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SOURCES OF BUSINESS FINANCE

Finance is one of the foundations of economic activity of mankind. It is needed for starting the business and also to keep it going. It is rightly described as the life blood of any industrial or commercial undertaking.

CLASSIFICATION OF CAPITAL

On the basis of the purpose for which finance is required, finance or capital may be classified into fixed or block capital and working or circulating capital.

Fixed Capital

It refers to the amount required for acquiring fixed assets like land, building, machinery etc.

Factors Governing Fixed Capital Requirements

The amount of fixed capital requirement of a project depends on the following factors :

- Nature of project.
- Size of the project.
- Diversity of production line.
- Method of production.
- Method of acquiring fixed assets.

Working Capital

It consists of funds invested in current assets. There are two concepts of working capital. One is gross concept and the other is net concept. Gross concept working capital refers to the amount of funds invested in current assets. Working capital is equal to total current assets. Net concept working capital refers to the excess of current assets over current liabilities. Working capital is equal to current assets minus current liabilities.

TYPES OF WORKING CAPITAL

It is broadly classified into two—permanent working capital and variable working capital.

(1) Permanent or Fixed Working Capital

It is the minimum amount of working capital required to ensure effective utilization of fixed assets and support the normal operation of the business. It is again divided into two.

(A) ***Initial Working Capital*** : It is the capital with which the project is commenced.

(B) ***Regular Working Capital*** : It is the minimum amount of the liquid capital to keep up the circulating capital from cash to inventories, to receivables and back again to cash.

(2) **Variable Working Capital**

This is the additional capital needed to meet seasonal and special needs. It is again divided into two :

(A) ***Seasonal Working Capital*** : It refers to the additional working capital required during busy seasons.

(B) ***Special Working Capital*** : It may be required to carry on a special sales campaign or financing slow moving stock or financing a period of strike or lockout etc.

FACTORS DETERMINING WORKING CAPITAL

It depends upon the following factors :

(a) Character of business.
(b) Size and volume of business.
(c) Length of processing period.
(d) Turnover.
(e) Terms of purchase and sales.
(f) Seasonal variation.
(g) Importance of labour.
(h) Cash flow.
(i) Stock.
(j) Cyclical fluctuation.

SOURCES OR MEANS OF FINANCE

There are basically two sources available for financing project- internal sources and external sources. If the size of the project is large, the fund requirement will have to be financed from external sources. The technique of raising capital from multiple sources is known as layered financing.

The following shows the various sources of project finance :

SOURCES OF FUNDING

Sources of funding may be may classified differently. But for convenience, the sources of fund may be broadly divided into long term sources of funding and short term sources of funding.

Sources of funding

Long term sources	***Short term sources***
1. Issue of shares	1. Trade credit
2. Issue of debentures	2. Bank credit
3. Issue of bonds	3. Public deposits

4. Retained earnings
5. Advances from customers
6. Commercial paper
7. Institutional finance.

4. Inter-corporate deposits
5. Sale of fixed assets
6. Innovative sources

I. LONG TERM SOURCES

Long-term sources of funding are through the issue of shares, debentures, bonds, retained earnings, sale of fixed assets, etc. Funding through the issue of equity and preference shares, debentures and bonds is known as security financing.

(A) Financing through Equity Shares

Equity shares are also known as ordinary shares. According to Sec. 43 of the Companies Act, 2013 "Equity shares are those shares which are not preference shares". It is the main source of finance to any company. It is the owners in the company.

Characteristics of equity shares

1. ***Maturity*** : Equity shares provide permanent capital to the company and cannot be redeemed during the lifetime of the company. Equity share holders can demand refund of their capital only at the time of liquidation of the company.

2. ***Claim on income*** : Equity shareholders have a residual claim on the income of the company. They have a claim on income left after paying dividend to preference shareholders. In periods of insufficient profits they may not get anything but in times or prosperity the will get high returns.

3. ***Claim on assets*** : Equity shareholders have a residual claim on ownership of company's assets. In the even of liquidation of a company, the assets are utilised first to meet the claims of creditors and preference shareholders and if anything is left it belongs to equity shareholders. Equity shares provide a cushion to absorb losses on liquidation.

4. ***Right to control or voting right*** : Equity shareholders are the real owners of the company. They have voting right in the meeting of the company and have a control over its working. The control of the company is vested with the Board of Directors who are elected by the equity shareholders.

5. ***Pre-emptive right*** : When a company makes subsequent issue of capital, it must be first offered to the existing shareholders. This right of the existing shareholders is called pre-emptive right. The shares thus issued are called right shares.

6. ***Limited liability*** : Limited liability means that the liability of a shareholder is limited to the extent of the face value of shares held by him.

Advantages of using equity capital

1. Equity capital is a permanent source of fund.
2. Equity shares do not create obligation to pay a fixed rate of dividend.
3. Fresh issue of equity shares provides flexibility to the capital structure because funds are obtained without creating any charge over the assets of the company.
4. By issuing right shares, it is possible to raise additional funds without diluting control.

Disadvantage of using equity capital

1. Cost of equity capital is the highest of all sources.
2. Payment of dividend will attract Corporate Dividend Tax which is an additional burden to the company.
3. Additional issue of equity shares will reduce the earning per share.
4. If only equity shares are issued, the company cannot take the advantage of trading on equity.
5. There is a danger of over capitalisation as equity share capital cannot be redeemed.
6. In periods of prosperity equity shareholders will get high dividend which will lead to speculation.

(B) Financing through Preferences Shares

These are the shares which enjoy preferential rights as to the payment of dividend at a fixed rate during the life of the company and as to the return of capital on winding up of the company over the equity shares.

TYPES OF PREFERENCE SHARES

There are the shares which enjoy preferential rights as to the payment of dividend at a fixed rate during the life of the company and as to the return of capital on winding up of the company over the equity shares.

1. **Cumulative Preference Shares**

Cumulative Preference Shares are those shares which carry the right to cumulative dividends. That means, if the company fails to pay the dividend in a particular year, due to insufficiency of profits, such dividend is payable even out of future profits. In other words, dividend on these shares accumulates till it is paid off in full. Such shares are therefore called Cumulative Preference Shares.

2. **Non-cumulative Preference Shares**

These are the preference Shares which do not carry the right to receive arrears of dividend. If the company fails to declare dividend in a particular year that dividend need not be paid out of future profits. If no dividend is paid in any particular year, it lapses.

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3. **Participating Preference Shares**

Preference Shares which have right to participate in the surplus profits and assets of the company after paying the equity shareholders, in addition to their fixed rate of dividend and return of capital are called Participating Preference Shares.

4. **Non-participating Preference Shares**

Preference shares which have no right to participate on the surplus profits and assets of the company are called non-participating Preference Shares.

5. **Redeemable Preference Shares**

These are shares which a company may issue on the stipulation that they may be repaid either after a fixed period or even earlier at the company's option. The repayment of these shares is called redemption and is governed by Section 80 of the Companies Act 1956. In India, companies can now issue only this category of Preference Shares.

6. **Irredeemable Preference Shares**

These are the shares which are redeemed (repaid) only on winding up of the company.

7. **Convertible Preference Shares**

These are the shares which enjoy the right to get converted into equity shares at a later date.

8. **Non-convertible Preference Shares**

Preference Shares which are not convertible into equity shares are called Non-convertible preference shares which are irredeemable. Hence, no company can issue any preference shares other than redeemable preference shares.

Advantages of using preference capital

1. Preference shares add to the equity base of the company and so strengthen it financial position.
2. Preference shares save the company from paying higher rate of interest.
3. Issue of preference shares doesn't create any sort of charge against assets of the company.
4. Preferences shares will not affect existing control of the company as the preference share holders have voting rights only on the matters affecting their interest.
5. Financing through preference shares is cheaper than that of equity financing.
6. It is useful to investors who want to get higher rate of return with low risk.
7. The company can utilise huge surplus funds by redeeming preference shares as per the provisions of the Company's Act.

Disadvantages of using preference capital

1. Preference dividend is not deductible as an expense for taxation purposes, out of the profits of the company.
2. In case of cumulative preference shares, arrears of dividend have to be declared before anything can be paid to the equity shareholders of the company.
3. Preference shares dilute the claim of equity shareholder over the assets of the company.
4. Compulsory redemption of preferences shares on maturity will lead to substantial outflow of cash.
5. The cost of capital of preference shares is higher than cost of debt.

Financing through Debentures

Debenture is an acknowledgement of debt. According to Section 71 of Companies Act, 2013 a company may issue debentures with an option to convert such debentures into shares, either wholly or partly at the time of redemption. It is only a written document issued by a company as an evidence of its debt capital.

DEFINITION

A debenture is "an instrument in writing acknowledging a debt under the seal of the company, usually secured by a fixed or floating charge on the assets of the company, bearing a fixed rate of interest and repayable within or after a specified period or irredeemable during the existence of the company".

KINDS OF DEBENTURES

Debentures are classified on the basis of :

(i) Transferability;

(ii) Security offered

(iii) Redeemability

(iv) Convertibility

(v) Priority.

(i) **On the basis of Transferability**

(a) ***Registered Debentures*** : These are debentures registered in the books of the company. In other words they are made out in the names of particular persons who are registered as debenture holders, with their full details, in the books of the company.

(b) ***Bearer Debentures*** : The names and other details of bearer debentures are not recorded in the 'Register of Debentures' of the company. They can be freely transferred. The principal amount and interest when due are payable to the (bearer) holders of these debentures.

(ii) On the basis of Security

(a) ***Secured or Mortgage Debentures*** : These are debentures which are secured by a fixed or floating charge on the assets of the company. Repayment of principal and interest on such debentures is secured. When specific assets are named as security it becomes a fixed charge. On the other hand when assets in general are offered as security, it becomes a floating charge.

(b) ***Simple or Unsecured Debentures*** : These debentures carry no security with regard to repayment of principal and interest. They are also called "naked debentures". The general solvency of the company is the only security for these debentures. On winding up of the company the holders of these debentures will be treated like other unsecured creditors.

(iii) On the basis of permanence (Redeemability)

(a) ***Redeemable Debentures*** : Debentures, the principal amount of which is repayable after a specified period of time are called redeemable debentures.

(b) ***Irredeemable Debentures*** : Debentures, which are not repayable during the life time of the company are called irredeemable debentures. They are also called perpetual debentures.

(iv) On the basis of convertibility

(a) ***Convertible debentures*** : A convertible debenture can be converted into shares of the same company at the option of the holders. Convertible debentures may be fully convertible or partly convertible.

(b) ***Non-convertible Debentures*** : Debentures which are not convertible into shares of a company are called non-convertible debentures.

(v) Priority

(a) ***First Mortgage Debentures*** : These debentures are payable first out of the property charged.

(b) ***Second Mortgage Debentures*** : These debentures are payable after satisfying the first mortgage debentures.

Advantages of Debenture Capital

1. It provides long term finance to a company.
2. The rate of interest payable is less than the rate of dividend on shares.
3. Interest on debenture is a tax deductible expense. So effective cost of debentures is lower as compared to ownership securities.
4. Debt financing does not dilute control.
5. It enhances trading on equity.
6. Redeemable debentures provide flexibility in the capital structure of a company.

Disadvantages of Debenture Capital

1. It is a permanent burden on the company to repay the principal on maturity.
2. Charge on assets of the company restrict it from the use of Debenture financing.
3. The use of Debt financing Debt financing usually increases the risk. The increased financial risk increases cost of debt.
4. Cost of raising financing through debentures is high because of high stamp duty.
5. It is not desirable to issue debentures by a company having irregular earnings.

Financing through Bonds

A bond is an instrument, whereby, one person binds himself to another for payment of a specified sum of money on a specified date. In India, traditionally the term bond is used to indicate the instruments issued by the government, semi government bodies and public corporations. But the term debenture is used to denote instruments issued by the corporate sector. Now a days companies also issue different types of bonds. Incase of winding up of the company, the amount due to the bond holders are paid prior to that of the debenture holders.

TYPES OF CORPORATE BONDS

1. ***Bearer Bonds*** : In this type of bonds, the amount is payable to the holders of the instruments at the time of maturity.

2. ***Registered bonds*** : In this case, the amount is payable to the person whose name is mentioned in the register of the company.

3. ***Zero coupon bonds or deep discount bonds*** : This is a new type of bond which has no periodic interest payment. They are issued at substantially discounted price and redeemed at face value. The difference between the purchase price and the face value is the gain to the holder of the instrument.

4. ***Sinking fund bonds*** : In the case of sinking fund bonds, the issuing company redeems a fraction of the issue every year. Finally, only a small portion of the principal amount remains to be repaid on maturity.

5. ***Junk bonds*** : Junk bonds are high risk and high yield bonds developed in USA. They are normally issued in connection with mergers, acquisitions, etc.

6. ***Privately placed bonds*** : These are privately planed bonds and are not negotiable. These are usually issued to institutional investors.

7. ***Bunny bonds*** : These are the bonds issued with the right to reinvest the income into the bonds with the same terms and conditions of the host bond.

8. ***Secured Premium Notes (SPN)*** **:** These instruments are issued with detachable warrants and are redeemable after a notified period, normally 4 to 7 years, the warrants enable the holders to get equity shares provided the SPN are fully paid.

Retained Earnings

Generally, the entire profits of the company are not distributed amongst the shareholders as dividend. Some portion of profits are retained by the company for their future expansion through transfer of profit to different reserves such as general reserve, dividend equalisation reserve, etc. The process of transfer of profits to different reserves is known as ploughing back of profits. A part of the profits are re-invested into the business operation and it is treated as an ideal source of financing for modernisation of the company.

Sale of fixed assets

Sale of fixed assets like land and building, lease hold premises, etc. which are not in use form a long term source of finance.

Institutional Finance

There are several financial institutions for giving financial assistance to entrepreneurs. Some of them are IDBI, IFCI, SIDBI, NABARD etc.

I. INNOVATIVE SOURCES

(I) Hire purchase financing

it is a new development of finance mechanism in certain selected sectors of Indian Industries. Under the hire purchase financing, the organisations are able to use high value assets with minimum capital.

It is an agreement between buyer and seller of the property. At the time of delivery the buyer has to pay only small amount of the asset value i.e., called down payment. He has to pay agreed amount on number of periodical instalments. Actually the seller retains the title of the assets up to the settlement of last instalment.

(II) Seed Capital

it is the new technique of financing system developed by the IDBI to the new entrepreneurs. Whenever the financial institutions are funding a project, it should insist the promoter's contribution towards the projects. But when technically qualified entrepreneurs lack financial capability to provide the required contribution, IDBI provides financial assistance to them.

(III)Indian Depository Receipts (IDR)

An Indian Depository Receipt (IDR) enables foreign companies to raise funds from the Indian securities market. IDR is a instrument denominated in Indian Rupees in the form of a domestic depository receipt against the underlying equity of issuing company.

(IV)Euro Issues

Euro issues means an issue listed on European Stock Exchange, the subscriptions for which may come from any part of the world other than India.

The following are the investments issued by Indian companies for foreign investors.

1. ***Global Depository Receipts (GDR)*** : It is a denominated instrument tradable on stock exchanges in Europe or US or both. It represents a certain number of equity shares and are quoted and trades in dollar terms. But the shares are denominated in rupees. The shares are issued by the issuing company to intermediary called 'depository'. The equity shares are registered in the name of depository who subsequently issues the GDR to the investors.

2. ***European Deposit Receipts (EDR)*** : These are financial instruments in the form of deposit receipts issued to non resident investor, represented by the equity shares iof the issuing company. They are marketed only in European countries including U.K. It resembles GDR, except with a difference that GDR us marketed both in Europe and the USA.

3. ***Foreign Currency Convertible Bonds (FCCB)*** : These are bonds issued to and subscribed by non resident investors in foreign currency and are convertible into ordinary shares of the issuing company at a fixed price. They have definite maturity dates. Euro Convertible Bonds also fall in this category.

(V)Lease Financing

Leasing is an agreement between the owner of the property and the user of the property. It provides a firm with use and control over the assets without buying and owning the same. It is one of the ways of renting assets.

(VI)Venture Capital

Venture capital financing is of recent origin in Indian capital market. It is an equity financing specifically for funding high risk and high reward projects. It is also concentrating research and development projects into commercial production. It other words the term venture capital refers the institutional investors who provide equity financing to new entrepreneurs and render advisory services to their managements.

II. SHORT-TERM SOURCES

Short-term sources of funding include :

1. Trade Credit

Sellers or suppliers of different kinds of products or raw materials provide credit to their customers. The credit offered by the seller or supplier is known as trade credit. It is a very important source of short-term finance.

2. Bank Credit

Banks provide short-term finance in the form of over draft, cash credit, discounting of trade bill and letters of credit to its customer. Overdraft facilities are allowed to customers having current account balance upto a limit. Cash credit is a regular system under which the bank offers the facilities to its clients to within the limit pre-fixed by the bank. Banks may also provide funds to customers on discounting hills.

3. Public deposit

Firms may mobilise savings from the general public and it is termed as 'public deposit'. It is a very old system of financing.

4. Inter corporate deposits

Deposits made by one company in another company is known as inter corporate deposit. It is an important short-term source of finance for firms in India.

5. Advances from customers

Usually, sellers or producers receive whole or part of the amount of goods in advance and such advance remains with them till the supply of goods. Normally no interest is paid on this amount.

6. Commercial paper (CP)

Commercial paper is a short-term money market instrument. It is a promissory note which is negotiable by endorsement and fit for delivery with a fixed maturity period between one month to one year. It helps to raise short-term deal at attractive rates.

7. Convertible debentures

For raising funds for working capital along with long term purpose, the issue of convertible debentures is considered as a popular method. Since banks generally grand loans/advances only on the security of current assets, the issue of debenture is regarded as the only other appropriate alternative source for raising fund.

QUESTIONS