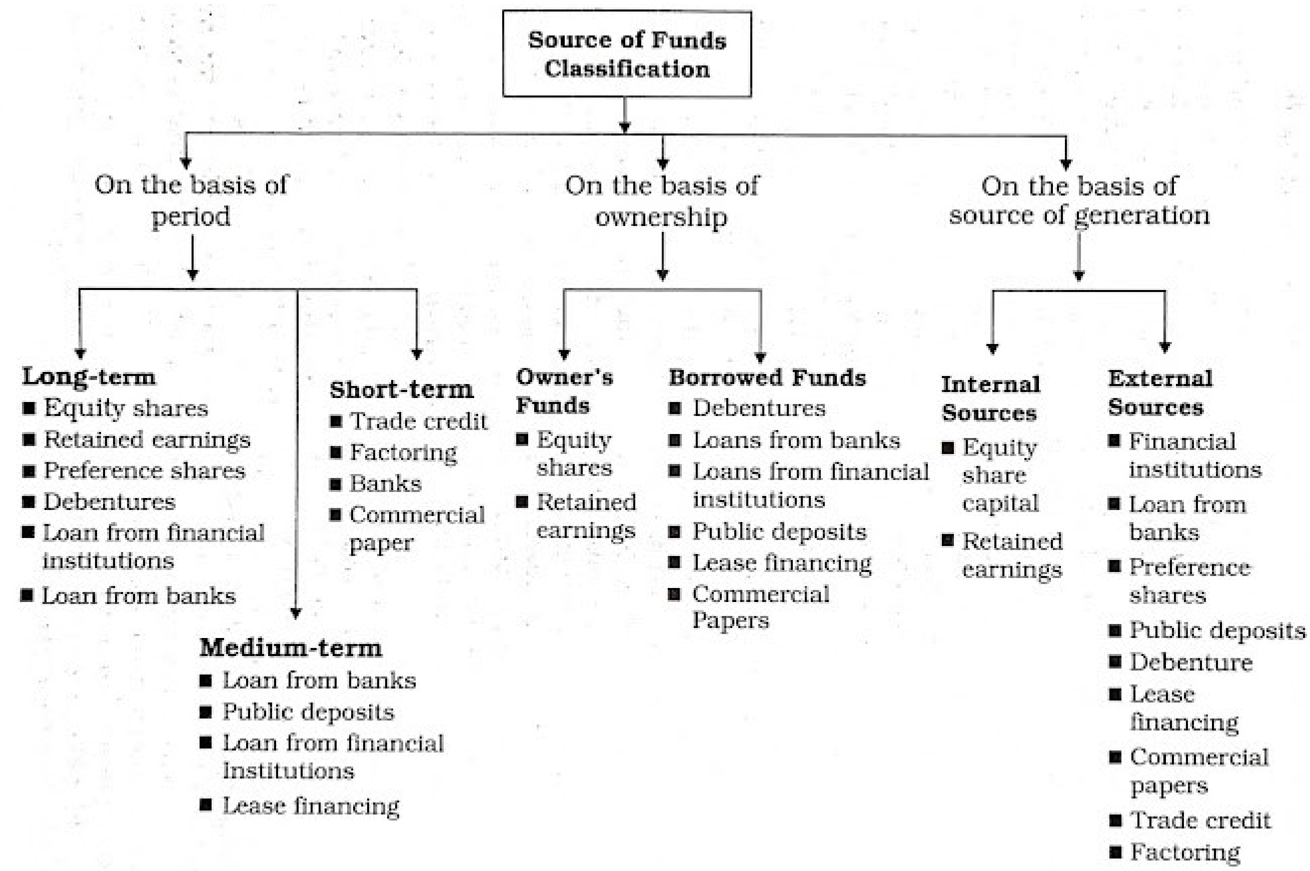
The financial needs of a business can be categorised as:

(a) Fixed Capital requirements, and

(b) Working Capital requirements

Classification of Sources of Finance





A. On the basis of Period

1. Long-term Finance

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

2. Medium-term Finance

It include funds required for a period exceeding one year but less than 5 years. These sources include borrowings from commercial banks, public deposits, lease financing and loans from financial institutions.

3. Short-term Finance

This source includes the funds required for a period not exceeding one year. Trade credit, loans from commercial banks and commercial papers are some of the examples of Short term finance.

B. On the basis of Ownership

1. Owner's Funds

Owner's funds mean funds that are provided by the owners of an enterprise. Issue of equity shares and retained earnings are the two important sources of owner's funds.

2. Borrowed Funds

Borrowed funds refer to the funds raised through loans or borrowings. The sources for raising borrowed funds include loans from commercial banks and financial institutions, issue of debentures, public deposits and trade credit.

C. On the basis of Source of Generation

1. Internal Sources

Internal sources of funds are those that are generated from within the business. A firm can generate the funds internally by accelerating collection of receivables, disposing of surplus inventories and ploughing back its profit.

2. External Sources

External sources of funds include those sources that lie outside an organisation, such as suppliers, lenders, and investors. Issue of debentures, borrowing from commercial banks and financial institutions and accepting public deposits are some of the examples of external sources.

Retained Earnings

The portion of profit which is retained in the business for future use is called retained earnings. It is also called ploughing back of profit or internal financing or self-financing.

Merits

a) It is a permanent source of funds.

b) It does not involve any cost in the form of interest or dividend.

c) No security is needed to raise funds.

d) It makes company financially strong.

e) It helps the company to meet unexpected losses.

f) It helps to increase the market price of the equity shares.

Limitations

a) Excessive ploughing back may cause dissatisfaction among shareholders.

b) It is an uncertain source of funds as the profits of business are fluctuating.

c) The opportunity cost associated with these funds is not recognised by many firms.

Issue of Shares

The capital obtained by issue of shares is called share capital. The capital of a company is divided into small units called shares. Each share has its nominal value. The person holding shares is called shareholder. There are two types of shares namely Preference shares and Equity shares.

a). Equity Shares

Equity shareholders are the real owners of the company and thus the capital raised by issue of such shares is called ownership capital. Equity shareholders do not get a fixed dividend but are paid on the basis of earnings by the company. They have the right to vote and participate in the management of the company.

Merits

a). Equity shares are suitable for investors who are willing to take risk.

b). Payment of dividend to equity shareholders is not compulsory.

c). Equity capital is a source of permanent capital.
d). Equity capital provides credit worthiness to the company.

e). Equity shares don't create any charge on the assets of the company.

f). Equity shareholders have control over management of the company due to their voting rights.

Limitations

a). Investors who want steady income may not prefer equity shares.

b). The cost of equity shares is generally higher than other sources.

c). Issue of additional equity shares dilutes the voting power of existing equity shareholders.

d). More formalities are involved in the issue of equity shares.

b). Preference Shares

Shares which carry preferential rights in receiving a fixed rate of dividend and repayment of capital on winding up of the company are called preference shares. They are paid a fixed rate of dividend only out of profit after tax before it is paid to the equity shareholders. Preference shareholders have voting rights only on matters affecting them.

Merits

a). As the rate of dividend is fixed, these shares provide a steady income.

b). These shares are suitable for investors who want a regular income with low risk.

c). It doesn't dilute the control of equity shareholders over the management of the company.

d). Payment of fixed rate of dividend to preference shares helps the company to declare higher rates of dividend for the equity shareholders.

e). They will get the repayment of capital at the time of liquidation, before it is paid to the equity shares. f) These shares do not create any charge on the assets of the company.

Limitations

a). These are not suitable for investors who are willing to take risk.

b). The rate of dividend on preference share is higher than the rate of interest on debentures.

c). As the dividend on these shares is to be paid only out of profit, there is no assured return for the investors.

d). The dividend paid is not deductible from profits as expense.

Types of preference shares

i) Cumulative and Non-cumulative

Cumulative preference shareholders will be paid arrear dividend in future years, if no dividend is paid in any year.

Non-cumulative preference shareholders will not get their arrear dividend, but only current year’s dividend.

ii) Participating and Non-participating

Participating shareholders have a right to share the surplus profits after a certain rate of dividend is paid to equity shareholders.

Non-participating shareholders have no right to share surplus profits, but will get only dividend at a fixed rate.

iii)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.

Preference shares that cannot be converted into equity shares are known as non-convertible preference shares.

Debentures

A debenture is an acknowledgement that the company has borrowed a certain sum of money, which it promises repay at a future date. Debenture holders are the creditors of the company.

They get a fixed rate of interest at specified intervals say 6 months or one year.

Merits

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

b) Debenture holders need not be paid share of profit of company.

c) It is suitable when company's earnings and sales are stable.
d) As Debenture holders don't have voting right, it doesn't dilute control of equity shareholders on management.

e). Financing through debentures is less costly as they have fixed interest.

Limitations

a) As the rate of interest is fixed, it puts a permanent burden on the earnings of a company.

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

c). In case of redeemable debentures, the company need to repay it on the specified date, even during periods of financial difficulty.

Types of debentures

i) Secured and Unsecured

Debentures which create a charge on the assets of the company are called secured debentures.

Debentures which don't create a charge on the assets of the company are called secured debentures

ii) Registered and Bearer

Registered debentures are those which are duly recorded in the Register of Debenture holders maintained by the company.

Bearer debentures are those which are issued without the names of debenture holders. These can be transferred by mere delivery.

iii) Convertible and Non-convertible

Convertible debentures are those which can be converted into equity shares after the expiry of a specified period.

Non-convertible debentures are those which cannot be converted into equity shares.

iv) First and Second

Debentures that are repaid before other debentures are repaid are called first debentures.

Debentures which are repaid after the first debentures are repaid are called second debentures.