Revision Notes for 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.
- An entrepreneur who carries out the activity invests a sum of money which is known as capital. He continuously needs to put money into the business for its expansion, that putting in of money is known as financing of business.
- Finance is the lifeblood 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.
- The 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.

- **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. based on period:

1. Short Term: These are the category of funds required for a short period 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. Based on 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 the source of generation

1. Internal Sources: Funds generated from within the organization are known as internal sources. However only short-term or limited needs could be fulfilled by this source. For example:

- Ploughing back profit, Disposing of 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

- A permanent source of funds.
- No explicit cost is involved in the form of dividends or interest.
- The greater degree of operational flexibility and freedom.
- Enhances the unexpected loss absorption capacity of the business.
- This may lead to an increase in 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 records and from industry to industry based on industry norms.

Merits

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

Limitations

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

3. Factoring

- This is a financial service in which a third party, namely factor, renders various services like discounting 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 the trading history of the organization, the creditworthiness of debtors, etc.
- There are two methods of factoring:
    - **Recourse Factoring:** The 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 collecting 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 charges on the assets of the firm.

Demerits

- It can be an expensive source if there are several 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 a lessor grants the right to use the asset for a certain 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 the business.
- Does not affect the debt-raising capacity of the organization.
- Lease rentals are tax-deductible expenses that lead to tax advantages.
- The risk of asset wear and tear is borne by the lesser.

Limitations

- The agreement may impose certain restrictions on 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

- An 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.

- 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 any time 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 the excess liquidity available.
- Extending the maturity of Commercial Paper is not possible.

7. Issue of Shares

1. A company needs huge investments to start a business, this amount is known as capital.
2. Since one individual can't 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.
3. Generally, there are two types of shares issued by the company:

a. Equity Shares

b. 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.
- The 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 a longer time to raise funds.

b. Preference Shares

- The holders of preference shares hold a preferential position with 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 dividends is generally high as compared to that of debentures.
- The 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 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 the 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

9. Commercial Banks

- Commercial Banks are those banks that provide funds to organizations for many purposes as well as various 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 need.

* 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 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 that are not provided by the commercial banks
* Provide various services such as managerial advice, and 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 instalment 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 with respect to the payment of dividends.

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 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 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 that have the option to be converted into equity or depository receipt after a certain 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 Source of Funds

1. **Cost of Finance:**
    - **a. Procurement Cost:** The expense involved in acquiring funds.
    - **b. Utilisation Cost:** The expense involved in using the funds.
2. **Financial Position:**
   Choose sources that don't burden the company, especially if it's not in a strong financial position.
3. **Form of Business:**
   The form of business, like sole-proprietorship or partnership, limits certain financing options (e.g., sole proprietors can't issue equity shares).
4. **Time Period:**
   Choose the source of funds based on whether they are needed short-term or long-term.

5. **Risk Factors:**
   Opt for sources with lower risk; for instance, equity is less risky than loans due to no fixed interest payments.

6. **Dilution of Control:**
   If equity shareholders don't want to dilute control, consider non-equity financing options.

7. **Credit Worthiness:**
   Select sources that maintain or enhance the firm's creditworthiness in the market.

8. **Ease of Issuance:**
   Consider the ease and flexibility of procuring funds, avoiding sources with excessive documentation and legal restrictions.

9. **Tax Advantages:**
   Opt for sources with tax benefits, like interest on debentures, which is tax-deductible.