UNIT 5 METHODS OF RAISING FINANCE

Structure

5.0 Objectives
5.1 Introduction
5.2 Need for and Importance of Finance
5.3 Types of Financial Needs
   5.3.1 Fixed Capital and Working Capital
   5.3.2 Long-term Capital and Short-term Capital
5.4 Capital Structure
   5.4.1 Ownership Capital
   5.4.2 Borrowed Capital
   5.4.3 What is Capital Structure'?
   5.4.4 Factors Determining the Capital Structure
5.5 Methods of Raising Capital
   5.5.1 Issue of Shares
   5.5.2 Issue of Debentures
   5.5.3 Loans from Financial Institutions
   5.5.4 Loans from Commercial Banks
   5.5.5 Public Deposits
   5.5.6 Retention of Profits
   5.5.7 Trade Credit
   5.5.8 Factoring
   5.5.9 Discounting Bills of Exchange
   5.5.10 Bank Overdraft and Cash Credit
5.6 Let Us Sum Up
5.7 Key Words
5.8 Some Useful Books
5.9 Answers to Check Your Progress
5.10 Terminal Questions

5.0 'OBJECTIVES

After going through this unit, you will be able to:

- explain the need for finance
- classify types of financial needs
- distinguish between ownership capital and borrowed capital
- explain the concept of capital structure and identify the factors determining it
- describe different methods of raising finance
- evaluate the advantages and limitations of different methods of raising finance

5.1 INTRODUCTION

In Unit 4 you have learnt about various steps taken by promoters before setting up any business venture. One of the important steps is of arrangement of finance for the business. No one can start a business unless adequate capital is available. In this unit you will learn why finance is needed, what the sources of finance are and the methods of raising finance to meet capital requirements of the business.

5.2 NEED FOR AND IMPORTANCE OF FINANCE

We all know that every business activity requires money to run it. Take the case of manufacturers. They must have a place to produce goods. They must buy machinery and raw materials, engage workers and managers, pay for electricity and water supply, and incur expenses for delivery of goods to their customers. Similarly, take the case of traders. They must buy goods and have godown to keep them. They have to arrange for the delivery of the goods to their customers. They must employ people for loading and unloading of goods, for keeping accounts as well as for bill collection. Take another example of goods transportation business, The transporters must buy trucks, must engage drivers and helpers, incur expenses on diesel, repairs and servicing of the vehicle, and so on. All these can be undertaken only with the help of finance. Thus, money is required for all types of business activities be it manufacturing or trading or transportation or any other kind. It is true that income is earned by business when goods are sold and services have been rendered. But this takes place afterwards. Goods must be produced or purchased before they can be sold. Arrangement of finance is therefore necessary much before any income can be earned. It costs money to build a factory, to buy machinery and raw materials, to hire a place for the business office, to pay rent, wages and salaries, and to meet to day expenses. So no one can run a business without first raising adequate finance, of course this is done in anticipation of future income, on the assumption that customers will buy the goods and services offered to them.

To run a business, besides finance, we also require men, materials, machinery and management. But finance may be regarded as the most important requirements of business. Men, materials, machinery and managers can be brought together and engaged in business when you have adequate finance. Many business firms are known to have failed mainly due to shortage of finance. The importance of finance has increased in modern times for two reasons. Firstly, the business activities are now undertaken on a much larger scale than in the past. Even if a business is started initially on a small scale, it grows in course of time. There is increasing need for finance with enlargement of business. Secondly, the manufacturing process have become more complex than in the past. Factory production requires expensive machinery, equipment and tools, and many men. It requires large quantities of materials to be procured and kept in stock. The products must be widely advertised. Distribution of the products must be arranged through wholesalers, dealers and salesmen. Thus, with the growth in size and volume of business and with the increasing complexity of production and trade, there is a growing need for finance. In an existing business on the one hand, money must be spent before money is realised from sales. On the other hand, cash realisation on account of sales over a certain period may not be equal to the amount of expenditure incurred during the same period. Finance should, therefore, be available in adequate amount as and when needed. To anticipate what amount of finance will have to be arranged at what point of time is not an easy task. This is because business conditions may change from time to time.

5.3 TYPES OF FINANCIAL NEEDS

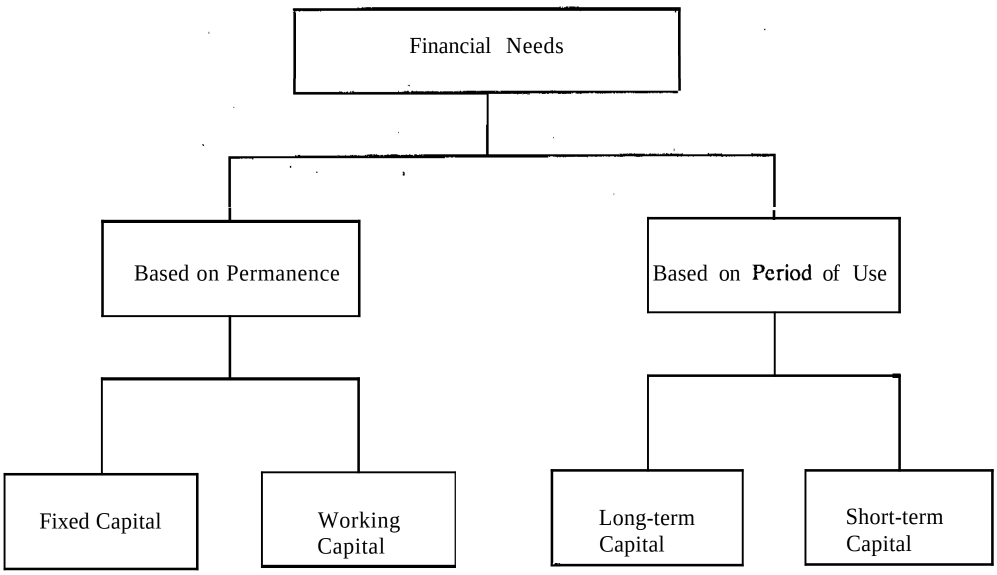
Broadly speaking, there are two ways of classifying the financial needs of the business. i) On the basis of the extent of permanence, we can classify the financial needs into: a) fixed capital, and b) working capital. ii) On the basis of the period of use, we can classify the financial needs into: a) long-term capital, and b) short-term capital. Look at Figure 5.1 for the classification of financial needs.

5.3.1 Fixed Capital and Working Capital

Fixed Capital: In every business concern money has to be invested in some fixed or durable assets like land, buildings, machinery, equipment, furniture, etc. These assets are required for permanent use, that is, for a long period of time. Funds required to purchase these assets is known as fixed capital or long-term capital. The nature and size of the business generally determines the amount of fixed capital needed. Manufacturing activities, particularly those engaged in heavy engineering, electrical, transport, shipping and ship building, electric supply, iron and steel manufacture, automobiles, etc. require large investments in plant and machinery, equipment, factory buildings, warehouses, etc. On the other hand, trading concerns need relatively lesser investment in fixed assets.

Investment in fixed assets involves a commitment for a longer period of time. These fixed assets continue to generate income and profits over an extended period of time. Moreover, funds which are once invested in fixed assets cannot be withdrawn and put to some other use.

Figure 5.1
Classification of Financial Needs



Working Capital: In business you require finance for purchase of raw material, payment of wages and salaries, rent, fuel, electricity and water, repairs and maintenance of machinery, advertising, etc. Requirements of finance for these purposes arise at short intervals. In course of business activities, it is also necessary to hold stocks of materials, spare parts, and finished goods. This involves investment in short-term assets or current assets in the form of stocks of raw materials, spare parts, stores, finished goods, etc. Besides, sale of goods on credit leads to the holding of debtors balances and bills receivable, which may also be regarded as current assets.

Money invested in current assets like stock of raw materials, finished goods, etc., and book debts (that is debtors balances as well as bills receivable) is known as Working Capital. It is sometimes known as Circulating Capital or Revolving Capital. That is because funds invested in current assets are continuously recovered through realisation of cash, and again reinvested in current assets. The amount keeps on circulating or revolving from cash to current assets and back again to cash. Although this takes place at short intervals, the amount is needed again and again. Hence part of the funds required for this purpose is of a permanent nature. It is known as the 'fixed or permanent' part of the working capital, The permanent part of working capital should accordingly be regarded as long term capital. The other part of working capital may vary due to the rise or fall in the volume of business. Hence it is known as the 'fluctuating' or 'variable' part of the working capital. Therefore, strictly speaking, only the fluctuating part of the working capital is regarded as short-term capital, the funds required are for less than a year. The amount of working capital required depends mainly on the nature of the business, the time rcquircd for completing the manufacturing process, and the terms on which materials are purchased and goods are sold. For instance, trading companies require more working capital than manufacturing companies. This is because the trading business requires large quantities of goods to be held in stock, and also carry large debtors' balances. Construction companies also require relatively larger amounts of working capital than manufacturing concerns. In both these types of business, the value of current assets is about 80% to 90% of the value of total assets. The investment in current assets is relatively smaller in the case of hotels and restaurants because they mostly have cash sales, and only small amounts of debtors balances.

Working capital requirements vary among manufacturing industries because of differences in the time involved in the production process i.e., time that passes 'between the purchase of raw materials and the production of finished goods. Longer' the processing time, the more is the amount of working capital required. For example, heavy engineering industry needs relatively more working capital than a rice mill or a cotton spinning mill or a steel rolling mill.

Another factor that determines the amount of working capital relates to the terms of credit allowed to customers. For instance, a company may allow only 15 days' credit, while another may allow 90 days' credit. One may extend credit facilities liberally to all customers, while another in the same business may grant credit only to selected reliable customers. The amount of working capital required will 'naturally be more if the credit period is longer and credit facilities are extended to all customers. In both these cases, there will be larger debtors' balance which will demand more working capital. On the other hand, if supplies of materials are available on favourable terms of credit (i.e., payments can be made at longer intervals), working capital needs will be correspondingly smaller.

5.3.2 Long-term Capital and Short-term Capital

As stated earlier fixed assets should be financed with permanent long-term capital. This is mainly because fixed assets are meant for use over a fairly long period of time, generally for five years or more. Long term capital is also required to finance the permanent part of the working capital. On the other hand, to finance current assets and meeting day-to-day expenses, capital is needed generally for a short period i.e., less than a year. This is because stocks of materials and finished goods are normally used for as sold within a year, and dues from customers are usually realised within three to six months. The main difference between long-term capital and short-term capital is that the former is required for a longer pesiod, (five years or more) while the latter is required for a short period (less than a year). Besides these capital needs, business concerns often require funds for a period of 2 to 5 years known as **medium-term capital.** Medium-term capital is required for certain activities like renovation of building, modernisation of machinery, heavy expenditure on advertising, etc.

5.4 CAPITAL STRUCTURE

The funds raised to meet both the long-term and short-term capital requirements may take the form of ownership capital or borrowed capital. Let us first understand these two terms before we talk of capital structure.

5.4.1 Ownership Capital

The amount of capital invested in a business by its owners is known as Ownership **Capital.** It is on the basis of their investment that owners become entitled to the profits of the business. In a business under sole proprietorship, the individual owner normally invests capital from his own savings. In a partnership business, each partner contributes capital as mutually agreed among partners. Companies raise capital by issuing shares. Investors who contribute towards the share capital of a company become its owners by virtue of their share holding. They are entitled to receive dividend out of the profits earned by the company. The owners cannot claim to get any return on their investment unless there is profit. The rate of return on owners investment depends on the level of profits earned. If there is no profit, the owners go without any dividend. The risk of losses and of low rates of return are, thus, associated with ownership capital. Hence it is known as 'risk capital'.

Ownership capital may be used for financing fixed assets as well'as continuous investment in current assets. Ownership capital is generally used as permanent capital or long-term capital. As risk-bearers, owners do not have any assurance whether they will get adequate returns on their investment or not. But they receive high returns if the business is successful. Besides, owners have a right to participate in the management of the business. **A** sole proprietor as also the partners of a business play an active part in running the business. Shareholders of companies do not manage the business directly. They elect members of the Board of Directors who manage the affairs of the company on behalf of the shareholders.

5.4.2 Borrowed Capital

The financial requirements of the business are often met by raising loans. Loans carry a certain fixed rate of interest which must be paid at regular intervals, half-yearly or yearly. There is also a commitment that the principal'amount will be repaid in due course. Thus, if loan is raised for a period of 10, 15 or 20 years, its repayment may fall due at the end of that period or after stated intervals according to the tams on which the loan has been raised. Interest on loan is a fixed expense which has to be paid irrespective of the income. Thus, borrowing of money involves fixed obligation to pay interest and repay the principal amount as and when due.

Money may be borrowed for short-term and long-term purposes i.e., to finance fixed assets as well as current assets. In a sole proprietory business the proprietor can borrow money on his persona! security or on the security of his existing assets. A partnership firm can raise loans on the personal security of the individual partners whereby they become jointly and severally liable. Companies can also borrow either by issuing debentures or bonds, or raise direct loans.

If business income is stable and cash is realised from debtors regularly, raising of loan is not difficult. But if conditions are such that payment of interest is not possible as and when due, serious consequences may follow. There is loss of credit worthiness, that is, suppliers may not be prepared any more to supply materials on credit, further loans may not be forthcoming and lender's and creditors may even start legal action to recover their dues. Hence, borrowing money without the ability to meet the obligations of paying interest and repaying the principal is not desirable.

However, there are certain advantages of financing business activities with loans. If the business is profitable, interest being a fixed charge, the return on owners' investment is much higher. Suppose total investment in a business is Rs. 1 lakh out of which owners have contributed Rs. 40,000 and loans have been raised for the balance of Rs. 60,000 at 15% interest per annum. The profit earned during the year is Rs. 30,000. In this case, the total amount of interest payable is Rs. 9,000. So profits after interest payment will amount to Rs. 21,000. Let us assume that tax is payable on profits at the rate of 50%. So, tax to be paid amount to Rs. 10,500. Net profit after tax will thus be Rs. 10,500. What will be the return on owner's capital? It will be Rs. 10,500 on their investment of Rs. 40,000 that is, 26.25%. Would it be so high if the owners had invested Rs. 1 lakh and there was no borrowings? Obviously not. Let us examine. Since no interest would be payable, tax would amount to Rs. 15,900 (50% of Rs. 30,000). The net profit after tax would amount to Rs. 15,000 (total profit of Rs. 30,000 minus Rs. 15,000 tax). The return on owners' capital would then be Rs. 15,000 on an investment of Rs. 1 lakh which works out to only 15%. You must have realised that owners got a higher rate of return when a part of the total investment was borrowed. If you examine all this carefully, you can notice two effects. Firstly, the amount of tax payable was less (Rs. 10,500 instead of Rs. 15,000). Secondly, the payment on account of interest was fixed. Although loans helped in the expansion of business, nothing more was to be paid to lenders. The remaining profit was entirely for the owners. Use of borrowed capital to derive the benefit of higher rates of return on owners' investment is known as 'Trading on Equity'.

5.4.3 What is Capital Structure?

You have noticed that borrowing is desirable when profits are high. But it may be dangerous to depend on loans when profits decline. Then what should be the amount of borrowing for financing business activities? The general principle is to maintain borrowed capital and owners' capital in proper proportions. For a very successful business in favourable conditions, borrowed capital may be twice or even thrice as large as owners' investment. But for a business which is suffering from declining profits, the proportion of borrowed capital should be as low as possible.

Since borrowing of funds has distinct advantages, you may expect promoters to raise as large an amount as possible through loans. But beyond a certain limit borrowing may be risky. This is because fluctuation in earning and inadequacy of available cash could lead to a situation where it may not be possible for the business to pay interest and repay the amount of loan. In that case, the financial position of the business is sure to be looked upon by suppliers and creditors as unreliable. They may stop extending credit, and in an extreme situation, the business may go bankrupt or insolvent. This danger arises basically on account of the fixed payments to be made on borrowed,capital irrespective of the earnings and the shortage of available cash.

The proportion of fixed interest bearing capital in the total capital is known as capital gearing. The capital is, thus, said to be highly geared if borrowed capital is proportionately very high in relation to the ownership capital. Correspondingly, low gearing of capital signifies a smaller proportion of borrowed capital compared with the ownership capital. The composition of the total capital consisting partly of long-term funds with fixed charge and partly of ownership funds is known as the capital structure. Thus, capital structure refers to the relative proportion in which various sources of long-term finance are used to meet the total financial requirements, like debentures and long-term loans, preference share capital, and equity capital (including reserves and surplus).

5.4.4 Factors Determining The Capital Structure

To what extent long-term funds should be raised from different sources so. as to determine the capital structure depends on a variety of factors. Let us now discuss about such factors.

1 Nature of the business: If a company is engaged in business activities in which sales are subject to wide fluctuations, it is desirable to have a smaller proportion of borrowed funds. Companies manufacturing televisions, refrigerators, machine tools and capital goods are normally subject to fluctuations in sales from time to time. If these companies have high debt ratios, they run the risk of facing financial distress during lean business due to their inability to discharge the fixed obligations. On the other hand, companies dealing in essential consumer goods of daily use dr products having inelastic demand generally have stable earnings, and thus may depend to a greater extent on borrowed capital.

Competitiveness among companies is also another aspect of business which may affect the level of earnings. For instance in the ready-made garment industry, competition among the firms is based on styles which are subject to frequent changes and mostly unpredictable. Hence, these firms rely less on borrowed capital and more on equity finance.

2 Characteristics of the company: The size of a company as well as its credit standing also determines the extent to which equity or debt capital should be raised. Small firms have to depend more on owners' funds as it is difficult for them to raise long-term loans. This is because investors consider lending to small firms to be more risky. In contrast, large companies must make use of different sources of raising funds as no single source can meet their total financial requirements. Normally investors prefer to lend money to large companies as they believe that their money is safe and the risk is less with big business firms. Similarly, firms which enjoy high credit standing among investors and lenders are in a better position to raise long-term finance from different sources.

3 Management control: Promoters who had major share holding and control the management of the company take into account the probable effect of raising funds through the issue of equity shares. Equity shareholders having voting rights can influence the policy decisions of the company or the selection of directors. But the persons whd give loans do not have any right to elect directors or to participate in the management of the company. Hence the existing management group, in order to retain their control over management, prefer to raise additional finance through the issue of debentures and preference shares.

4 Cost **of finance:** Since interest paid on borrowings is chargeable to profits before tax calculation, the cost of debt financing is inevitably lower than the expected rate of earnings (i.e. profitability) on equity capital. Hence, it is always beneficial to raise part of the total financial requirement through long-term loans. With lower cost of debt financing, the overall (average) cost of financing is reduced, and the return on equity capital is higher. This is one of the important determinants of the capital structure.

5 **Effect** of debt financing on the earnings per equity **share:** We have already explained how the rate of return on equity share capital increases if borrowed

capital is used. The effect of debt on the rate of return on equity (or earning per share) is known as 'trading on equity' or 'leverage effect', Thus in business ventures with assured prospect of rising income, there is greater emphasis on debt capital in the capital structure.

6 Expected earning in relation to interest charges: Another factor determining debt-equity ratio is the estimated coverage of interest by profits. If the average earnings of the company are expected to be three to four times the amount of interest payable on borrowed capital, it may be considered safe to raise long-term loans rather than equity capital. Three to four times coverage of interest by earnings is regarded as a reasonable assurance that interest payment would be possible even if profits decline substantially.

7 Availability of cash (cash flow): The ability of a business to discharge its fixed obligations depends essentially on the availability of liquid cash. Profits earned may be adequate to cover the fixed charges arising out of debt, but the firm may not have sufficient cash to pay as the income gets continually invested in the form of more inventory, book debts or even purchase of equipment, particularly, if it is a growing concern. Hence, besides profitability, it is necessary to estimate the cash flows before deciding on the proportion of debt in the capital structure.

8 Flexibility of capital structure: The capital structure decision is usually made by management keeping in view their ability to adjust the sources of funds. The scope of changing the capital structure in future happens to be a basic consideration. For instance, in case additional funds are needed, a firm which is already financed with heavy debt may be forced to issue equity shares with a higher cost of finance involved. Or, again if funds raised are to be refunded on account of declining business, a firm may be unable to do so if it earlier relied heavily on equity capital. Indeed, to preserve operating flexibility, it is desirable that every firm should have unused debt raising capacity for future use. On the other hand, there should be a judicious mix of debt and equity capital so that refund of debt is possible when necessary.

The most suitable capital structure known as optimal capital structure is planned taking into account the effect of alternative sources of financing and the mix of debt and equity capital which will maximise the wealth of the firm.

Check Your Progress A

1 State which of the following statements are True or False.

i) There is increasing need for finance in business only because workers always demand higher wages.

ii) No one can run a business without finance.

iii) Fixed capital is required to finance the purchase of raw materials.

iv) Relatively more fixed capital is required by manufacturing companies than trading companies.

v) Long-term investment is required for financing fixed assets as well as current assets.

vi) High gearing of capital indicates more of debt financing.

vii) The permanent part of working capital may be regarded as long-term finance.

viii) Working capital is not required by traders who buy and sell goods on credit.

ix) In a profitable business, the return on owners' capital will be more if part of the total is borrowed,

2 Fill in the blanks with appropriate words,

i) Ownership capital is also known as .... capital.

ii) .... capital is sometimes called revolving or circulating capital.

iii) Funds required for 5 years or more is regarded as .... finance.

iv) Short-term finance is required for a period upto .... years.

v) Medium-term finance is required for a period of .... years.

vi) Trading companies need more working capital than .... capital.

vii) Investment in current assets generally means .... investment.

viii) Loans may be raised for long-term as well as .... purposes.

3 Match the items in Column A with those in Column B.

Column **A**	Column B
1) Fixed capital	i) Current assets
2) Long-term finance	ii) Short-term finance
3) Medium-term finance	iii) Risk capital
4) Capital structure	iv) Durable assets
5) Working capital	v) More than 5 years
6) Ownership capital	vi) Modernisation of machinery
7) Bills receivable	vii) Borrowed capital and equity capital

5.5 METHODS OF RAISING CAPITAL

You have learnt that there are different purposes for which funds have to be raised for periods ranging from very short to fairly long duration. The size and nature of business determine the total amount of financial needs. The scope of raising funds depends on the sources from which funds may be available. For a sole proprietor, there are limited opportunities for raising funds. He can finance his business by any of the following means:

1 Investment of own savings

2 Raising loans from friends and relatives

3 Arranging advances from commercial banks

4 Borrowing from finance companies

The same methods of financing are available to partnership firms also. In both these forms of business organisations, long-term capital is generally provided by the owners, i.e., sole proprietor or the partners.

Fixed capital can be raised by way of loans from friends and relatives on the personal security of owners. Generally short-term working capital needs are met partly by trade creditors (suppliers of materials and goods) and loans from finance companies. Another method of securing both long and short-term finance is the reinvestment of profits earned from time to time.

In the case of companies, there are a number of methods of raising finance. To raise long-term and medium-term capital, companies have the following options:

1 Issue of shares

2 Issue of debentures

3 Loans from financial institutions

4 Loans from commercial banks

5 Public deposits

6 Retention of profits

The following methods may be used to finance short-term capital:

I Trade credit

2 Factoring

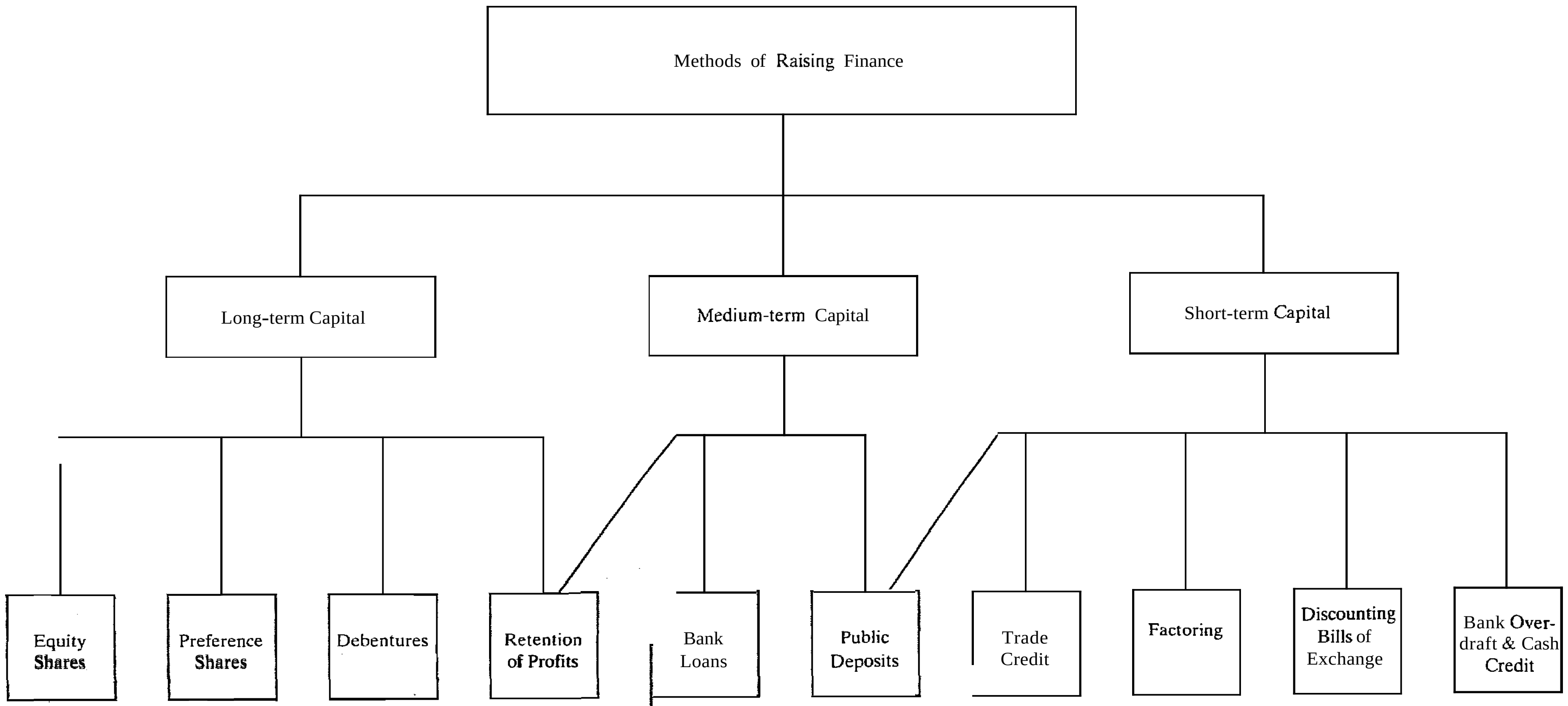
3 Discounting bills of exchange

4 Bank overdraft and cash credit

5 Public deposits

Look at Figure 5.2 for various methods adopted by companies for raising finance.

Figure 5.2 Methods of Raising Finance by Companies



Note: 1. Public deposits could be used for both medium-term as well as short-term purposes.
2. Retention of profits could be used for both Long-term as well as short-term capital purposes.

5.5.1 Issue of Shares

Issue of shares is the most important method of raising long-term capital for companies. There are two types of shares: i) equity shares and ii) preference shares. In the case of shares, the liability of shareholders is limited to the face value of shares, and also they are easily transferable. For these reasons investors prefer to invest their money in shares. Moreover, shares issued are generally of small face value viz., Rs. 10 or Rs. 100. So investment in shares is within the means of ordinary people. As you know, a private company cannot invite the general public to subscribe for its share capital. Private companies can issue shares to a limited number of persons not exceeding fifty. Also shares of private companies are not freely transferable. But for public limited companies there are no such restrictions.

Equity shares: There are several advantages of issuing equity shares to raise ownership capital. The rate of dividend on these shares depends on profits available and the discretion of directors. There is, therefore, no fixed burden on the company. The shareholders expect high rates of dividend in profitable years. But they also bear the risk associated with uncertainty of earnings of the company. Thus, risk capital is available by issuing these shares. Further, the amount raised by issue of equity shares can be used permanently. It is not required to be paid back so long as the company exists. Moreover, equity shares do not require mortgaging of the company's assets. Additional funds can be raised as loan on the security of assets.

However, excessive issue of equity shares may create problems for the promoters who may like to control the management of the company. Each equity share carries one vote for the holder. So holders of equity shares may form groups and vote against the existing directors of the company. This may not be always in the best interest of the company as a whole. Secondly exclusive dependence on equity share capital may not permit the company to take advantage of trading on equity. Besides, once equity shares are issued the amount become a permanent capital which at times may be more than what the company can use profitably. In that case, there is no way of reducing it unless detailed legal formalities are complied with. Also reduction of share capital damages the image of the company.

Preference shares: Issue of preference shares is another method of raising long-term capital. It has certain merits. Dividend is payable on preference shares at a fixed rate and is payable only if there are profits. Hence, there is no compulsory burden on the company's finances. Secondly, preference shareholders do not have voting right. So they cannot take part in the management of the company and thus are not a threat' to the promotkrs. Another advantage of preference shares is that the company can declare higher rates of dividend for equity shareholders in good years because the rate of preference dividend is fixed. Besides, permanent use of preference share capital is also not essential. A company may issue redeemable preference shares and have the flexibility of paying off the amount if necessary and replace it by some other type of capital.

Some investors subscribe to preference shares because of preferential rights as to the payment of dividend'and the return of capital. But others do not prefer it due to the fixed return as well as some risk of non-payment of dividend. Also they do not derive any benefit by way of rise in market price of the shares as is the case with equity shares.

5.5.2 Issue of Debentures

Companies generally have powers to borrow and raise loans by issuing debentures as securities of specified face value. The rate of interest payable on debentures is fixed at the time of issue, and they are recovered by a charge on the property or assets of the company, which provide the necessary security for payment. Debentures are mostly issued to finance the long-term requirements of business. There are certain advantages of issuing debentures.

i) Because of the fixed interest on debentures, companies with stable income can secure higher returns on equity capital by trading on equity.

ii) The rate of interest is usually lower than the expected rate of return on share capital. This is because debenture holders do not bear any risk.

iii) Debentures do not carry any voting right. Hence management by promoters or existing directors remains unaffected.

However, if the earnings of the company are uncertain or unpredictable, issue of debentures may pose serious problems for the company due to the fixed obligation to pay interest and repay the principal. The company is liable to pay interest even if there is no profit. If there is default in payment of interest or repayment of the principal, assets can be attached by order of the court. Trading companies which generally do not have large fixed assets, cannot provide adequate security for issue of debentures. Even for manufacturing companies the capacity to raise loans is limited by the value of their properties and assets.

5.5.3 Loans from Financial Institutions

Long-term and medium-term loans can be secured by companies from financial institutions like the Industrial Finance Corporatioh of India, Industrial Credit and Investment Corporation, State-level Industrial Development Corporations, etc. You will learn in detail about financial institutions in Unit 6. These financial institutions grant loans for a maximum period of 25 years against approved schemes or projects. Loans agreed to be sanctioned must be covered by securities by way of mortgage of the company's property or hypothecation or assignment of stocks, shares, gold, etc.

Usually the financial institutions nominate one or two directors to have some degree of control over the functioning of the company. These nominee directors may not allow decisions to be made by the Board of Directors affecting the interest of the lending institution. The loan agreement may also provide for conversion of loans into equity capital after a stated period if the lending institution so desires.

The most important advantage of this method of raising finance is that the rate of interest payable is lower than the market rate. But there is a close security of the investment project before loan is sanctioned. Preference is given to companies which submit projects in accordance with the priorities of industrial development laid down in the five year plan. The potential profitability of the project and the potential ability of the company to discharge its interest and repayment obligations are strictly evaluated. Also the companies are required to comply with a number of legal and technical formalities. Hence a long time is taken in the process of negotiating a loan from the financial institutions.

5.5.4 Loans from Commercial Banks

Medium-term loans can be raised by companies from commercial banks against the security of properties and assets. Thus, funds required for modernisation and renovation of assets can be borrowed from banks. Generally 50% to 75% of the value of industrial assets are granted as loan after the bank is satisfied about the earning capacity of the company and its ability to generate sufficient cash flows. The bank does not interfere with the management of the company. Also this method of financing does not require any legal formality except that of creating a mortgage on the assets. Besides, the loan can be repaid in parts and interest saved to that extent. Short-term loans can also be obtained from banks on the personal security of the directors of the company. These are known as **clean advances.**

5.5.5 Public Deposits

Companies often find it convenient and necessary to raise funds by inviting their shareholders, employees and the general public to deposit their savings with the company. The Companies Act permits such deposits to be received for a period up to **3** years at a time. Thus, public deposits can be raised by companies to meet their short-term and medium-term financial needs. It is a simple method of raising finance for which the company has only to advertise in the newspapers giving particulars about its financial position as prescribed by the Companies Act. The deposits are not required to be covered by mortgaging assets or by other securities. Moreover deposits can be invited by offering a higher rate of interest than the interest on bank deposits.

But companies are not permitted to raise unlimited amounts of fund through public deposits. The aggregate of all outstanding deposits cannot exceed 25% of the paid up capital and free reserves of the company. Interest to be allowed on deposits must also be in accordance with the rate fixed by the Government. Further, it is laid down in the Companies Act that at the beginning of each year, the company must deposit in a bank at least 10% of the deposits maturing during that year, or invest an equivalent amount in Government securities for repayment of deposits. Besides, the company has to file a return or statement every year with the Registrar of Companies giving all information relating to the deposits.

However, small scale industries (i.e. manufacturing companies with investment in plant and machinery not exceeding Rs. 35 lakhs) are exempted from the restrictions as to the maximum limit of deposits if the following conditions are satisfied.

i) The amount of deposit does not exceed Rs. 8 lakhs or the amount of paid up capital whicfiever is less.
ii) The paid up capital does not exceed Rs. 12 lakhs.
iii) The number of depositors is not more than 50%.
iv) There is no invitation to the public for deposits.

5.5.6 Retention of Profits

Profitable companies do not generally distribute the whole amount of profits as dividend. A certain proportion is transferred to reserves and utilised as additional capital. Thus the financial needs of a company can be met by retaining a part of the annual profits. This may be regarded as reinvestment of profits or '**ploughing back of** profits'. Since retained profits actually belong to the shareholders of the company, these are treated as a part of ownership capital, and may be used to meet long, medium and short-term financial needs. The main advantage is that there is no legal formality involved, nor does the company has to depend on external investors to raise capital. Retention of profit is a sort of self financing of business. However, only the on-going profitable companies can make use of this source of finance. For profitable companies transfer upto 10% of current profits is legally permitted. A company may transfer more than 10% of profits to reserves provided it fulfils certain conditions laid down in the rules framed under the Companies Act. In short, more than 10% of current profits can be retained only after declaring a minimum rate of dividend consistent with the dividend distributed in the past.

5.5.7 Trade Credit

Just as companies sell goods on credit, they also buy raw materials, components, stores and spare parts on credit from different suppliers. Hence, outstanding amounts payable to trade creditors as well as bills payable relating to credit purchases are regarded as sources of finance. Generally suppliers grant credit for a period of 3 to 6 months, and thus provi short-term finance to the company. Availability of this type of finance is closely connected with the volume of business. When the production and sale of goods increase, there is automatic increase in the volume of purchases, and more of trade credit is available. On the other hand, if sales decline there-is a corresponding decline in purchases of materials, and consequent decline in trade credit as a source of finance. Thus, creditors' balances (accounts payable) and bills payable help companies to finance current assets, i.e., stock of materials and finished goods as well as book debts. However, trade credit also involves loss of cash discount which could be earned if payments were made within 7 to 10 days from the date of purchase. This loss is regarded as the cost of trade credit.

5.5.8 Factoring

The amounts due to a company from customers on account of credit sale generally remain outstanding during the period of credit allowed i.e. till the dues are collected from the debtors. If necessary, book debts may be assigned to a bank and cash realised in advance from the bank. By this arrangement the responsibility of collecting the debtors' balances is taken over by the bank on payment of specified charges by the company. This is a method of raising short-term capital and known as **'factoring'.** It helps companies to secure finance against debtors' balances before the debts are due for realisation, and incidentally also helps in saving the effort of collecting the book debts. The bank charges payable for the purpose is treated as the cost of raising funds. Keeping in view the risk of bad debts, the amount to be made available by banks is calculated so as to provide for a margin for non-realisation of debts. The disadvantage of factoring is that customers who are in genuine difficulty do not get the facility of delaying payment which they might have otherwise got from the company.

5.5.9 Discounting Bills of Exchange

This method is widely used by companies for raising short-term finance. When goods are sold on credit, bills of exchange are generally drawn for acceptance by the buyers of goods. The bills so drawn are payable after **3** or 6 months depending on the prevailing practice among traders. Instead of holding the bills till the date of maturity, companies generally prefer to discount them with commercial banks on payment of a charge known as bank discount. Bills are endorsed in favour of the bank so as to enable it to realise the amount of the bill on maturity from concerned parties. The amount of discount is deducted from the value of bills at the time of discounting. The rate of discount to be charged by banks is prescribed by the Reserve Bank of India from lime to time. It really amounts to the interest for the period from the date of discounting to the date of maturity of the bill. If any bill is dishonoured on maturity, the bank returns it to the company which then becomes liable to pay the amount to the bank. The cost of raising finance by this method is the discount charged by the bank.

5.5.10 Bank Overdraft and Cash Credit

Arranging cash credit and overdraft with commercial banks is a common method adopted by companies for meeting short-term financial requirements. Cash credit refers to an arrangement on a continuing basis whereby the commercial bank allows money to be drawn as advance from time to time within a specified limit known as cash credit limit. This facility is granted against the security of goods in stock, or promissory notes bearing a second signature, or other marketable instruments like Government bonds. The company is allowed to draw whatever amount is required at different times within the limit agreed upon. The cash credit limit may bc revised according to the value of securities. The money drawn can be repaid as and when possible. Interest is charged on the actual amount withdrawn.

Overdraft is a temporary arrangement with the bank which permits the company to overdraw from its current deposit account with the bank upto a certain limit. The overdraft facility is also grantecl against securities as in the case of cash credit. Interest is charged only on the amount actually overdrawn.

The rate of interest charged on cash credit and overdraft is relatively much higher than the rate of interest on bank deposits. But this method of financing has the flexibility of allowing funds to be drawn for short-term purposes according to changing needs which depend on business conditions.

Check Your Progress B

1 Six methods of raising finance are mentioned below. Indicate by tick marks the methods which can be used for raising fixed capital.

i) Issue of equity shares
ii) Clean advance from banks
iii) Public deposits
iv) Loans from financial institutions
v) Discounting of bills
vi) Issue of preference shares

2 Which of the following methods can be used by a company for raising short-term finance? Put a tick mark against those methods only.

i) Issue of debentures
ii) Cash credit
iii) Public deposits
iv) Bank overdraft
v) Term loans from banks

3 Read the following statements and indicate which of them are True or False.

i) 'Trading on equity' is possible if a company issues preference shares and debentures for raising necessary capital.
ii) Fixed capital can be raised by issuing preference shares.
iii) Factoring means appointing a bank as collecting agent.
iv) Equity share capital can be used for investment in fixed assets as well as current assets.
v) Bills of exchange can be discounted with a bank on payment of interest in advance.
vi) Any amount of public deposits can be raised by a company.
vii) Issue of debentures must be covered by adequate security of assets.
viii) Cash credit is just like clean advance from banks.
ix) Term loans can be raised from commercial banks for long-term purposes.
x) Trade credit helps in financing short-term investments.

4 Fill in the blanks with appropriate words selected from the words given in the brackets.

i) Equity shares are issued for ....(investment in fixed assets, financing operating expenses, modernisation of plants)
ii) Short-term working capital is generally raised from ....(financial institutions, general public, commercial banks)
iii) Cash credit is granted against the security of ....(fixed assets, goods in stock, bank balance)
iv) The cost of trade credit is ....(loss of profit, loss of cash discount, loss of interest)
v) Amount due from customers on account of credit sale requires ....financing. (long-term, medium-term, short-term)
vi) Public deposits can be raised by companies for a maximum period of .... (2 years, 3 years, 4 years)

5.6 LET US SUM UP

Every business firm requires money or finance to run its activities. The importance of finance has increased in modern times for two reasons: (i) business activities are now undertaken on a much larger scale than in the past, and (ii) manufacturing processes have become more complex than before.

Broadly speaking, the financial requirements of a business are of two types: i) fixed capital and ii) working capital. Finance required to purchase fixed assets is known as fixed capital or long-term capital. Finance needed for investment in current assets is known as working capital or circulating capital. The nature of business and size of the business unit generally determine that amount of fixed capital needed. On the other hand, the amount of working capital depends upon the nature of business, the time required for completing the manufacturing process, and the terms on which materials are purchased or goods are sold.

Funds raised to meet the financial requirements of a business can be classified as ownership capitaland borrowed capital. The amount of capital invested in a business by its owners (proprietor, partners or shareholders) is known as ownership capital. Borrowed capital may be raised by way of direct loans, or by issue of debentures or bonds in the case of a company. Ownership capital is raised by companies by issuing shares. Borrowed capital is often used to derive the benefit of higher rates of return on owners' investment. This is known as 'trading on equity'.

'Capital structure' refers to the relative proportion in which different sources of long-term finance is used to meet the total requirements. The proportion of fixed interest bearing capital in the total capital is known as 'capital gearing'.

The main difference between long-term finance and short-term finance is that the former is required for use over a longer period, five years or more, while the later is required for a short period of less than a year. Finance required for a period of 2 to 5 years is known as medium-term finance.

Sole proprietorship concerns and partnership firms have limited opportunities of financing their business. They can use one or more of the following methods of raising funds: investment of own savings, raising loans from friends and relatives, advance from commercial banks and borrowings from finance companies, all against personal security or against the security of their own assets and properties.

A company may decide to use one or more of the following methods to meet the needs of long-term and medium-term finance: issue of shares, issue of debentures, loans from financial institutions, loans from commercial banks, public deposits and retention of profits.

To raise short-term finance, a company may use trade credits, factoring, discounting bills of exchange, arranging bank overdraft and cash credits, and raising public deposits. Each of these methods have certain advantages as well as disadvantages.

5.7 KEY WORDS

Borrowed Capital: Funds raised by way of loans or issue of debentures, which entitle the investors (i.e. lenders) to claim regular payment of interest and repayment of the loan when due.

Capital Gearing: The proportion of fixed interest-bearing capital in the total capital of a business.

Capital Structure: Proportion in which different sources of long-term finance are used to meet the total funds requirement, like shares, debentures, loans, retained profits, etc.

Factoring: Assignment of book debts to a bank and receiving cash in advance with the responsibility of collecting the debts taken over by the bank on payment of specified charges.

Fixed Capital: Funds required for purchase of fixed assets like land, building, plant and machinery, furniture, etc..

Long-term Finance: Finance required for use over a long period, five years or more, meant for purchase of fixed assets and continuous investment in a part of the current assets.

Mediutn-term Finance: Funds required for use over a period of 2 to 5 years, generally for renovation of building, modernisation of plant and machinery, etc.

Ownership Capital: Funds invested by owners of business for permanent use, which entitle them to decide how the business activities will be managed and what will be their share in the profits.

Public Deposits: Deposits raised from the public for medium or short-term financial needs.

Short-term Finance: Funds required for short periods, less than a year, meant for financing current assets which fluctuate due to changing volume of business.

Trade Credit: Outstanding amounts payable to suppliers of raw materials and consumable items and bills payable relating to credit purchases.

Trading on Equity: Use of borrowed capital to have a higher rate of return on equity capital.

Working Capital: Funds required for holding current assets like stock of raw materials; finished goods, book debts, bills receivable, etc.

5.8 SOME USEFUL BOOKS

Bhushan, Y.K. 1987. *Fundamentals of Business Organisation and Management,* Sultan Chand & Sons: New Delhi. (Part 8, Chapters 1 & 2)

Kuchhal, S.C. *Corporation Finance,* Chaitanya Publishigg House: Allahabad.

Paish, F.W. 1975. *Business Finance,* Pitman: London (Chapters 1-3)

Singh, B.P. and T.N. Chhabra. 1988. *Business Organisation & Management,* Kitab Mahal: Allahabad. (Chapters 16 & 17).

5.9 ANSWERS TO CHECK YOUR PROGRESS

A 1 i) False ii) True iii) False iv) True
v) True vi) True vii) True viii) False
ix) True

2 i) Fixed ii) Working iii) Long-term iv) One
v) 25. vi) Fixed vii) 'short-term viii) Short-term

3 1) iv 2) v 3) vi 4) vii 5) ii 6) iii 7) i

B 1 i, iv, vi

2 ii, iii, iv

3 i) False ii) True iii) False iv) True v) True
vi) False vii) True viii) False ix) False x) True

4 i) investment in fixed assets
ii) commercial banks
iii) goods in stock
iv) loss of cash discount
v) short-term finance
vi) 3 years

5.10 TERMINAL QUESTIONS

1 Discuss briefly the importance of finance in business. Distinguish between fixed capital and working capital.

2 State the purposes for which working capital is required. Discuss the factors determining working capital needs.

3 What are the advantages of raising capital through borrowings?

4 What is meant by ownership capital? What are its merits and limitations?

5 State the methods of raising fixed capital.

6 What are the methods of raising short-term capital? Discuss.

7 Briefly explain the merits and demerits of issuing debentures. Compare it with equity shares as a method of raising fixed capital.

8 Compare the relative advantages and disadvantages of issuing equity shares and preference shares.

9 What are the advantages of raising finance through public deposits? What are the legal requirements to be fulfilled for raising public deposits?

10 Discuss briefly 'factoring' and 'discounting of bills of exchange' as methods of raising short-term finance.

11 What do you understand by overdraft and cash credit facilities? Mention the types of securities required for cash credit and overdraft.

12 What is meant by capital structure? What factors should management take into account while deciding on a capital structure?

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not send your answers to the university. They are for your practice.