Sources of Finance

Question 1. Answer in not more than 15 words:
(i) What is public financing?
(ii) Define debentures as a source of finance.
(iii) Why is equity share capital called “Risk Capital”?
(iv) From which type of capital are raw-materials purchased?
Answer:
(i) It is a process of arranging finance from public by an entrepreneur. It is usually raised through shares and debentures.
(ii) Debenture is a formal document issued by an enterprise containing acknowledgement of debt. It normally have set terms and conditions. These conditions may be regarding payment of interest, time period of repayment, mode of repayment etc. According to Section 2 (12) of Indian Companies Act, 1956 debenture includes debenture stock, bonds and any other securities of the company whether constituting a charge on the company’s assets or not.
(iii) Equity shareholders are the virtual owners of the company. Thus, company is under no obligation to pay them either the principal amount or dividend and that’s make them true risk bearers. For start-up entrepreneur, accessing equity capital may be a difficult task as risk involved for investor is high.
(iv) It is working capital because working capital is a short-term capital.

Question 2. Answer in not more than 50 words:
(i) On the basis of duration, classify the sources of finance.
(ii) What are the major sources of capital of a Public Limited Company?
(iii) In terms of tax benefits, which one of the two-preference shares or debentures will be preferred by the organization? Give reasons.
Answer: (i) Sources of finances can be classified on the basis of duration:

Sources of Long-term Finance	Sources of Short-term Finance
There are numbers of sources of long-term finance which are listed below: Venture capital • Debentures Share issues • Owners savings • Bank loans– medium or long term loans • Leasing	There are a number of sources of short-term finance which are listed below: 1. Trade credit 2. Bank credit – Loans and advances – Cash credit – Overdraft – Discounting of bills 3. Customers’ advances 4. Installment credit 5. Loans from co-operatives

(ii) Equity.
(iii) Debentures will be preferred.
Reason: The interest paid on the borrowed fund is tax deductible, i.e. no tax is to be paid the entrepreneur on interest.

Question 3. Answer in not more than 75 words:
(i) Define ‘personal financing’. Give its sources.
(ii) Differentiate between ‘equity shares’ and ‘preference shares’.
(iii) Differentiate between ‘owner’s funds’ and ‘borrowed funds’.
Answer: (i) The entrepreneur always makes the initial investment capital available. Either he invests his personal cash or converts his assets into cash for investment. Generally, the entrepreneur very

often mobilizes his personal resources for enterprise development using his private assets or from his members of the family, dear and the near ones.
The investors from the family may not have a legal hold on the enterprise. They tend to remain as silent partners extending informal assistance.
Sources
(a) Personal Savings: Past savings, if any, is the most conventional source of financing, dependable, readily available and without incurring any liability. This accumulated form of minor or major savings done by entrepreneur is an internal source and meets out small, short term requirements.
(b) Friends and Relatives: Arranging finance from near and dear ones viz. (a) friends
(b) relatives (c) known persons, in informal manner is even a popular source of financing.
(c) Chit Funds: This customary source where in some members who might be friends, or known, etc. form a type of club, committee, party, association, etc. keep paying monthly deposits privately and can claim the 'chit' if his sudden demand for money i.e. like 'kitty'. This premature encashing of the deposited amount is like an internal source of financing and personal.
(d) Deposits from Dealers: When the dealers or distributors are appointed by the business firm, the dealers selected are required to give security deposits to the entrepreneurs, depending upon the reputation, goodwill and creditability of the enterprise. This can be used as a short term source of financing.
(ii)

S.No.	Basis	Equity Shares	Preference Shares
1.	Payment of dividend	They get the dividend after the payment to preference share holders.	The holder of these shares have the preferential right as to the payment of dividend.
2.	Voting rights	The holder of these share holders enjoy voting rights.	The holder of these shares do not enjoy any voting right except at their class meeting.
3.	Repayment of capital	They get the repayment after making repayment to preference share holders.	They get the first preferential right for the repayment of capital.
4.	Rate of interest	The rate of dividend are fluctuating means can vary from year to year.	The rate of dividend is fixed.
5.	Convertibility	It cannot be converted.	It can be converted into equity shares.
6.	Redeemable	Equity shares are not redeemable during the lifetime of the company.	Preference shares are redeemable during the lifetime of the company.

(iii)

S.No.	Basis	Owners Fund's	Borrowed Fund's
1.	Permanence	It is a permanent capital of an enterprise except redeemable preference shares.	It is not a permanent capital.
2.	Risk of Capital	Risk of such capital is bared by an entrepreneur.	Risk of such capital is not bared by an entrepreneur.
3.	Obligation	It do not increase the obligation interest periodically.	It increases the obligations of paying of the enterprise.
4.	Security	Such type of funds do not need any security of assets.	Assets are to be provided as security.
5.	Control	Such funds strengthens the entrepreneurs control over the enterprise.	Such funds normally do not dilute the control of enterprise, however some conditions are to be fulfilled by the entrepreneur.
6.	Types	Equity shares, retained earnings.	Debentures and long-term loan.

Question 4. Answer in not more than 150 words:
(i) Public deposits are a good source of raising medium term finance. How?
(ii) When is it appropriate to use financial institutions as a source of financing?
(iii) Name the following:

(a) The persons who are given preference in payment of dividend and repayment of capital.
(b) The person who are owners of a company.
(c) The secured creditors of a company.
(d) The source of finance in which the right to use assets for a specific period is worked out.
Answer: (i) Public deposits are a good source of raising medium term finance
(a) It is source of investment through the general public and public are supposed to deposit their savings with his company.
(b) The company at the time of accepting the amount of deposit immediately issues a receipt mentioning the amount of loan, rate of interest and date of repayment.
(c) The deposit period should not exceeding 36 months.
(d) The existing shareholders or any employees of the company can deposit the money.
(e) The depositor will get the principal amount and the rate of return (interest).
(f) The rate of interest is generally higher than the rate applicable on bank deposits.
(g) The depositors have no rights and control over the management, and
(j) The company does-not give any guarantee of paying back of interest and loan amount.
(i) They are like unsecured creditors of the company.
(j) The deposit amount of depositer with the company are not insured with the insurance company.
(ii) Financing an enterprise-whether large or small-is a critical element for success . in business. Financing is the use and manipulation of money. Raising money for a business is one aspect of financing. All new entrepreneurs most of the time face difficult problems to arrange startup finance.
While finance is a life blood of the business and is needed throughout the life of business, the new entrepreneur faces significant difficulties in acquiring capital at start-up.
(a) The entrepreneur needs to consider all possible sources of capital and select the one that will provide the needed funds at minimal.
(b) Different sources of funds are used at various st ages in the growth and development of the venture.
(c) If an entrepreneur cannot personally supply the necessary amount of money, other option is 'OTHER PEOPLE'S MONEY (OPM)'. It means, before seeking outside financing; an entrepreneur should first explore all methods of internal financing and the other external financing and if it suits an entrepreneur he can go for use financial institutions as a sources of financing.
(d) Financial institutions provide services as intermediaries of financial markets. There are three major types of financial institutions.
(i) Depository institutions (ii) Contractual instutions
(iii) Investment institutions
(e) Sources of finance to industry, other than commercial banks. These institutions are established by the Central/State Government, aiming at:
(a) Promoting the industrial development of a country.
(b) Providing both owned capital and land capital for long and medium term requirements.
(c) Supplement the traditional financial agencies like commercial banks.
(d) To encourage setting up of industries in backward areas.
(e) To provide technical assistance to industrial units.
(f) To develop investment markets.
(iii) (a) Preference shares (b) Sharesholders
(c) Debentures (d) Term loan.

Question 5. Answer in not more than 250 words:
(i) What is 'venture capital'? Explain the mode of raising funds.
(ii) Discuss the various sources of financing capital through ownership.
(iii) Explain the term 'debt financing'. How are Banks an important source of debt financing?
Answer: (i) The term venture capital is defined as a equity by which an investor supports an
entrepreneur talent with finance and business skills to exploit market opportunities and thus obtain a long term market gains. These are investors and investment companies whose specialty is financing new, high potential, high-technology oriented entrepreneurial ventures.
The mode of raising finds through venture capitalists :
(a) They are more interested in financing ventures which are in their second or third stage of development.
(b) They often provide initial equity investment to start up a business.
(c) Such ventures can be of software, biotechnology, high-potential ventures, high- technology ventures or are venture having high potential prospects and returns expected.
(d) Venture capitalists look for a high rate of return. Thus, they want equity, or some share of ownership in return for their capital.
(e) They are willing to take the higher risk of losing their capital for a chance of profit from the business's success.
(f) The venture capitalist sells his or her percentage of the business to either another investor or back to the entrepreneur after specific number of years association or when he finds returns lowering down.
(g) Mostly small business approach to venture capitalists when they want to start or grow a business but couldn't persuade banks to lend money.
(h) These investors have a deep insight about the fields in which they make their investment, but they behave like more or less as non-working partners do not interfere in the management of the enterprise but protect them at initial stage by keeping good contact with them.
(i) Venture capitalist more careful while investing in any venture as they know that investment is highly liquid. It means it is not subject to repayment on demand.
(ii) On the basis of ownership, finance may be classified into two categories:

Basis	Owner's Funds	Borrowed Funds
Meaning	Owners fund is that part of the total investment which is invested by the owner of the business.	It is that amount of borrowed by the enterprise from outsiders for the normal running of the enterprise.

Forms of Organisation:		
Sole Tradership	Capital contributed by the sole trader and profit reinvested by him.	Loan raised by sole trader with or without any security from relatives friends, banks and institutions money lenders.
Partnership firm	Capital contributed by the partners.	Loans raised by partner's wife, friends, relatives, money lenders, banks and financial institutions.
Joint Stock Company	Capital raised by issuing shares *plus* net reserves and surplus profit.	Loans raised by secured or unsecured loans from banks and financial institutions and secured and unsecured debentures.
Advantages	• Right to control over management. • It provides risk capital. • It decreases obligations of an entrepreneur. • It always encourages development of the enterprise.	• No right to control over management of the enterprise. • There is no risk of control over management. • Interest is tax deductible expenses.
Disadvantages	• It will be difficult to raise owner's funds if the profit earning capacity is comparatively. • The capital raised through owner's funds always depends on large number of persons, those who are ready to take risk of investing personal savings.	• Banks and other financial institutions provide loan to the enterprise against some collateral securities. • There is a fixed obligation to pay the principal amount and amount of interest.

(iii) Debt-financing is a financing method involving an interest-bearing instruments, usually a loan, the payment of which is only indirectly related to the sales and profits of the venture. Typically, debt financing called as asset-based financing requires that some asset, e.g. car, house, etc. be used as a collateral. Here, the entrepreneur is to pay back the amount of funds borrowed and the amount of interest.

Commercial banks, generally extends short term to medium term loans to firms of all sizes and in many ways like:

(a) Overdraft: A temporary arrangement in the form of a permission granted to the customers to withdraw more than the amount standing to his/her credit.

How it works:

1. Under overdraft, the bank permits the customer to overdraw his account up to a certain limit for an agreed period.
2. To avail of this facility, a customer should have a current account with that bank.
3. Interest is charged on the amount actually overdrawn.
4. Overdraft may be allowed on the security of assets or customer's personal security.

(b) Cash Credit: This facility is like overdraft arrangement with its features being:

1. The bank allows the borrower to borrow up to a specified limit.
2. The amount is credited to the account of the borrower.
3. The customer can withdraw this amount as and when he requires.
4. Interest is charged on the amount actually withdrawn.
5. Cash credit is usually granted on a bond or some other security.

(c) Discounting of Bills/Factoring: Discounting of bills, is an arrangement, where in the bank encashes the customer's bills before they become due for payment. For this, the bank charges a nominal amount called discounting charges. In case the bill is dishonoured on due date, the bank can recover the amount from the customer. Similarly, factoring is a financial service which is rendered by the specialized person known as a 'factor', who deals in realizing the book debts, bills receivables, managing sundry debtors and sales registers of the commercial and trading firms in the capacity of agent for a commission called commercial charges or discount, Thus, it is the sale of accounts receivables to a bank or finance company or anyone else.

(d) Loans and Advances: A loan is a lump sum advance made for a specified period. Here, the entire amount is paid to the borrower in lumpsum either in cash or by way of transfer to his account. In this:

1. The borrower may withdraw the entire amount in a lumpsum or in installments as per his/her needs.
2. The interest is charged on full amount of loan irrespective of how

much had been actually withdrawn.
3. Loans are generally granted against the security.
(f) Term Loan: These loans are extended by the banks to their customers for fixed period to purchase:
1. Machinery 2. Trucks, scooters 3. Houses, etc.
The borrower repays these back in monthly/quarterly/half yearly/annual installments.
(g) Demand Loans: These loans are provided by the banks against the security of Fixed Deposits Receipts (FDR), Government Securities, Life Insurance Policies, etc. These loans are called demand loans because bank can demand them at any time, by giving notice to the customer.

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