Class XI Business Studies

Chapter 8 Sources of Business Finance

Revision Notes

MEANING, NATURE AND SIGNIFICANCE OF BUSINESS FINANCE

- A business cannot function unless adequate funds are made available to it. The initial capital contributed by the entrepreneur is not always sufficient to take care of all financial requirements of the business.
- A business person, therefore, has to look for different other sources from where the need for funds can be met.
- The financial needs of a business can be categorised as follows:
    - Fixed capital requirements: In order to start business, funds are required to purchase fixed assets This is known as fixed capital requirements of the enterprise. The funds required in fixed assets remain invested in the business for a long period of time.
    - Working Capital requirements: No matter how small or large a business is, it needs funds for its day-to-day operations. This is known as working capital of an enterprise, which is used for holding current assets
- The requirement for fixed and working capital increases with the growth and expansion of business. At times additional funds are required for upgrading the technology employed so that the cost of production or operations can be reduced
- It is important to evaluate the different sources from where funds can be raised

CLASSIFICATION OF SOURCES OF FUNDS

Period Basis	Ownership Basis	Source of Generation Basis
• The different sources of funds can be categorised into three parts. These are long-term sources, medium-term sources and short-term sources • The long-term sources fulfil the financial requirements of an enterprise for a period exceeding 5 years and include sources such as shares and debentures, long-term borrowings and loans from financial institutions • Where the funds are required for a period of more than one year but less than five years, medium-term sources of finance are used. These sources include borrowings from commercial banks, public deposits, lease financing and loans from financial institutions • Short-term funds are those which are required for a period not exceeding one year. Trade credit, loans from commercial banks and commercial papers	• The sources can be classified into 'owner's funds' and 'borrowed funds'. • Owner's funds means funds that are provided by the owners of an enterprise, which may be a sole trader or partners or shareholders of a company. • Issue of equity shares and retained earnings are the two important sources from where owner's funds can be obtained • The sources for raising borrowed funds include loans from commercial banks, loans from financial institutions, issue of debentures, public deposits and trade credit. • Borrowed funds are provided for a specified period, on certain terms and conditions and have to be repaid after the expiry of that period. A fixed rate of interest is paid by the borrowers on such funds.	• The funds are generated from within the organisation or from external sources. • Internal sources of funds are those that are generated from within the business. For example, can generate funds internally by accelerating collection of receivables, disposing of surplus inventories and ploughing back its profit • External sources of funds include those sources that lie outside an organisation, such as suppliers, lenders, and investors • External funds may be costly as compared to those raised through internal sources • Issue of debentures, borrowing from commercial banks and financial institutions and accepting public deposits are some of the examples of external sources of funds

SOURCES OF FINANCE

- A business can raise funds from various sources.
- Each of the source has unique characteristics, which must be properly understood so that the best available source of raising funds can be identified.
- There is not a single best source of funds for all organisations.
- Depending on the situation, purpose cost and associated risk, a choice may be made about the source to be used

Retained Earnings

Meaning	Merits	Limitation
• A portion of the net earnings may be retained in the business for use in the future is known as retained earnings. • It is a source of internal financing or selffinancing or 'ploughing back of profits'	• It is a permanent source of funds • It does not involve any explicit cost in the form of interest, dividend or floatation cost • It has greater degree of operational freedom and flexibility • It enhances the capacity of the business to absorb unexpected losses • It may lead to increase in the market price of the equity shares of a company	• Cause dissatisfaction amongst the shareholders as they would get lower dividends • Uncertain source of funds as the profits are fluctuating • The opportunity cost associated with is not recognised by many firms and may lead to sub-optimal use of the funds.

<u>Trade Credit</u>

Meaning	Merits	Limitation
• Trade credit is the credit extended by one trader to another for the purchase of goods and services. • Trade credit facilitates the purchase of supplies without immediate payment • It is short-term financing source • It is granted to those customers who have reasonable amount of financial standing and goodwill • Terms of trade credit may vary from one industry to another and from one person to another. A firm may also offer different credit terms to different customers	• It is a convenient and continuous source of funds • It is readily available in case the credit worthiness of the customers is known to the seller • It helps in promoting the sales of an organisation • It does not create any charge on the assets of the firm while providing funds.	• It may induce a firm to indulge in overtrading, which may add to the risks of the firm • Only limited amount of funds can be generated through it • It is a costly source of funds as compared to most other sources

<u>Factoring</u>

Meaning	Merits	Limitation
• Factoring is a financial service under which the 'factor' renders various services which includes: • Discounting of bills (with or without recourse) and collection of the client's debts. Under this, the receivables on account of sale of goods or services are sold to the factor at a certain discount. • There are two methods of factoring—recourse and non-recourse. • Under recourse factoring, the client is not protected against the risk of bad debts. • On the other hand, the factor assumes the entire credit risk under non-recourse factoring • Providing information about credit worthiness of prospective client's etc., Factors hold large amounts of information about the trading histories of the firms. • For example : SBI Factors and Commercial Services Ltd., Canbank Factors Ltd., Foremost Factors Ltd., State Bank of India, Canara Bank, Punjab National Bank, Allahabad Bank	• Cheaper than financing through other means such as bank credit • Factoring as a source of funds is flexible and ensures a definite pattern of cash inflows from credit sales. It provides security for a debt • It does not create any charge on the assets of the firm • The client can concentrate on other functional areas of business as the responsibility of credit control is shouldered by the factor	• This source is expensive when the invoices are numerous and smaller in amount • The advance finance provided by the factor firm is generally available at a higher interest cost • The factor is a third party to the customer who may not feel comfortable while dealing with it

Lease Financing

Meaning	Merits	Limitation
• A lease is a contractual agreement whereby one party i.e., the owner of an asset grants the other party the right to use the asset in return for a periodic payment • The owner of the assets is called the 'lessor' while the party that uses the assets is known as the 'lessee'. Fixed periodic amount called lease rental • At the end of the lease period, the asset goes back to the lessor	• It enables the lessee to acquire the asset with a lower investment; • Simple documentation makes it easier to finance • It provides finance without diluting the ownership or control of business • The lease agreement does not affect the debt raising capacity of an enterprise • The risk of obsolescence is borne by the lesser	• A lease arrangement may impose certain restrictions on the use of assets • The normal business operations may be affected in case the lease is not renewed • It may result in higher payout in case the equipment is not found useful and the lessee opts for premature termination of the lease agreement • The lessee never becomes the owner of the asset

Public Deposits

Meaning	Merits	Limitation
• The deposits that are raised by organisations directly from the public are known as public deposits • While the depositors get higher interest rate than that offered by banks, the cost of deposits to the company is less than the cost of borrowings from banks • Regulated by RBI • Companies generally invite public deposits for a period upto three years	• The procedure of obtaining deposits is simple and does not contain restrictive conditions as are generally there in a loan agreement • Cost of public deposits is generally lower than the cost of borrowings • Public deposits do not usually create any charge on the assets of the company • As the depositors do not have voting rights, the control of the company is not diluted	• New companies generally find it difficult to raise funds through public deposits; • It is an unreliable source of finance as the public may not respond when the company needs money; • Collection of public deposits may prove difficult, particularly when the size of deposits required is large

Commercial Paper

Meaning	Merits	Limitation
• Commercial paper is an unsecured promissory note issued by a firm to raise funds for a short period, varying from 90 days to 364 days • The amount raised by CP is generally very large • Regulated by RBI	• A commercial paper is sold on an unsecured basis and does not contain any restrictive conditions • As it is a freely transferable instrument, it has high liquidity • It provides more funds compared to other sources • A commercial paper provides a continuous source of funds. • Companies can park their excess funds in commercial paper thereby earning some good return on the same	• Only financially sound and highly rated firms can raise money through commercial papers • The size of money that can be raised through commercial paper is limited to the excess liquidity available with the suppliers of funds at a particular time • Commercial paper is an impersonal method of financing

Issue of shares: Equity shares

Meaning

- Equity shares represent the ownership of a company and thus the capital raised by issue of such shares is known as ownership capital or owner's funds.
- They are referred to as 'residual owners'
- They enjoy the reward as well as bear the risk of ownership.
- Their liability is limited to capital contributed
- They have right to participate in the management

Merits

- Suitable for investors who are willing to assume risk for higher returns
- Payment of dividend to the equity shareholders is not compulsory. So, no burden
- Equity capital serves as permanent capital as it is to be repaid only at the time of liquidation of a company
- Equity capital provides credit worthiness to the company and confidence to prospective loan providers;
- Funds can be raised through equity issue without creating any charge on the assets
- Democratic control over management of the company

Limitation

- Investors who want steady income may not prefer equity shares as equity shares get fluctuating returns
- The cost of equity shares is generally more as compared to the cost of raising funds through other sources
- Issue of additional equity shares dilutes the voting power, and earnings of existing equity shareholders
- More formalities and procedural delays are involved while raising funds through issue of equity

<u>Preference Shares</u>

Meaning

- The preference shareholders enjoy a preferential position over equity shareholders in two ways:
  - receiving a fixed rate of dividend, out of the net profits of the company, before any dividend is declared for equity shareholders;
  - receiving their capital after the claims of the company's creditors have been settled, at the time of liquidation
- Preference shareholders generally do not enjoy any voting rights.

Merits

- It provides steady income in the form of fixed rate of return and safety of investment
- It does not affect the control of equity shareholders over the management as preference shareholders don't have voting rights
- Payment of fixed rate of dividend to preference shares may enable a company to declare higher rates of dividend for the equity
- Preference shareholders have a preferential right of repayment over equity shareholders
- Preference capital does not create any sort of charge against the assets

Limitation

- Not suitable for those investors who are willing to take risk and are interested in higher returns
- Preference capital dilutes the claims of equity shareholders over assets of the company
- The rate of dividend on preference shares is generally higher than the rate of interest on debentures
- Dividend on these shares is to be paid only when the company earns profit, there is no assured return for the investors
- The dividend paid is not deductible from profits as expense. Thus, there is no tax saving

<u>Debentures</u>

Meaning	Merits	Limitation
• The debenture issued by a company is an acknowledgment that the company has borrowed a certain amount of money, which it promises to repay at a future date • A company can raise funds through issue of debentures, which bear a fixed rate of interest	• It is preferred by investors who want fixed income at lesser risk • Debentures are fixed charge funds and do not participate in profits of the company • The issue of debentures is suitable in the situation when the sales and earnings are relatively stable • As debentures do not carry voting rights, financing through debentures does not dilute control of equity shareholders on management • Financing through debentures is less costly as compared to cost of preference or equity capital as the interest payment on debentures is tax deductible.	• Debentures put a permanent burden on the earnings of a company • In case of redeemable debentures, the company has to make provisions for repayment on the specified date, even during periods of financial difficulty • Each company has certain borrowing capacity. With the issue of debentures, the capacity of a company to further borrow funds reduces.

<u>Commercial Banks</u>

Meaning	Merits	Limitation
• Commercial banks occupy a vital position as they provide funds for different purposes as well as for different time periods • The rate of interest charged by banks depends on various factors such as the characteristics of the firm and the level of interest rates in the economy	• Timely assistance to business by providing funds as and when needed • Secrecy of business can be maintained as the information supplied to the bank by the borrowers is kept confidential • Formalities such as issue of prospectus and underwriting are not required for raising loans from a bank. This, therefore, is an easier source of funds • Loan from a bank is a flexible source of finance as the loan amount can be increased according to business needs	• Funds are generally available for short periods and its extension or renewal is uncertain and difficult • Banks make detailed investigation of the company's affairs, financial structure etc., and may also ask for security of assets and personal sureties. This makes the procedure of obtaining funds slightly difficult • Difficult terms and conditions are imposed by banks for the grant of loan

<u>Financial Institutions</u>

Meaning	Merits	Limitation
•The government has established a number of financial institutions all over the country to provide finance to business organisations •They provide both owned capital and loan capital for long and medium term requirements and supplement the traditional financial agencies like commercial banks •These are also called 'development banks'	•Financial institutions provide longterm finance, which are not provided by commercial banks •Many of these institutions provide financial, managerial and technical advice and consultancy to business firms •Obtaining loan from financial institutions increases the goodwill of the borrowing company in the capital market •As repayment of loan can be made in easy instalments, it does not prove to be much of a burden on the business •The funds are made available even during periods of depression, when other sources of finance are not available	•Too many formalities make the procedure time consuming and expensive •Certain restrictions such as restriction on dividend payment are imposed on the powers of the borrowing company by the financial institutions •Financial institutions may have their nominees on the Board of Directors. Thereby restricting the powers of the company

<u>International Financing</u>

There are various avenues for organisations to raise funds internationally. Various international sources from where funds may be generated include

- **Commercial Banks:**
  Commercial banks all over the world extend foreign currency loans for business purposes. The types of loans and services provided by banks vary from country to country.
- **International Agencies and Development Banks:**
  A number of international agencies and development banks have emerged over the years to finance international trade and business. These bodies provide long and medium-term loans and grants to promote the development of economically backward areas in the world.
- **International Capital Markets:**
  - **Global Depository Receipts (GDR's):**
    The local currency shares of a company are delivered to the depository bank. The depository bank issues depository receipts against these shares. Such depository receipts denominated in US dollars are known as Global Depository Receipts (GDR). The holders of GDRs do not carry any voting rights but only dividends and capital appreciation.
  - **American Depository Receipts (ADRs):**
    The depository receipts issued by a company in the USA are known as American Depository Receipts. It is similar to a GDR except that it can be issued only to American citizens and can be listed and traded on a stock exchange.
  - **Indian Depository Receipt (IDRs):**

An Indian Depository Receipt is a financial instrument denominated in Indian Rupees in the form of a Depository Receipt. It is created by an Indian Depository to enable a foreign company to raise funds from the Indian securities market. According to SEBI guidelines, IDRs are issued to Indian residents in the same way as domestic shares are issued. The issuer company makes a public offer in India, and residents can bid in exactly the same format and method as they bid for Indian shares.

- **Foreign Currency Convertible Bonds (FCCBs):**
  Foreign currency convertible bonds are equity linked debt securities that are to be converted into equity or depository receipts after a specific period. Thus, a holder of FCCB has the option of either converting them into equity shares at a predetermined price or exchange rate, or retaining the bonds. They carry a fixed interest rate which is lower than the rate of any other similar nonconvertible debt instrument. FCCB's are listed and traded in foreign stock exchanges

<u>FACTORS AFFECTING THE CHOICE OF THE SOURCE OF FUNDS</u>

1. **Cost:**
   There are two types of cost viz., the cost of procurement of funds and cost of utilising the funds. Both these costs should be taken into account while deciding about the source of funds.

2. **Financial strength and stability of operations:**
   In the choice of source of funds business should be in a sound financial position so as to be able to repay the principal amount and interest on the borrowed amount. When the earnings of the organisation are not stable, fixed charged funds should be carefully selected as these add to the financial burden

3. **Form of organisation and legal status:**
   A partnership firm, for example, cannot raise money by issue of equity shares as these can be issued only by a joint stock company

4. **Purpose and time period:**
   Business should plan according to the time period for which the funds are required. A short-term need for example can be met through borrowing funds at low rate of interest through trade credit, commercial paper, etc. For long term finance, sources such as issue of shares and debentures are more appropriate. Similarly, the purpose for which funds are required need to be considered so that the source is matched with the use

5. **Risk profile:**
   Business should evaluate each of the source of finance in terms of the risk involved For example, there is a least risk in equity as the share capital has to be repaid only at the time of winding up A loan on the other hand, has a repayment schedule for both the principal and the interest which is to be paid irrespective of the firm earning a profit or incurring a loss.

6. **Control:**
   Issue of equity shares may mean dilution of the control. Thus, business firm should choose a source keeping in mind the extent to which they are willing to share their control over business.

7. **Effect on credit worthiness:**
   Issue of secured debentures may affect the interest of unsecured creditors of the company and may adversely affect their willingness to extend further loans as credit to the company.

8. **Flexibility and ease:**
   Restrictive provisions, detailed investigation and documentation may be the reason that a business organisations may not prefer it, if other options are readily available.

9. **Tax benefits:**
   Non taxable instrument will be preferred over tax deductible. For example, while the dividend on preference shares is not tax deductible interest paid on debentures and loan is tax deductible and may, therefore, be preferred by organisations seeking tax advantage