Sources of Business Finance

SOURCES OF BUSINESS FINANCE

❖ **Business Finance**

➢ **Meaning**

It refers to the funds required for the setting up of businesses and carrying out their various operations.

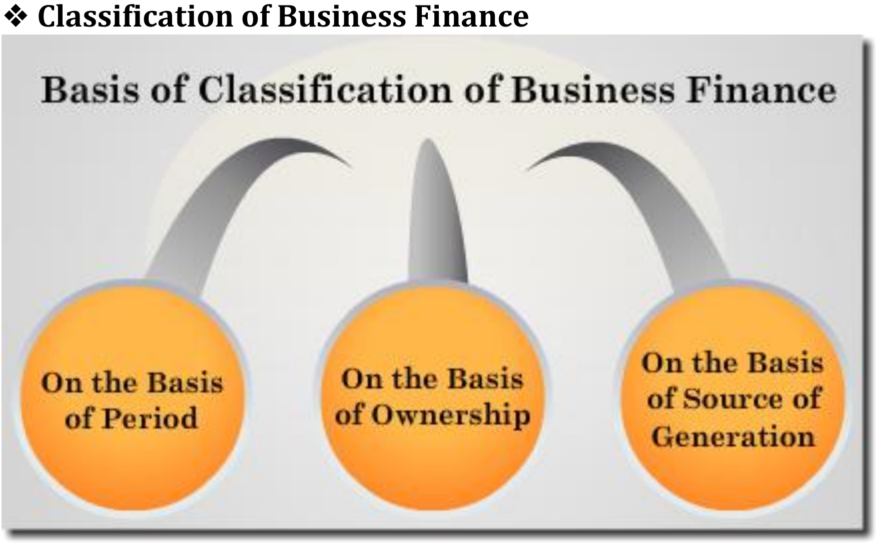
➢ **Nature of Business Finance**

i. Required to ***carry out various business operations and activities***
ii. Primarily ***involves the estimation of the amount of funds*** that are needed by the business
iii. The ***requirement for business finance differs across business types and across time***
iv. ***Required for maintaining continuity*** of business operations

➢ **Need for Business Finance**

The following are the reasons why a business needs funds:
a. A business requires funds for the purchase of fixed assets (***fixed capital requirement***) such as building, machinery and furniture.
b. Funds are required to finance the day-to-day operations (***working capital requirement***) such as purchase of raw materials and payment of wages.

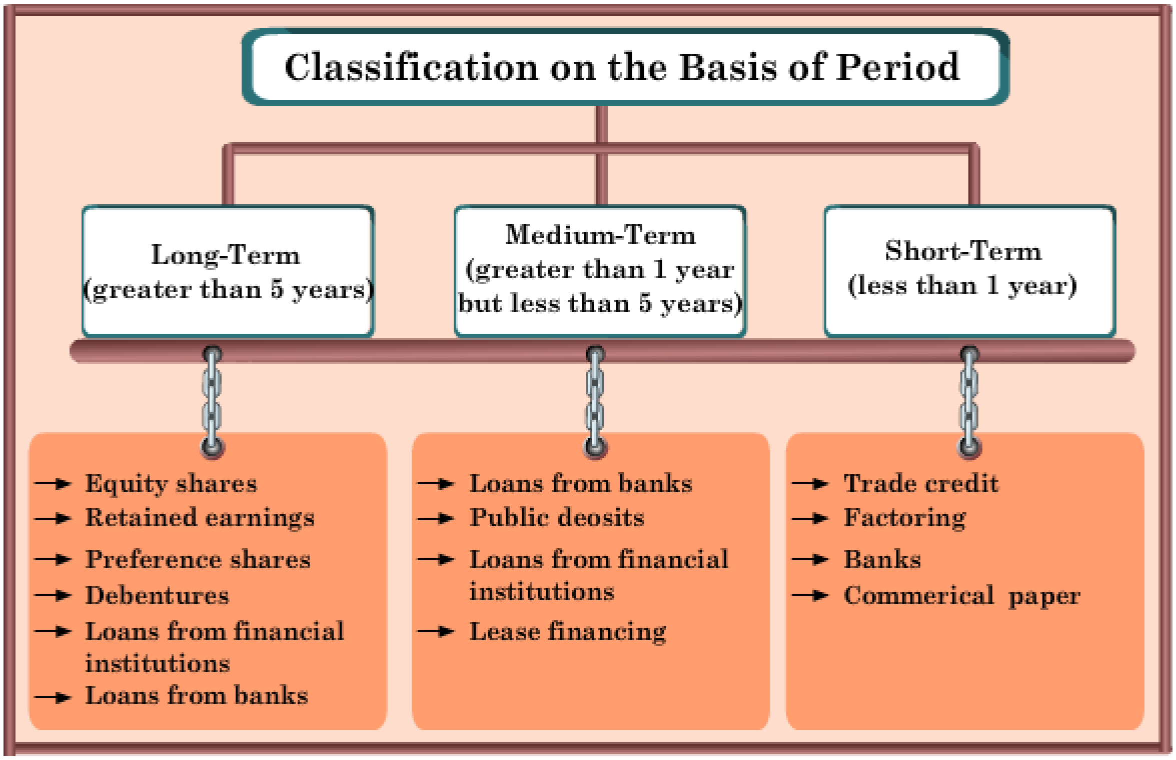
❖ **Classification of Business Finance**



Business finance can be classified on the basis of the following:

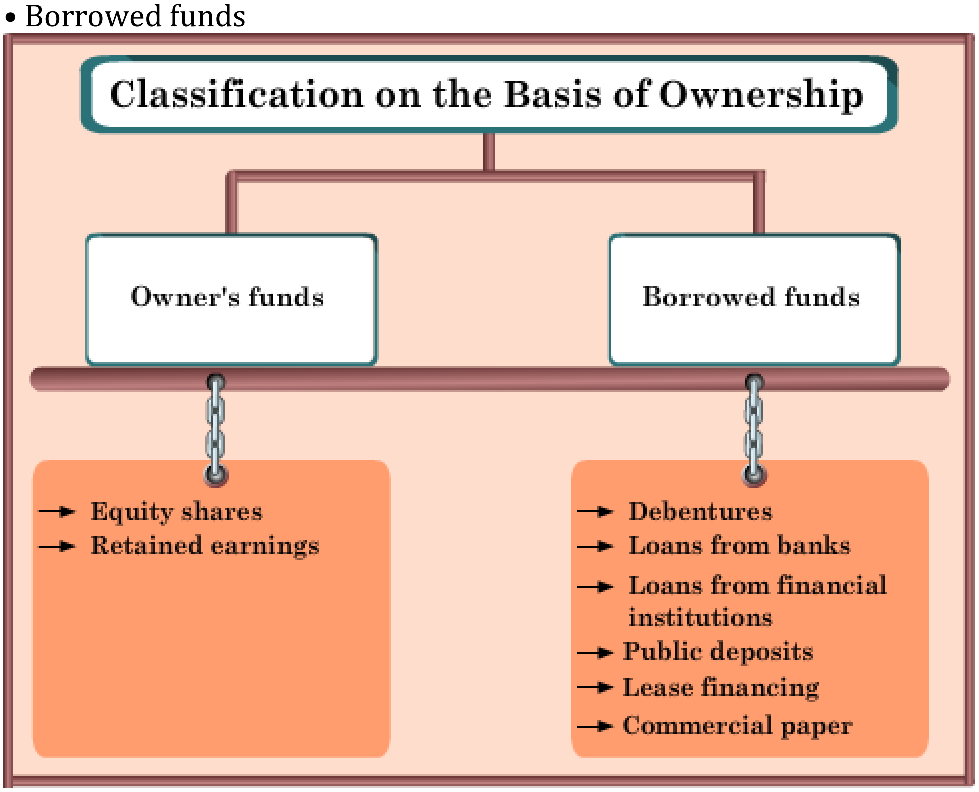
➢ **On the basis of period**

• ***Long-term*** funds
• ***Medium-term*** funds
• ***Short-term*** funds



➢ **On the basis of ownership**

- Owners' funds
- Borrowed funds

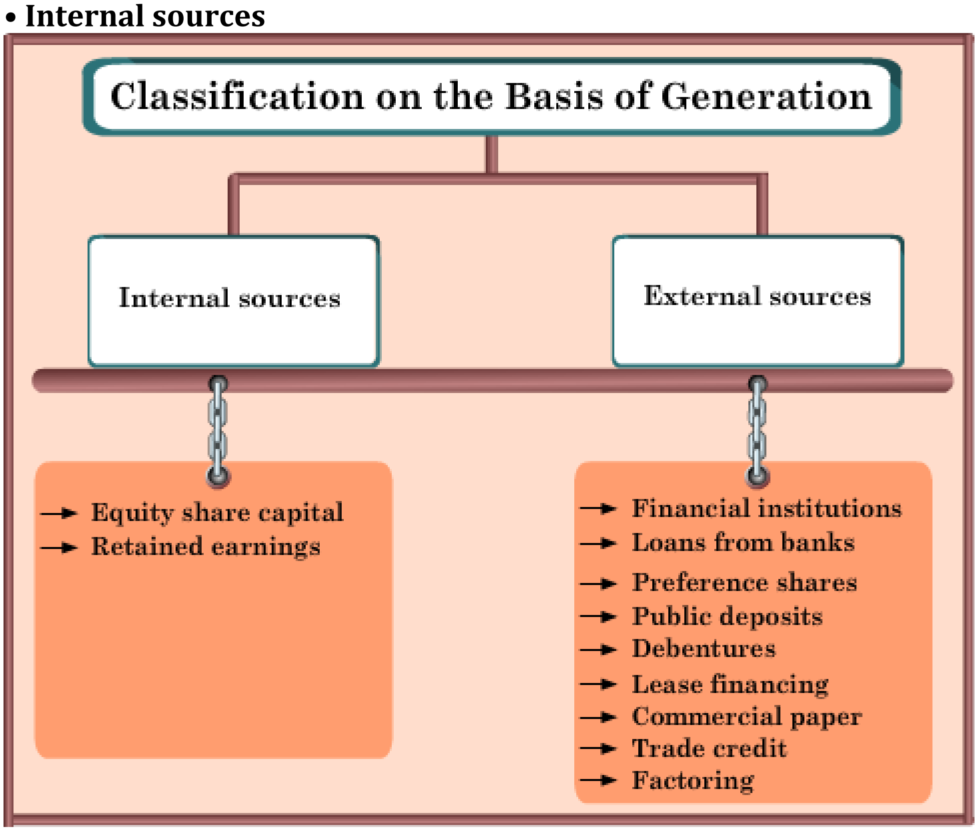


Owners' Funds vs Borrowed Funds

Basis of Difference	*Owners' Funds*	*Borrowed Funds*
Investor	Invested by the owners of the company	Invested by outsiders
Type	Permanent source of capital	Not a permanent source of capital
Security	No security required	Security required
Return	No returns are paid.	Returns are paid.
Control	Grants control over the company	Does not grant any control over the company
Risk	It is called risk capital of the business as neither the principle nor the returns are guaranteed	Carries less risk as both the principle the returns are guaranteed.

➢ **On the basis of source of generation:**

- **External sources**
- **Internal sources**



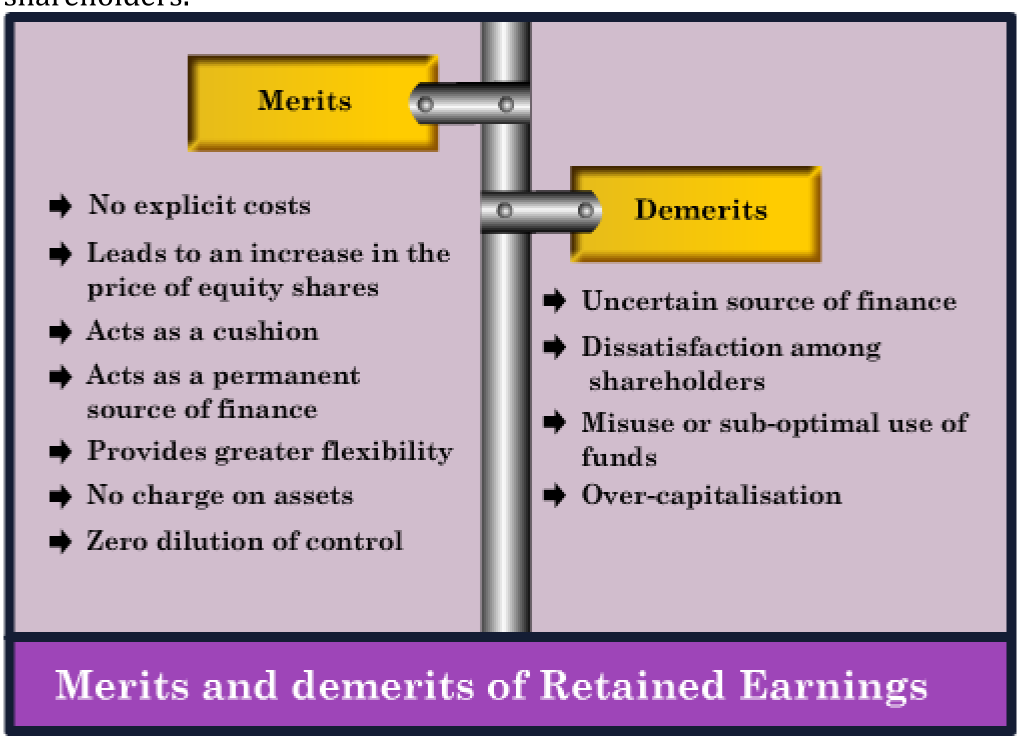
Internal Sources vs External Sources:

Basis of Difference	*Internal Sources*	*External Sources*
Meaning	Refers to funds generated within the business	Refers to the funds generated outside the business
Control	Can be controlled by the management	Cannot be controlled by the management
Extent of funding	Can be used for financing limited needs of a business	Can be used for financing large financial requirements of a business
Obligations	No such obligations as interest payment	Obligation to pay interest and principle amount

❖ **Various Sources of Finance**

➢ **Retained Earnings**

It refers to the part of profits retained by the business after distributing dividends to the shareholders.



➢ ***Merits***

i. As these funds are raised internally, they ***do not involve any kind of explicit costs*** in the form of interest, dividend or floatation.

ii. High retained earnings ***may lead to an increase in the price of equity shares.***

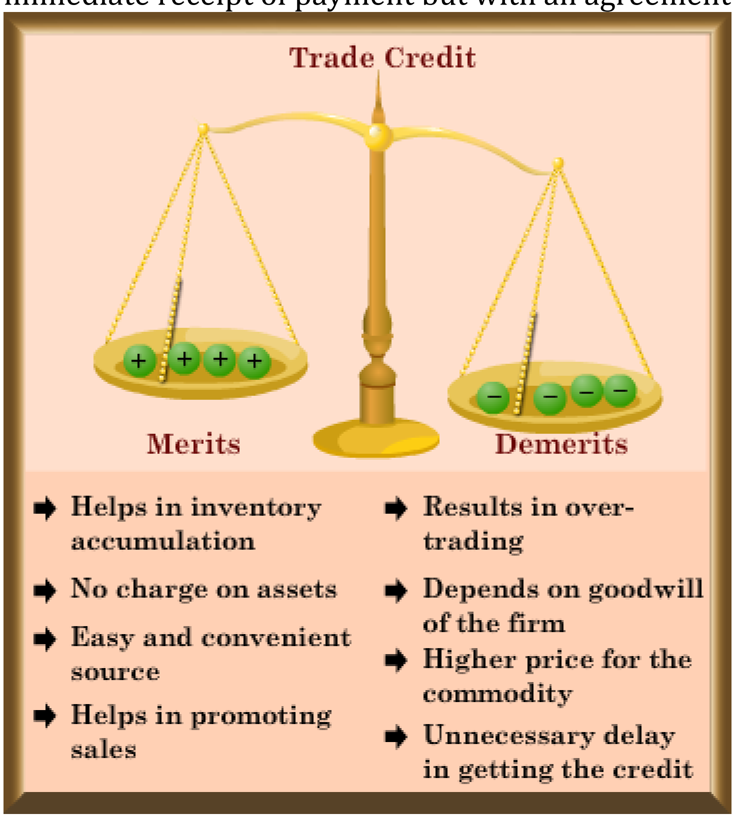
iii. These ***earnings act as a cushion at the time of crises***, thereby helping the business in reducing the burden of unexpected losses.

iv. As these funds remain invested in the business for longer periods, they ***act as a permanent source of finance*** for the business.

v. The internal generation of ***funds provides greater flexibility and operational freedom*.**
vi. Financing through this source ***does not create any charge on the assets*** of the company.
vii. They ***do not dilute the control of management*** over the company.

➢ ***Limitations***
i. As retained earnings depend on the profits earned, they are an ***uncertain source of finance*.**
ii. Higher retained earnings → Lower dividends → ***Dissatisfaction among the shareholders***
iii. Funds may be ***misused or sub-optimally utilised*.**
iv. Using the funds to issue bonus shares to equity shareholders can result in ***over-capitalisation*.**

❖ **Trade Credit**
It refers to the sale of goods and services by the supplier to the purchaser without immediate receipt of payment but with an agreement of payment at some future date.



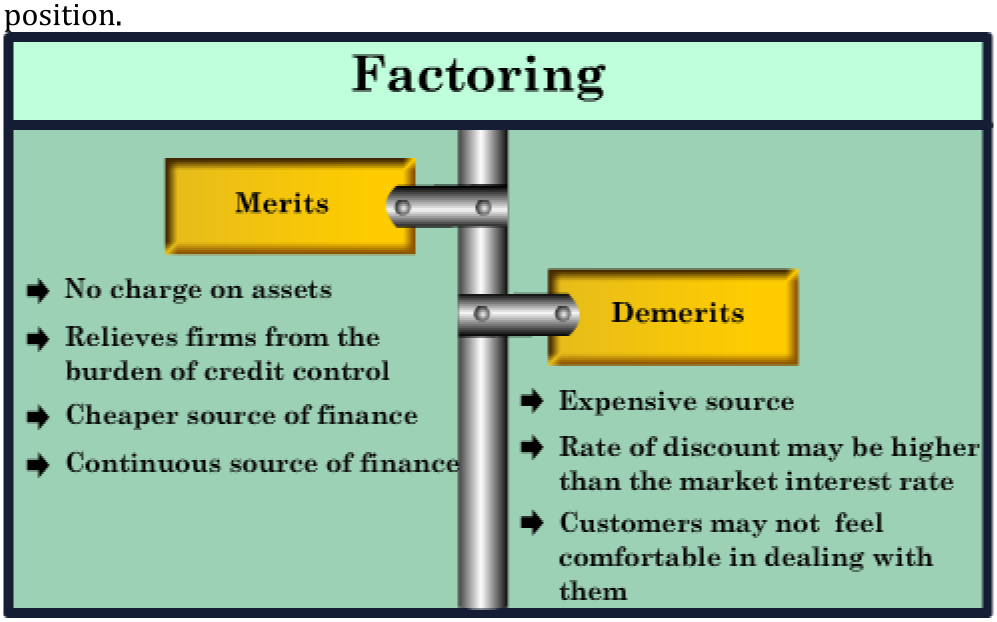
➢ ***Merits***
i. It ***helps business firms in inventory accumulation*** for meeting any increase in the demand.
ii. It is a simple arrangement that ***does not involve any rights over the assets*** by the creditor.
iii. It is an ***easy and convenient*** source of finance, as it does not involve any legal paper

work, security mortgage, etc.
iv. It ***helps in promoting the sales,*** as the purchaser need not make immediate cash payments.

➢ ***Limitations***
i. Easy availability of trade ***credit can result in over-trading,*** which, in turn, can increase the future liabilities of the buyer.
ii. The amount of ***trade credit extended varies*** as per the financial reputation or the goodwill of the buyer.
iii. The seller of goods on trade credit may charge a ***higher price for the commodities.***
iii. If the supplier asks for bank guarantee or other such ***formalities, then it may cause an unnecessary delay*** in getting the trade credit.

❖ **Factoring**
It refers to an arrangement under which the financial service providers known as 'factors' agree to provide certain types of services to their clients.

➢ ***Types of Financial Services Provided under Factoring***
i. *Collection of debts on behalf of clients and discount on bills*: The clients sell their bill receivables at a discount to the factors who then become responsible for getting the bills cleared.
ii. *Verification of finances*: Factors provide useful information regarding the financial position of the firms with which their clients wish to enter a contract. In this way, they prevent their clients from entering into contracts with firms that are in a poor financial position.

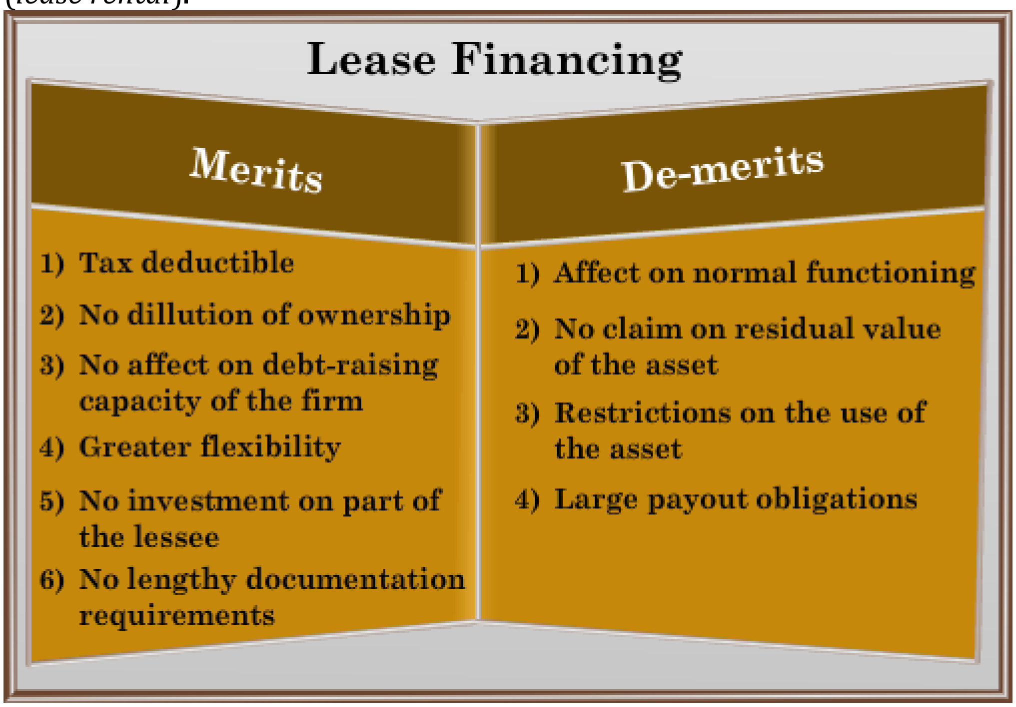


➢ ***Merits***
i. Factoring ***does not create any charge on the assets of the companies.***
ii. By collecting debts and discounting bills on behalf of their clients, it ***provides security***

***against bad debts*.**
iii. It ***relieves the firms from the burden of credit control,*** particularly in case of bad debts.
iv. It is a ***cheaper source of raising funds*** compared to bank credit.
v. Factoring ***ensures a continuous source of finance, thereby enabling firms to meet their liabilities on time*.**

➢ ***Limitations***
i. At times, factoring becomes ***an expensive source of financing, particularly when there are a large number of invoices of a small amount*.**
ii. Under factoring, the client sells bill receivables at a discount to the factors. This ***rate of discount may be higher than the market interest rate*.**
iii. As the factors are the third parties, ***customers may not feel so comfortable in dealing with them*.**

❖ **Lease Financing**
It refers to an agreement wherein the owner of an asset (*lesser*) grants the other (*lessee*) the right to use his/her assets for a specific period of time in return for a specific amount (*lease rental*).

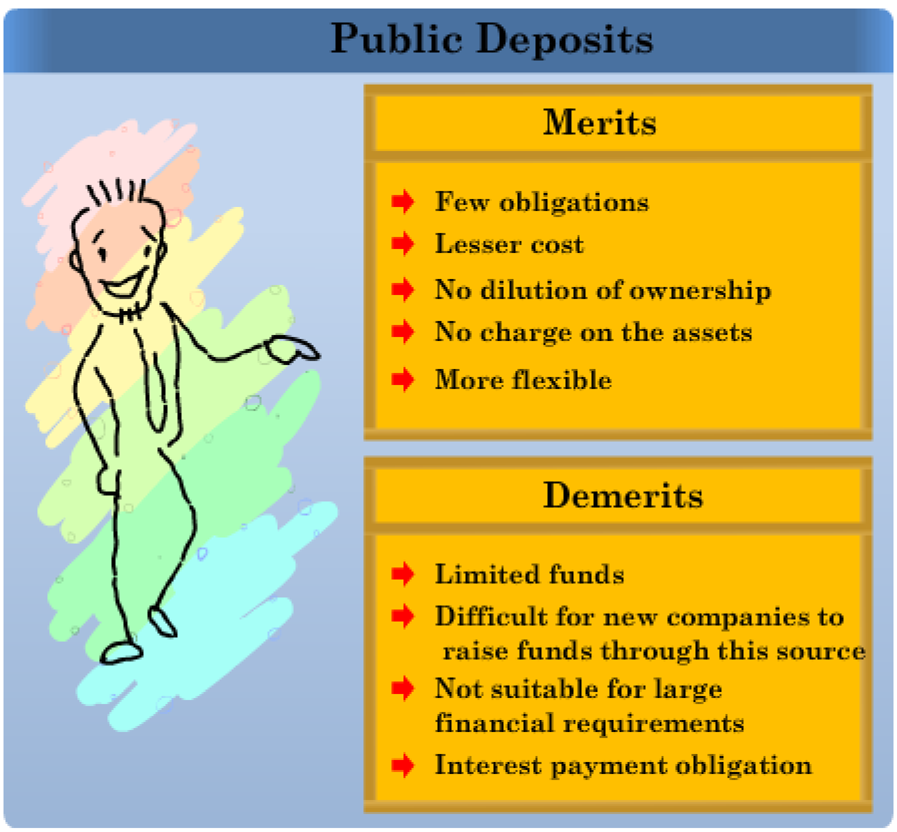


➢ ***Merits***
i. The rent paid for using the leased asset is ***tax-deductible*.**
ii. It ***does not cause dilution of the ownership of a firm*.**
iii. It ***does not affect the debt-raising capacity of the firm*.**
iv. Lease financing provides ***greater flexibility to the lessee in terms of replacement of the asset,*** as in this agreement, the lesser bears the burden of the obsolescence of the asset.

v. It ***does not involve any investment on part of the lessee*** for using the asset.
vi. There are ***no lengthy documentation requirements*** involved under lease financing.

➢ ***Limitations***
i. Any ***delay in renewing the lease may affect the normal functioning*** of the business enterprise concerned.
ii. It cannot ***claim the residual values of the asset,*** as in this agreement, the lessee is not the owner of the asset.
iii. The lease agreement ***may, at times, impose certain restrictions on the use of the asset by the lessee.*** This imposition of restrictions on the use of assets, in turn, may affect the functioning of the business enterprise.
iv. In case the lessee terminates the agreement before the due date, the ***payout obligations become large.***

❖ **Public Deposits**
It refers to the deposits raised directly from the public to finance. The rate of return on such deposits is generally higher than that on bank deposits.

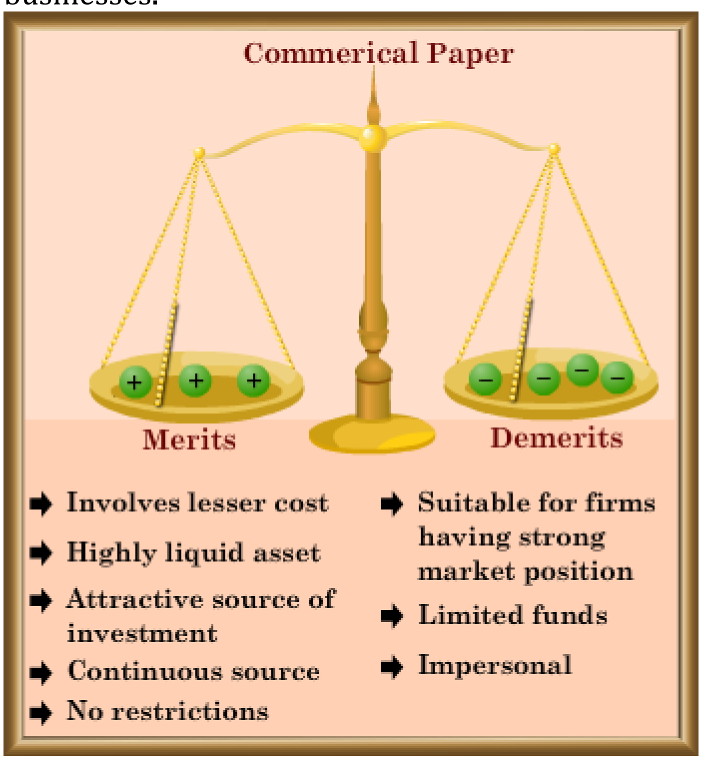


➢ ***Merits***
i. Raising funds through public deposits ***is very simple and involves only a few regulations.***

ii. It involves ***lesser cost*** than that involved in borrowing loans from commercial banks.
iii. It ***does not involve dilution of ownership,*** as the depositors do not have any voting or management rights.
iv. It ***does not create any charge on the assets*** of the firm.
v. It is ***more flexible,*** in the sense that funds can be raised through public deposits as and when needed.

➢ ***Limitations***
i. The ***amount of money that can be raised from public deposits is limited,*** as it depends on the availability of funds and the willingness of the people to invest in the company concerned.
ii. Generally, it is ***difficult for new companies*** to raise capital through public deposits, as people lack faith in such deposits.
iii. It ***does not*** prove to be ***suitable in case of a large requirement of funds.***
iv. It ***involves an obligation regarding the payment of interest,*** irrespective of whether the firm earns profit or loss.

❖ **Commercial Paper**
These are unsecured promissory notes used by one firm towards other firms to obtain short-term finance (maturity period ranging from 90 days to 364 days) for their businesses.



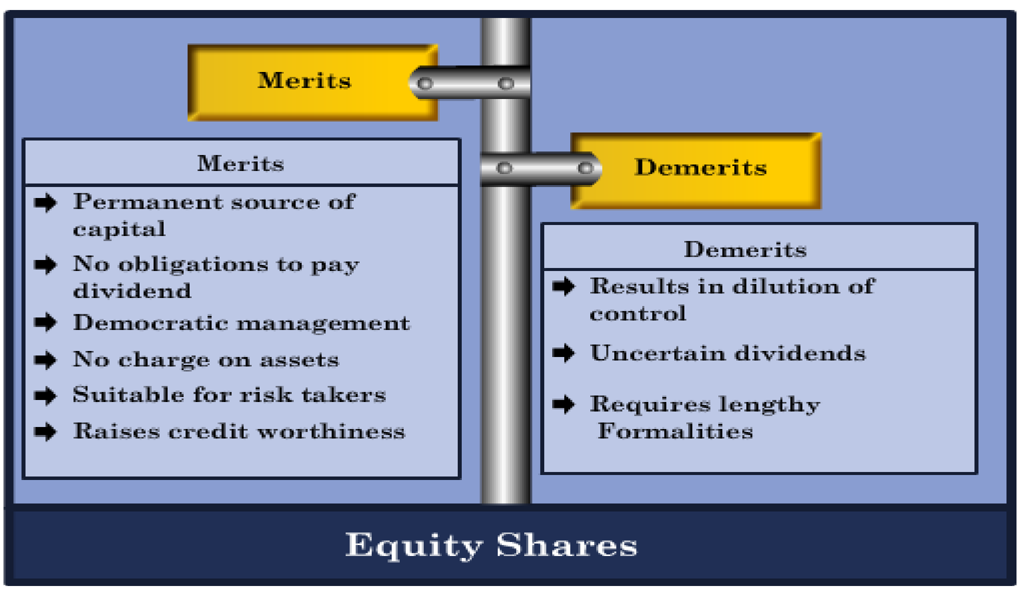
➢ ***Merits***
i. It ***involves lesser cost*** compared to the cost of securing loans from commercial banks.
ii. It is a ***highly liquid asset,*** as it can be transferred to anyone at any time.

iii. It proves to be an ***attractive source for investing surplus funds,*** as the investors earn good returns.
iv. It provides a ***continuous source of finance*** to firms, as the maturing funds can be repaid by issuing fresh commercial paper.
v. As commercial papers are unsecured promissory notes, they ***do not involve any restrictive conditions.***

➢ ***Limitations***
i. As commercial papers are unsecured securities, they ***can only be used by firms that have a strong market position.***
ii. The ***amount of money that can be raised through commercial paper is limited,*** as it depends on the availability of funds with buyers at the time of its issue.
iii. It is said to be ***impersonal*** in the sense that if a firm is unable to redeem its commercial papers on time, then it cannot extend the time period of the commercial papers.

❖ **Equity Shares**
These shares represent the ownership of a firm. The holders of such shares are known as equity shareholders; they are the ones who enjoy a say in the management.

➢ ***Features of Equity Shares***
i. Equity shareholders are the ***primary risk bearers*** of the company, in the sense that they bear the losses of the company.
ii. The ***dividends payable to the equity shareholders are uncertain,*** as they vary with the amount of profits, that is, higher the profits, higher the dividends payable.
iii. Equity shareholders are entitled to ***equal voting rights*** in the company.
iv. Equity shares ***cannot be redeemed before the winding-up of the company.***
v. Equity shareholders can ***claim only the residual income*** of the company. A residual income is the income that is left after settling the claims of creditors, preference shareholders and other outsiders.



➢ ***Merits***
i. They are a ***permanent source of capital,*** in the sense that funds raised from the issue of equity shares remain invested in the business till the liquidation of the company.
ii. There is ***no obligation on the company to pay dividends*** to the equity shareholders, as equity shareholders are only the residual claimants or residual owners of the company,
iii. Equal voting rights of equity shareholders in the company yields to a ***democratic management*** of the company.
iv. They ***do not create any charge on the assets of the company.***
v. They ***provide a good means of investment to those willing to take risks.***
vi. High equity capital ***raises the credit worthiness*** of the company.

➢ ***Limitations***
i. Issue of equity shares ***results in the dilution of the control of the management*** of the company.
ii. The ***dividends payable to the shareholders are uncertain,*** as they vary with the amount of profits, that is, higher the profits, higher the dividends payable.
iii. Issue of equity shares ***require lengthy formalities;*** thus, they result in delays in fund raising.

❖ **Preference Shares**
These shares provide shareholders a preferential right regarding the repayment of capital and payment of earnings after a certain specified period of time as governed by Section 80 of the Companies Act, 1956.

➢ **Types of Preference Shares**

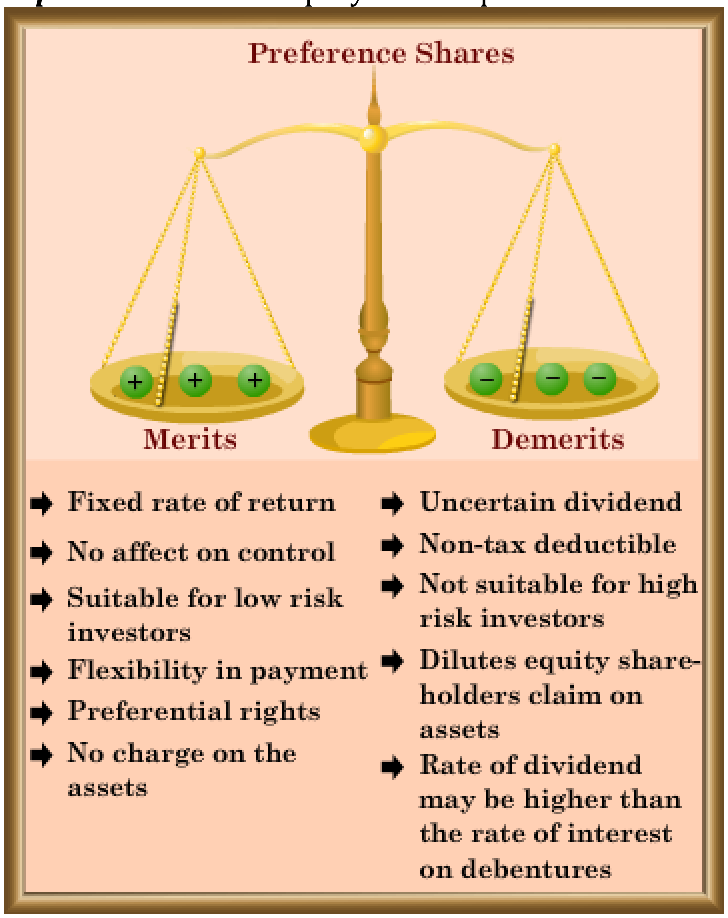
1. Cumulative Shares In which the unpaid dividend can be accumulated.	***Non- cumulative Shares*** In which the dividend cannot get accumulated.
2. Participating Shares Which enjoy a participating right in the profits of the company after dividend is paid to equity shareholders.	***Non-Participating Shares*** Which do not enjoy participating rights.
3. Convertible Shares Which can be converted into equity shares within a specific period.	***Non-Convertible Shares*** Which cannot be converted into equity shares.

➢ **Features of Preference Shares**
i. Preference shares ***do not carry any voting rights*** (except for in certain situations).
ii. Redeemable preference shares ***can be refunded before the winding-up of the company.***
iii. Convertible preference shares can be converted into equity shares.
iv. Under cumulative preference shares, the ***unpaid dividend for a particular event can be accumulated.***

➢ **Preferential rights enjoyed by preference shareholders**

i. They entitle their holders the ***right to receive dividends at a fixed rate*** or of a fixed amount.

ii. They entitle their holders the ***preferential right to receive the repayment of capital*** before their equity counterparts at the time of liquidation of the company.



➢ ***Merits***

i. The ***rate of return on preference shares is fixed***; thus, the risk of uncertainty is less.

ii. As preferential shareholders do not have any voting rights in the company, there is no ***dilution of control by the management.***

iii. Preferential rights prove to be ***suitable for the investors who want a fixed rate of return*** at comparatively low risk.

iv. As the return on preference shares is fixed, it ***renders greater flexibility regarding payment for equity share holders.***

v. Preference shareholders enjoy ***preferential rights over equity shareholders.***

vi. Preferential rights ***do not create any charge on the assets*** of the company.

➢ ***Limitations***

i. The dividends on preference shares are uncertain, as they are paid only when the company earns profits.

ii. The return on preference shares is ***not tax-deductible*** and thus does not result in any tax

savings for investors.
iii. As the return on preference shares is fixed, such shares are ***not suitable for those investors who are willing to bear a high risk*** in exchange of a higher return.
iv. They ***dilute the equity shareholders' claim on the assets of the company*.**
v. The ***rate of dividend that a company must pay is higher than the rate of interest for debentures*.**

Difference between Preference Shares and Equity shares

Basis of Difference	**Preference Shares**	**Equity Shares**
Return	Receive a fixed rate of dividend before any payment is made to the equity shareholders	Receive dividends from profits left after paying the outsiders
Voting rights	Do not have any voting rights (except for in case of non-repayment of dividend for two years)	Carry equal voting rights
Type of investors	Suitable for risk-averse individuals	Suitable for risk-loving individuals.
Repayment of capital	Preference shareholders are repaid before the equity shareholders.	Equity shareholders are the last ones to be repaid.
Redemption	Can be redeemed on the expiry of a fixed period	Cannot be redeemed
Convertibility	Can be converted into equity shares	Not convertible

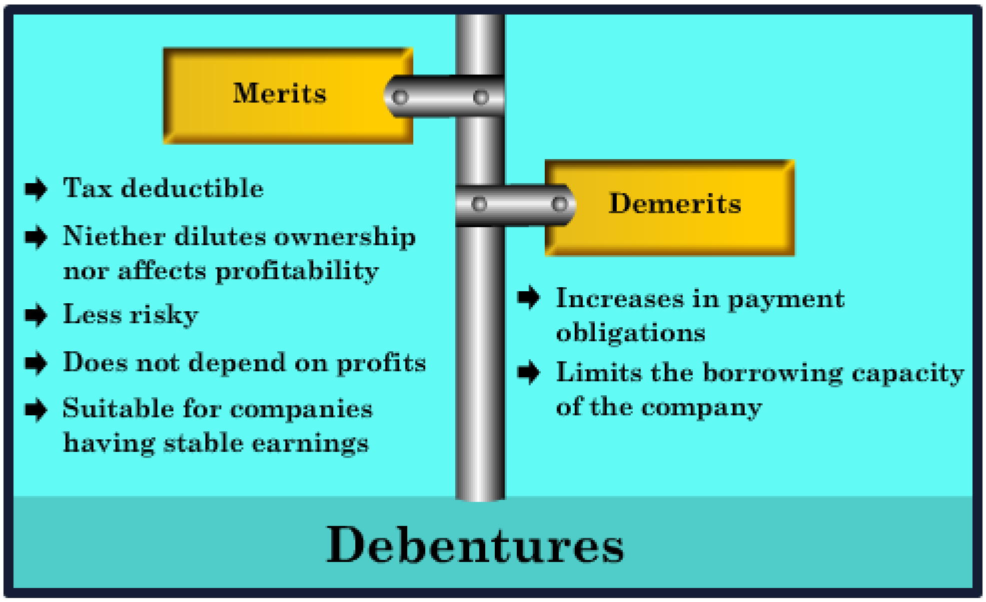
❖ **Debentures**
These are the financial instruments that represent the loan capital of a company; they are used to raise long-term debt capital.

➢ ***Features of Debenture***
i. It is a ***debt instrument issued by a company*.**
ii. It is ***issued under a seal of a company*** specifying the way of repayment of principal sum and interest on specific intervals. It also specifies the date of its redemption.
iii. It is a ***transferable instrument*** and thus can also be considered a movable property of the company.

➢ ***Types of Debentures***

1. Secured/mortgaged Debentures They are secured against certain assets of a company.	***Unsecured Debentures*** They are not secured against any assets of a company.

2. Registered Debentures The company has to maintain a record of the debenture holders.	***Bearer Debentures*** The company does not maintain any record of the debenture holders.
3. First hand Debentures That are repaid before any other debentures are repaid	***Second hand Debentures*** That are paid after the first hand debentures are paid



➢ ***Merits***

i. The rate of interest on debentures is ***tax-deductible.***
ii. Issuing debentures ***neither dilutes the ownership nor affects profitability*** of a company.
iii. Debentures are ***less risky*** securities, as they carry a fixed rate of return.
iv. They ***do not depend on the profits of the company.***
v. Debentures ***are suitable for the companies that have stable earnings.***

➢ ***Limitations***

i. The legal boundation of a company to pay interest on debentures ***increases its payment obligations*** (particularly in the event of losses).
ii. The ***borrowing capacity of a company gets limited*** with further issue of debentures.

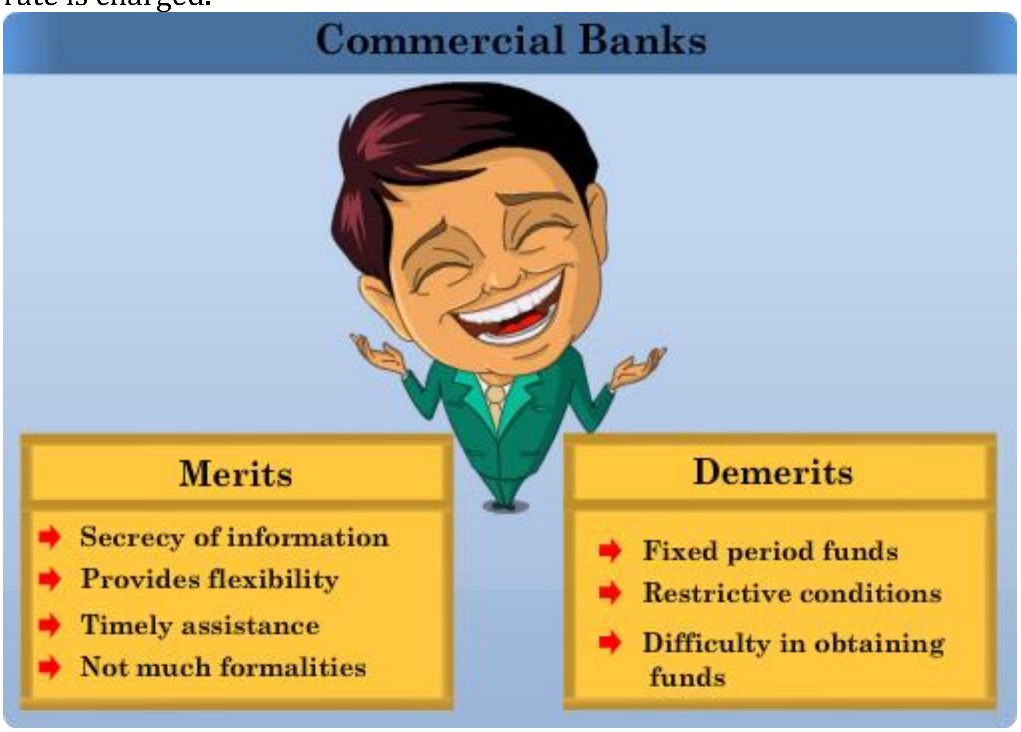
➢ **Difference between Shares and Debentures**

Basis of Difference	Shares	Debentures
Control	Grant ownership and control to the holders	Do not carry any rights over ownership or management
Returns	Do not have any fixed rate of return	Carry a fixed rate of return

Charge on assets	Do not create any charge on the assets	Create a charge on the assets of the company
Redemption	Cannot be redeemed	Are redeemable on the expiry of a fixed period
Conversion	Cannot be converted into debentures	Can be converted into shares
Repayment priority	Payment to the shareholders is made after the settlement of all external liabilities, that is, after paying debenture holders.	Payment to the debenture holders is made before the shareholders.

❖ Commercial Banks

Commercial Banks issue bank credit in the form of loans and advances on which an interest rate is charged.



➢ ***Merits***

i. Banks maintain ***secrecy over information related to their customers*.**
ii. Bank credit ***provides flexibility*** to the borrower, as the amount of credit can be altered as per the need.
iii. Banks provide funds to the firms whenever required, thereby providing ***timely assistance*.**
iv. There are ***not much formalities*** involved in raising credit from commercial banks.

➢ ***Limitations***

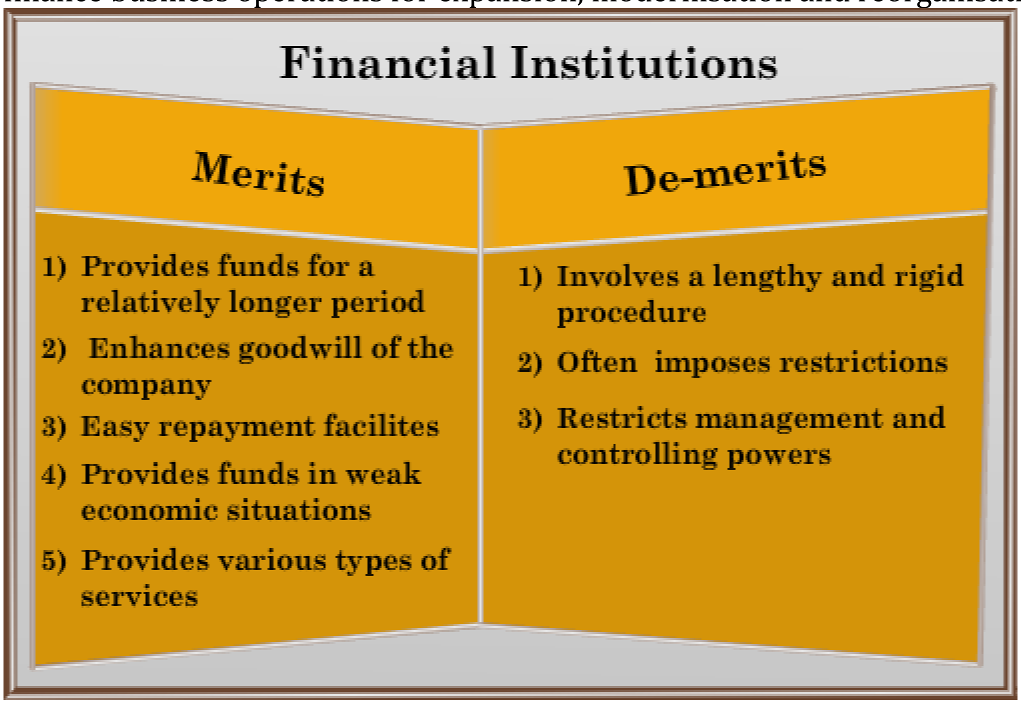
i. The funds provided by the commercial banks ***are only for a fixed period.*** Extension of the period is difficult and uncertain.

ii. The banks often impose ***restrictive conditions***; they can restrict the sale of goods mortgaged to them by the borrowers.

iii. Mortgage of assets or other such requirements makes it ***difficult to obtain funds.***

❖ **Financial Institutions**

Financial institutions are the institutions established by the central or state government to finance business operations for expansion, modernisation and reorganisation.



➢ ***Merits***

i. Financial institutions ***provide funds for a relatively longer period*** compared to commercial banks.

ii. Borrowing funds from financial institutions ***enhances the goodwill of the company*** in the capital market, thereby making borrowing easy.

iii. They also provide ***easy repayment facilities*** to its borrowers.

iv. They ***provide funds to the borrower even in weak economic situations.***

v. Many financial institutions also provide ***various other services including consultancy and advisory services*** to the borrowers.

➢ ***Limitations***

i. Borrowing from financial institutions ***is a lengthy, rigid procedure,*** with too many complex and time-consuming formalities.

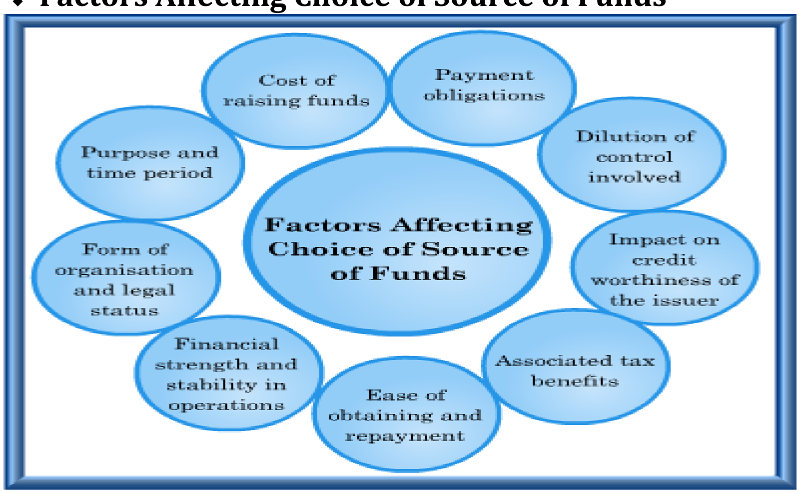
ii. Financial institutions ***often impose restrictions*** such as dividend payments on the borrowers.

iii. They may appoint their members to be the board of directors of the company, thereby ***restricting the management and control*** of the company.

❖ International Financing

Raising funds from international markets is known as international financing.
The following are some of the international sources of funds:
• ***Commercial banks-*** These banks are located globally and provide credit in international currencies to enable firms to undertake international business operations.
• ***International agencies and development banks-*** These agencies and banks are set up by the government of the developed nations to finance the development projects of the economically backward areas of the world.
• ***International capital markets-*** International capital markets are the institutes having their operations globally, with a sizeable amount of domestic as well as foreign currency.
Some of the instruments used for this purpose are as follows:
i. *Global Depository Receipts* (*GDRs*)- These are the instruments issued abroad by a domestic company to raise funds in foreign currency. They can be converted at any point of time into an equitable number of shares.
ii. *American Depository Receipts* (*ADRs*)- These are the instruments issued in the US by a domestic company to raise funds. They are sold only to the American citizens and are traded in the U.S. securities market only.
iii. *Foreign Currency Convertible Bonds* (*FCCBs*)- FCCBs are the debt securities that are converted into equity shares or depository receipts after a specific period of time. They are traded in foreign stock exchanges.

❖ Factors Affecting Choice of Source of Funds



The following factors affect the choice of source of business finance:

i. *Cost of raising funds-* Raising finance through different sources involves costs such as interest obligations, procurement cost and utilisation cost.
Higher cost → Less preference for the source and vice versa.

ii. *Payment obligations-* A business must honour the payment obligations of capital as well as the return on investment. The company should ***opt for those sources where payment obligations are non-binding in nature*.**

iii. *Dilution of control involved-* The company ***should also consider the extent to which the owners are ready to share their control*** over the business.

iv. *Impact on credit worthiness of the issuer-* High dependence on secured debentures hampers the interest of the unsecured creditors. As a result, they may not extend further credit to the company.

v. *Associated tax benefits-* Interest paid on most of the borrowed funds is tax-deductible, which, in turn, helps in reducing the overall cost of the company.

vi. *Ease of obtaining and repayment-* The length of the procedures and formalities and time must be weighed before choosing the source of finance.

vii. *Financial strength and stability in operations*-
Stable financial position → Debentures are preferred
Unstable financial position → Shares are preferred

viii. *Form of organisation and legal status-* The form of business organisation affects the choice of source of funds, as only the company is permitted to issue equity shares.

ix. *Purpose and time period-* The choice of source also depends on the time period for which the funds are needed. For short-term finance requirements, bank loans or commercial papers may be selected.