Revision Notes

Class 11 Business Studies

Chapter 8 - Sources of Business Finance

MEANING AND NATURE OF BUSINESS FINANCE

- Every business activity is undertaken with a motive of serving the society and profit earning in the long run.
- Also, the business is formed on the going-concern concept which means the business activity is carried out with a motive of continuing it for a long period of time.
- An entrepreneur who carries out the activity invests a sum of money which is known as capital. He continuously needs to put in money into the business for its expansion, that putting in of money is known as financing of business.
- Finance is the life blood of a business and the money required to run the business is known as business finance.

SIGNIFICANCE OF BUSINESS FINANCE

- To purchase plant and machinery, land, buildings and other fixed assets.
- Smooth functioning of day to day operations of the business
- Expansion

Financing Needs Of The Business:

- **Fixed Capital Requirements:**
  Funds required by a business to purchase land, building, plant and machinery, furniture and fixtures, etc are known as Fixed Capital Requirements. The amount of fixed capital differs from organization to organization and level of operations. The fixed capital is invested for a longer period of time.

- **Working Capital Requirements:**
  Working capital requirements are the funds required for running the day to day activities and operations of the business. It is used for holding current assets such as stock of materials, debtors, etc. The working capital requirements are influenced by various factors such as type of business, size of business, operation cycle etc.

CLASSIFICATION OF SOURCES OF FUNDS

A.On the basis of period:

1. **Short Term:** These are the category of funds required for a short period of time generally one year or less than one year. For example:

- Trade credit
- Loans from commercial banks
- Commercial papers

2. **Medium Term:** These funds are required for a term of one to five years. For example:
- Public deposits
- Lease financing
- Loans from financial institutions

3. **Long Term:** These sources fulfill the requirements of the business for the long term or a time exceeding five years. For example:
- Shares
- Debentures
- Long-term borrowings

B. On the basis of ownership

1. **Owners' Funds:** Funds provided by the owners of the organization are known as Owners' funds. It includes profits that are reinvested into the business. The important sources of owners' funds are
- Retained earnings
- Issue of equity shares.

2. **Borrowed Funds:** These are the funds raised through loans and borrowings. This source includes raising funds from
- Issue of debentures,
- Loans from financial institutions,
- Public deposits,
- Trade credit, etc.

C. On the basis of source of generation

1. **Internal Sources:** Funds generated from within the organization are known as internal sources. Though only short term or limited needs could be fulfilled by this source. For example:
- Ploughing back profit,
- Disposing surplus inventory, etc.

2. **External Sources:** Large amounts of money requirements are fulfilled through external sources. These are more expensive sources than internal sources of financing. These are done through:
- Borrowings from commercial banks

- Acceptance of Public deposits,
- Raising debentures etc.

SOURCES OF FINANCE

1. Retained Earnings

When a company earns profit, a certain amount or percentage of those profits is retained within the business for future use and this is known as retained earnings. When the business is financed through this source it is known as ploughing back of profit or internal financing.

Merits

- Permanent source of funds.
- No explicit cost involved in the form of dividend or interest.
- Greater degree of operational flexibility and freedom.
- Enhances the unexpected loss absorption capacity of the business.
- May lead to an increase of the market price of the company's equity shares.

Limitations

- Excess retention of profits may lead to dissatisfaction among shareholders.
- Since the profits keep on fluctuating, it is an uncertain source of funds.
- Opportunity cost remains unrecognized so it may lead to suboptimal use of funds.

2. Trade Credit

- It refers to the extension and provision of credit by one one trader to another for the purchase of goods and services, or other supplies without on the spot payment..
- This is generally used by organizations as short term financing. The terms of trade credit may vary from person to person based on past records and from industry to industry based on industry norms.

Merits

- A continuous and a convenient source of funds.
- It is readily available if credit worthiness is known to the seller.
- It helps in increasing the inventory levels in case of increase in sales volume.
- While providing funds, It does not create a charge on assets of the firm .

Limitations

- There can be chances of over-trading.
- Fulfils only limited financial needs.
- Costly in comparison to few other sources.

3. Factoring

- This is a financial service in which a third party, namely factor, renders various services like discounting of bills and collection of clients' debts.
- In this a company gives the responsibility of the collection of debts from the debtors to the factor.
- Also, through factoring large amounts of information can be fetched about trading history of the organization, the credit worthiness of debtors etc.
- There are two methods of factoring:
  - **Recourse Factoring:** Factor does not assume the credit risk.
  - **Non-recourse factoring:** Factor assumes and takes responsibility for the entire credit risk in case the debtor defaults.

Merits

- A cheaper source of finance as compared to other means such as bank credit.
- The organization is relieved from the task of collection of bad debt.
- Protection against bad debts to the firm in case of non-recourse factoring
- At times, the factor also provides finance to the company, that is he makes advance payment of the debts taken by him to the firm.
- It is flexible and does not create charge on assets of the firm.

Demerits

- It can be an expensive source, if there are number of invoices of smaller amounts.
- Customers may not feel comfortable dealing with a third party(factor).

4. Lease Financing

- This is a contractual agreement where the owner of an asset called as lessor grants the right to use the asset for a certain time period that is lease period to another party named as lessee in return for lease rentals.
- Once the lease period ends, the lessee gives back the asset to the lessor.

Merits

- It helps to acquire the asset for a lower investment.
- Provides finance without dilution of or ownership of or control of business.
- Does not affect the debt raising capacity of the organization.
- Lease rentals are tax deductible expenses that leads to tax advantages.
- Risk of asset wear and tear is borne by the lesser.

Limitations

- The agreement may impose certain restrictions to use.
- Normal course of business may be affected in case of non- renewal of the agreement.

- The lessee cannot take advantage of the salvage value of the asset, as he is not the owner of the asset, and has to return it to the lessor.

5. Public Deposits
- A public deposit is money raised from public organizations. They have higher interest rates than bank deposits and may be used for short term and medium term funding requirements.
- It can be for a period of up to 3 years and the regulating authority for public deposits in India is RBI.

Merits
- Easy and convenient source of finance.
- Lower costs as compared to banks.
- No charge on the assets of the company is created.

Limitations
- Not suitable for new companies.
- Higher dependency on the public exists, thus making this source unreliable..
- It is not suitable in case the deposits are large.

6. Commercial Papers
- A commercial paper is an unsecured promissory note which has been used in India since 1990.
- A Commercial Paper is used as a promissory note by corporate buyers who are highly rated.
- It helps them meet their short term funding requirements and can be issued for anytime between 7 days to 1 year.
- Non Resident Indians (NRIs), primary dealers, Foreign Institutional Investors (FIIs), All-India financial institutions can raise commercial papers.

Merits
- It can be sold without any restrictions
- Highly liquid.
- Provides higher funds as compared to loans.
- Freely transferable
- Companies with idle funds can invest in commercial paper, and earn good returns.

Limitations
- New firms cannot raise money using Commercial Paper.
- The amount of money depends on excess liquidity available.
- Extending the maturity of Commercial Paper is not possible.

7. Issue of Shares

- A company needs huge investments to start a business, this amount is known as capital.
- Since, it is impossible for one individual to bring in such a huge amount of capital, the entire capital is divided into small units known as shares, where each person holding shares is referred to as a shareholder.
- Generally, there are two types of shares issued by the company:
  - Equity Shares
  - Preference Shares.

a. Equity Shares:

- It is one of the most important sources of raising long term capital.
- Equity shareholders are said to be the owners of the company as they invest money into the company and become fractional owners of it.
- Also, they have the right to vote in the company, and they receive dividends on the amount invested by them.
- The capital procured from such a source is referred to as ownership capital or owner's funds.

Merits

- It is suitable for those investors who seek to assume high risks for better returns.
- No burden to the company, as paying a dividend is not compulsory.
- It serves as permanent capital as it has to be repaid at the time of liquidation.
- Democratic control over the management of the company is given to shareholders through voting rights.

Limitations

- The returns are fluctuating in nature so investors who need steady income may not prefer equity shares.
- Cost of raising funds from equity shares is quite high as compared to other sources.
- It is more of a complicated process and may take longer time to raise funds.

b. Preference Shares

- The holders of preference shares hold a preferential position in respect to equity shareholders in two ways:
  - They receive a fixed rate of dividend before any dividend for the equity shareholders.
  - Their claim for receiving the capital at the time of liquidation is settled just after the creditors of the company.

Merits
- It provides steady income in the form of fixed returns.
- It comparatively bears a lower risk.
- They have preferential rights over equity shareholders.
- It doesn't create any sort of charge against the assets of the company.

Limitations
- It is not suitable for investors aspiring for higher returns.
- The rate of dividend is generally high as compared to that of debentures.
- Dividend paid is not deducted from profits as expenses.

8. Debentures
- It is an important source of raising funds or long term debt capital.
- It bears a fixed rate of interest.
- Debenture holders are the creditors of the company.

Merits
- Preferred by investors who want fixed income with lower risk.
- Non dilution of the voting rights as they do not carry voting rights.
- Less costly as compared to that of equity and preference share capital.

Limitations
- A permanent burden on the company as they are fixed charge instruments.
- The company has to make provisions for repayment in case of issue of redeemable debentures.
- Raising finance from this source limits the borrowing ability of the firm.
- Debenture holders do not get voting rights.

Types of Debentures
- Secured and Unsecured
- Registered and Bearer
- Convertible and Non-convertible
- First and Second

9. Commercial Banks
- Commercial Banks are those banks which provide funds to organizations for many purposes as well as various time periods.
- They extend their loan support to organizations irrespective of their size in the form of cash, credit, overdraft facility, discounting of bills, etc.

Merits

- They provide banks with timely assistance by providing funds at the time of needs.
- Secrecy of business is maintained.
- An easier source of finance as formalities of issuing of prospectus and underwriting is not required.
- A flexible source as funds can be increased as per requirements.

Limitations
- Generally, the funds are available for a short period of time and renewal becomes a difficult process and is uncertain.
- The company may have to keep assets as security as the banks ask for security assets before issuing such loans.
- Sometimes, the terms and conditions imposed by the banks are quite difficult.

10. Financial Institutions
- There are numerous financial institutions established by the government of India across the country.
- These institutions finance the businesses and are set up by both state and central governments.
- There are development banks especially established to promote industrial development in the country.

Merits
- Provide long term funds which are not provided by the commercial banks
- Provide various services such as managerial advice, financial and technical advice to the companies.
- Increases the goodwill of the borrowing company in the capital markets.
- Funds can be made available even at the time of contingency and can be paid in easy installment without being a burden to the company.

Limitations
- A rigid criteria is followed to sanction loans.
- Too many legal formalities to follow make it a lengthy process.
- Certain restrictions are put on the company to restrict the powers of the management of the company. For example: restrictions in respect to payment of dividend.

11. International Financing

a. Commercial Banks

These banks act as an important source of financing to non-trade international operations. They extend their support all over the world for foreign currency loans. For example: Standard Chartered.

b. International Agencies and Development Banks

They provide medium to long term loans for the development of economically backward areas of the world. These are set up by the governments of various developed countries. Example: EXIM Bank and Asian Development Bank (ADB).

c. International Capital Markets

Various MNCs and corporate houses depend on borrowings in the form of rupees and other foreign currency. The financial instruments used for the same are:

i. **Global Depository Receipts:** A GDR is a negotiable instrument or an instrument that can be traded freely in various foreign capital markets. These are issued by the Indian companies to raise funds from abroad and can also be traded on foreign stock exchanges.

ii. **American Depository Receipts:** This instrument is issued by the American companies and can be traded in American markets. It can be issued to only citizens of America and can only be traded in US stock exchanges.

iii. **Indian Depository Receipts:** IDRs are issued to Indian residents only and can be traded on Indian Stock Exchange. It is denominated in Indian Rupees. It is issued by an Indian Depository to enable foreign companies to raise funds from Indian Capital Markets. Standard Chartered PLC was the first company to issue IDRs.

iv. **Foreign Currency Convertible Bonds (FCCBs):** As the name suggests, FCCBs are those bonds or securities which have an option to be converted into equity or depository receipt after a certain span of time. It is generally done at a predetermined rate or exchange rate. It has a fixed rate of interest and is issued in a foreign currency. It resembles the convertible debentures in India.

FACTORS AFFECTING THE CHOICE OF THE SOURCE OF FUNDS

The choice of source of funds greatly depends upon various factors like:

1. **Cost of finance:** The source of funds generally bears two types of costs namely:
   a. The cost of procurement of funds
   b. Cost of utilisation of funds.
   Both these costs are to be strongly analyzed before deciding which source to consider.

2. **Financial Position:** Business should be in a sound position to repay the borrowed funds. In case when the company is not in a very good position to pay, those

sources should be selected which do not become a financial burden to the company.

3. **Form of business organization:** Raising of funds strongly depends upon the form of business a company undertakes. For example, in case it is a sole-proprietorship it cannot issue equity shares.

4. **Time period:** It is important for an organization or a business to choose the funds requirement as per the time period that whether it is required for a short period of time or a longer period and then raise funds accordingly from the market.

5. **Risk factors:** A strong analysis of the risk involved in each source of fund should be carefully analysed. The source that has the least risk should be selected. For example, equity is less riskier as compared to loans in respect to financial risk that arises from fixed interest payments, and repayment aspects.

6. **Dilution of Control:** The choice of what source from which financing has to be procured also depends upon the extent to which firm is ready for the dilution of control. Such as if existing equity shareholders aren't willing to dilute the control they enjoy, in such a case the company may issue finance from source other than equity share capital.

7. **Credit worthiness:** The type of sources from which the firm raise its capital impacts its credit worthiness. Hence the firm should choose sources which do not adversely affect its creditworthiness in the market.

8. **Ease of issuance of finance:** The flexibility and ease with which the firm is able to procure finance also affects the choice of source of finance. Excessive documents, legal restrictions, heavy investigation and other reasons may discourage the company from using a particular source of finance.

9. **Tax Advantages:** Some sources of finance are tax deductible, and hence firms can enjoy tax advantage using those sources. For example interest on debentures is a tax deductible expense, hence firms wanting to enjoy tax benefits may go for these sources.