Sources of Finance- Classification of Source of Finance

Business Finance Meaning

Business finance is the funds required to establish, operate business activities, and expand in the future. Funds are specifically required various purchase type of tangible assets such as furniture, machinery, buildings, offices, factories, or intangible assets like patents, technical expertise, and trademarks, etc.

Apart from the assets mentioned above, other things that require funding are the day-to-day operational activities of a business. This activity includes purchasing raw materials, paying salaries, bills, collecting money from clients, etc. It is essential to have sufficient amount of money to survive and grow the business.

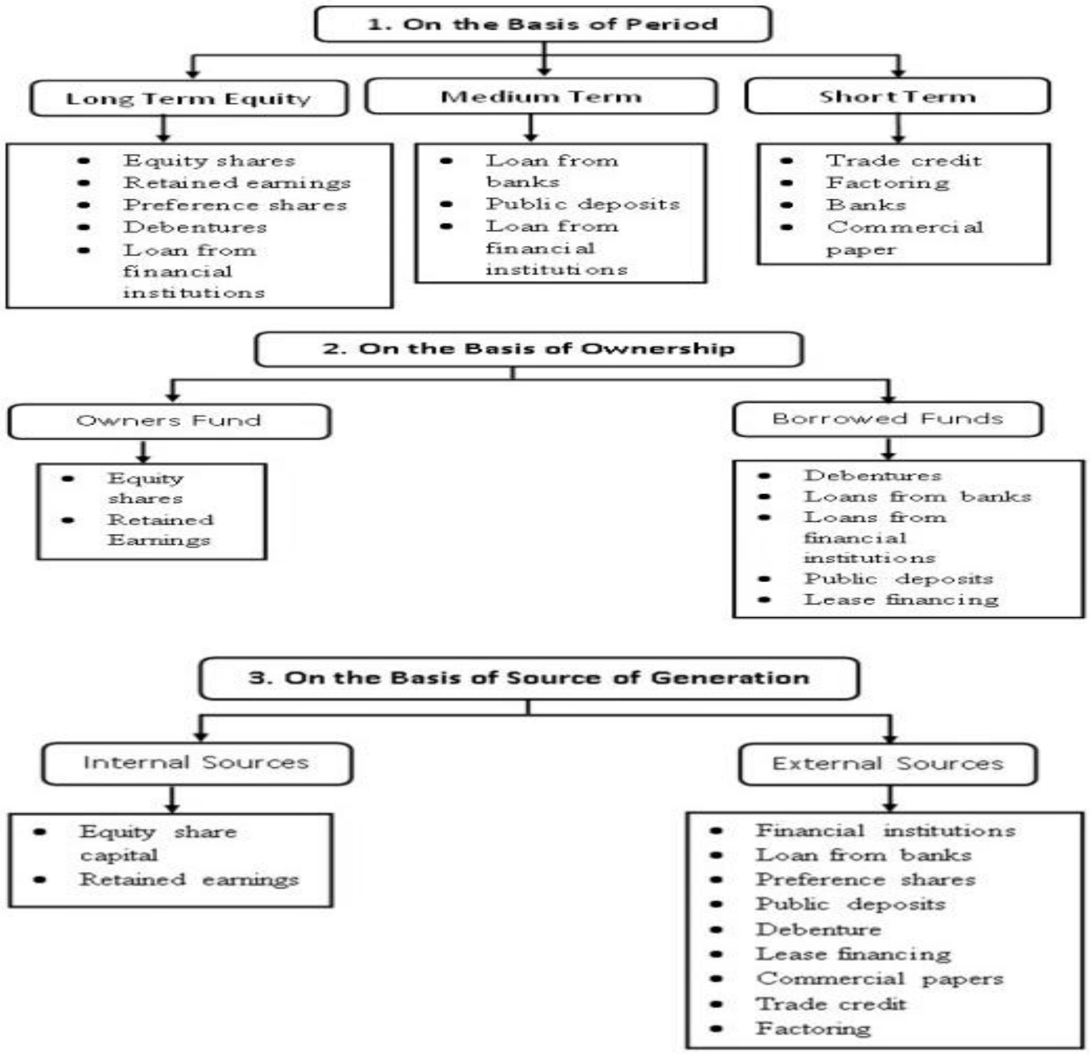
Source of Finance

Sources of finance for business are equity, debt, debentures, retained earnings, term loans, working capital loans, letter of credit, euro issue, venture funding etc. These sources of funds are used in different situations. They are classified based on time period, ownership and control, and their source of generation. It is ideal to evaluate each source of capital before opting for it.

Sources of capital are the most explorable area especially for the entrepreneurs who are about to start a new business. It is perhaps the toughest part of all the efforts. There are various capital sources, we can classify on the basis of different parameters.

Classification of Sources of Funds

Businesses can raise capital through various sources of funds which are classified into three categories.



1. Based On Period

The period basis is further divided into three sub-division.

i. Long Term Source of Finance –

Long-term financing means capital requirements for a period of more than 5 years to 10, 15, 20 years or maybe more depending on other factors. Capital expenditures in fixed assets like plant and machinery, land and building etc of a business are funded using long-term sources of finance. Part of working capital which permanently stays with the business is also financed with long-term sources of funds. Long-term financing sources can be in form of any of them:

- Share Capital or Equity Shares

- Preference Capital or Preference Shares
- Retained Earnings or Internal Accruals
- Debenture / Bonds
- Term Loans from Financial Institutes, Government, and Commercial Banks
- Venture Funding
- Asset Securitization
- International Financing by way of Euro Issue, Foreign Currency Loans, ADR, GDR etc.

ii. Medium Term Source of Finance –

Medium term financing means financing for a period of 3 to 5 years and is used generally for two reasons. One, when long-term capital is not available for the time being and second when deferred revenue expenditures like advertisements are made which are to be written off over a period of 3 to 5 years. Medium term financing sources can in the form of one of them:

- Preference Capital or Preference Shares
- Debenture / Bonds
- Medium Term Loans from
- Financial Institutes
- Government, and
- Commercial Banks
- Lease Finance
- Hire Purchase Finance
- Commercial paper

iii. Short Term Source of Finance –

Short term financing means financing for a period of less than 1 year. The need for short-term finance arises to finance the current assets of a business like an inventory of raw material and finished goods, debtors, minimum cash and bank balance etc. Short-term financing is also named as working capital financing. Short term finances are available in the form of:

- Trade Credit
- Short Term Loans like Working Capital Loans from Commercial Banks
- Fixed Deposits for a period of 1 year or less
- Advances received from customers
- Creditors
- Payables
- Factoring Services
- Bill Discounting etc.

2. Based On Ownership and Control

These sources of finance are divided into two categories.

i. Owner's Fund –

This fund is financed by the company owners, also known as owner's capital. It is sourced from promoters of the company or from the general public by issuing new equity shares. Promoters start the business by bringing in the required capital for a startup. Following are the sources of Owned Capital

- Equity Capital

- Preference Capital
- Retained Earnings
- Convertible Debentures
- Venture Fund or Private Equity

Further, when the business grows and internal accruals like profits of the company are not enough to satisfy financing requirements, the promoters have a choice of selecting ownership capital or non-ownership capital. This decision is up to the promoters. Still, to discuss, certain advantages of equity capital are as follows

It is a long-term capital which means it stays permanently with the business.

There is no burden of paying interest or installments like borrowed capital. So, the risk of bankruptcy also reduces. Businesses in infancy stages prefer equity capital for this reason.

ii. Borrowed Funds –

These are the funds accumulated with the help of borrowings or loans for a particular period of time. This source of fund is the most common and popular amongst the businesses. Borrowed or debt capital is the capital arranged from outside sources. These sources of debt financing include the following:

- Financial institutions,
- Commercial banks or
- The general public in case of debentures

In this type of capital, the borrower has a charge on the assets of the business which means the company will pay the borrower by selling the assets in case of liquidation. Another feature of borrowed capital is regular payment of fixed interest and repayment of capital. Certain advantages of borrowing capital are as follows:

- There is no dilution in ownership and control of the business.

- The cost of borrowed funds is low since it is a deductible expense for taxation purpose which ends up saving on taxes for the company.
- It gives the business a leverage benefit.

3. Based On Source of Generation

This source of income is categorized into two divisions.

i. Internal Sources –

The owners generated the funds within the organization. These are as follows:

- Retained profits
- Reduction or controlling of working capital
- Sale of assets etc.

The internal source of funds has the same characteristics of owned capital. The best part of the internal sourcing of capital is that the business grows by itself and does not depend on outside parties. Disadvantages of both equity capital and debt capital are not present in this form of financing. Neither ownership dilutes nor does fixed obligation/bankruptcy risk arise.

ii. External Sources-

An external source of finance is the capital generated from outside the business. Apart from the internal sources of funds, all the sources are external sources of capital.

Deciding the right source of funds is a crucial business decision taken by top-level finance managers. The wrong source of capital increases the cost of funds which in turn would have a direct impact on the feasibility of project under concern. Improper match of the type of capital with business requirements may go against the smooth functioning of the business.

For instance, if fixed assets, which derive benefits after 2 years, are financed through short-term finances will create cash flow mismatch after one year and the manager will again have to look for finances and pay the fee for raising capital again.