

**SOURCES OF BUSINESS**  
**FINANCE**





# SOURCES OF BUSINESS FINANCE

- ◆ INTRODUCTION
- ◆ This chapter provides an overview of the various sources from where funds can be procured for starting as also for running a business. It also discusses the advantages and limitations of various sources and points out the factors that determine the choice of a suitable source of business finance.



# MEANING, NATURE AND SIGNIFICANCE OF BUSINESS FINANCE

Business is concerned with the production and distribution of goods and services for the satisfaction of needs of society. For carrying out various activities, therefore, is called the life blood of any business.

(A) fixed capital requirements

(B) working capital requirements



# CLASSIFICATION OF SOURCES OF FUNDS

- ◆ In case of proprietary and partnership concerns, the funds may be raised either from personal sources or borrowings from banks, friends etc.
- ◆ Period basis
- ◆ Ownership basis
- ◆ Sources of generation basis





# 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 sources of raising funds can be identified. there is not a single best source of funds for all organizations.



# RETAINED EARNINGS

## (merits)

- (i) Retained earnings is a permanent source of funds available to an organization.
- (ii) It does not involve any explicit cost in the form of interest, dividend or floatation cost.
- (ii) As the funds are generated internally, there is a greater degree of operational freedom and flexibility.



## (LIMITATIONS)

- (i) Excessive plugging back may cause dissatisfaction amongst the shareholders as they would get lower dividends.
- (ii) it is an uncertain source of funds as the profits of business are fluctuating;
- (ii) the opportunity cost associated with these funds is not recognized by many firms.



# TRADE CREDIT

- ◆ Merits
- ◆ Trade credit is a convenient and continuous source of funds;
- ◆ Trade credit may be readily available in case the credit worthiness of the customers is known to the seller;
- ◆ Trade credit needs to promote the sales of an organisation
- ◆ If an organisation wants to increase its inventory level in order to meet expected rise in the sales volume in the near future.





# LIMITATIONS

- ◆ Availability of easy and flexible trade credit facilities may induce a firm to indulge in overtrading which may add to the risk of the firm.
- ◆ Only limited amount of funds can be generated through trade credit
- ◆ It is generally a costly source of funds as compared to most other sources of raising money.



# FACTIRING MERITS

- ◆ Obtaining funds through factoring is cheaper than financing thorough other means such as bank credit
- ◆ With cash flow accelerated by factoring the clients is able to meet his/ her liabilities promptly as and when these arise.
- ◆ Factoring as a source of funds is flexible and ensures a definite pattern of cash inflows from credit debt that a firm might otherwise be unable to obtain.



# LIMITATIONS

- (I) This source is expensive when the invoices are numerous and smaller in amount
- (II) The advance finance provided by the factor firm is generally available at a higher interest cost than the usual rate of interest.
- (II) The factor is a third party to the customer who may not feel comfortable who may not feel comfortable while dealing with it.



# LEASE FINANCING (MERITS)

- ◆ It enables the lessee to acquire the asset with a lower investment.
- ◆ Simple documentation makes it easier to finance assets.
- ◆ Lease rentals paid by the lessee are deductible for computing taxable profits.
- ◆ It provides finance without diluting the ownership or control of business.





# LIMITATIONS

- ◆ 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 obligation in case the equipment is not found useful and the lessee opts for premature termination of the lease agreement and .



# PUBLIC DEPOSITS (MERITS)

- i The procedure of obtaining deposits is simple and does not contain restrictive conditions as are generally there in a loan agreements.
- ii public deposits do not usually create any charge on the assets of the company.the assets can be used as security for raising loans from other sources.



# LIMITATIONS

- ◆ New companies generally find it difficult to raise funds through public deposits
- ◆ It is an unreliable source of the 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 (MERITS)

- ◆ 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 source
- ◆ A commercial paper provides a continuous source of funds.
- ◆ Companies can park their excess funds in commercial paper thereby earning some good returns on the same.





# LIMITATIONS

- ◆ 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

## a) EQUITY SHARES

- ◆ MERITS
- ◆ Equity shares are suitable for investors who are willing to assume risk for higher returns
- ◆ Payment of dividend to the equity shareholders is not compulsory
- ◆ 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



# LIMITATIONS

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 share.



## b) PREFERENCE SHARES (MERITS)

- ◆ Preference shares provide reasonably steady income in the form of fixed rate of return and safety of investment.
- ◆ Preference shares are useful for those investors who want fixed rate of return with comparatively low risk.
- ◆ It does not affect the control of equity shareholders over the management as preference shareholders don't have voting rights.





# LIMITATIONS

- ◆ Preference shares are 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.



# DEBENTURES (MERITS)

- ◆ It is preferred by investors who want fixed income at lesser risk
- ◆ Debentures are fixed charge funds and do not particulars in profits of the company.
- ◆ The issue of debentures is suitable in the situation when the sales and earnings are relatively stable.



# LIMITATIONS

- ◆ As fixed charge instruments 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.



# COMMERCIAL BANKS

## MERITS

- ◆ Banks provide timely assistance to business by providing funds as and when needed by it.
- ◆ 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 not required for raising loans from a bank.
- ◆ Loan from a bank is a flexible source of finance as the loan according to business needs and can be repaid in advance when funds are not needed.





# LIMITATIONS

- ◆ Funds are generally available for short periods and its extension or renewal is uncertain and difficult
- ◆ Bankers make detailed investigation of the company affairs financial structure etc and may also ask for security of assets and personal sureties .
- ◆ In some cases difficult terms and conditions are imposed by banks for the grant of loan.



# FINANCIAL INSTITUTIONS MERITS

- ◆ Financial institutions provide long term finance which are not provided by commercial banks.
- ◆ Besides providing funds many of these institutions provide financial managerial and technical advice and consultancy to business firms.
- ◆ As repayment of loan can be made in easy installments, it does not prove to be much of a burden on the business.



# LIMITATIONS

- ◆ Financial institutions follow rigid criteria for grant of loans. 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.



# INTERNATIONAL FINANCING

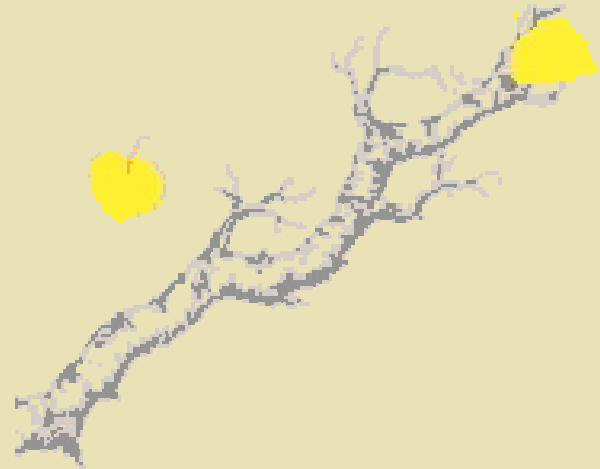
- ◆ Commercial banks
- ◆ International agencies and development banks
- ◆ International capital markets.
- ◆ (a) Global depository receipts(GDRs)
- ◆ (b) American depository receipts(ADRs)
- ◆ ©Foreign currency convertible bonds(FCCBs)





# FACTORS AFFECTING THE CHOICE OF THE SOURCE OF FUNDS

- ◆ Cost
- ◆ Financial strength and stability of operations.
- ◆ Form of organization and legal status.
- ◆ Purpose and time period.
- ◆ Risk profile.
- ◆ Control.
- ◆ Effect on credit worthiness.
- ◆ Flexibility and ease.
- ◆ Tax benefits.



**THANK YOU**

