

## Chapter 7

### Sources of Business Finance

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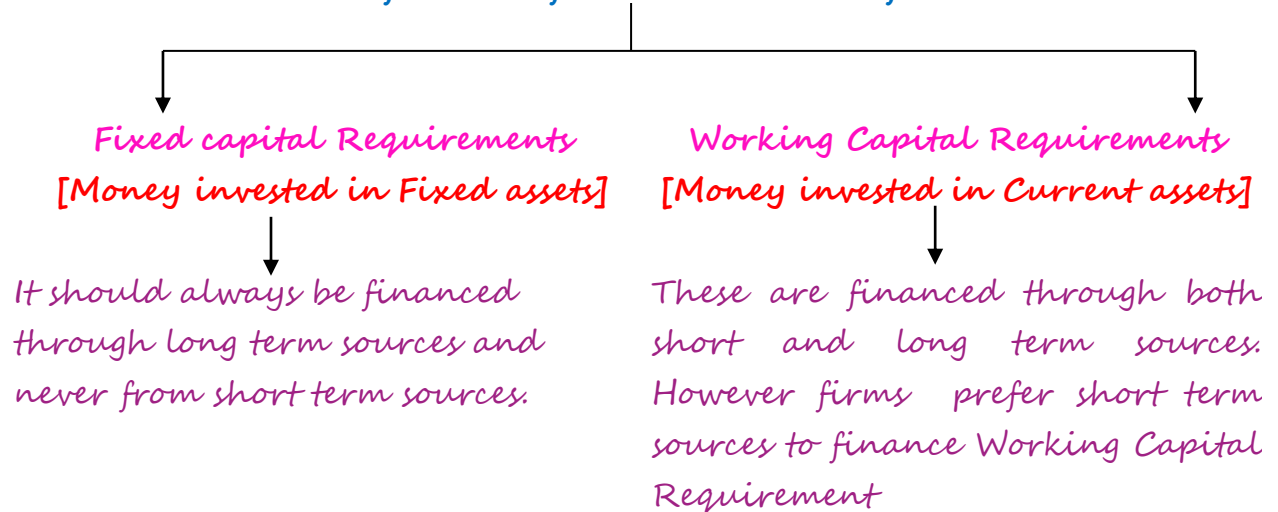
## 1. Introduction

Business finance refers to the money required for carrying out business activities.

### Need for Business Finance

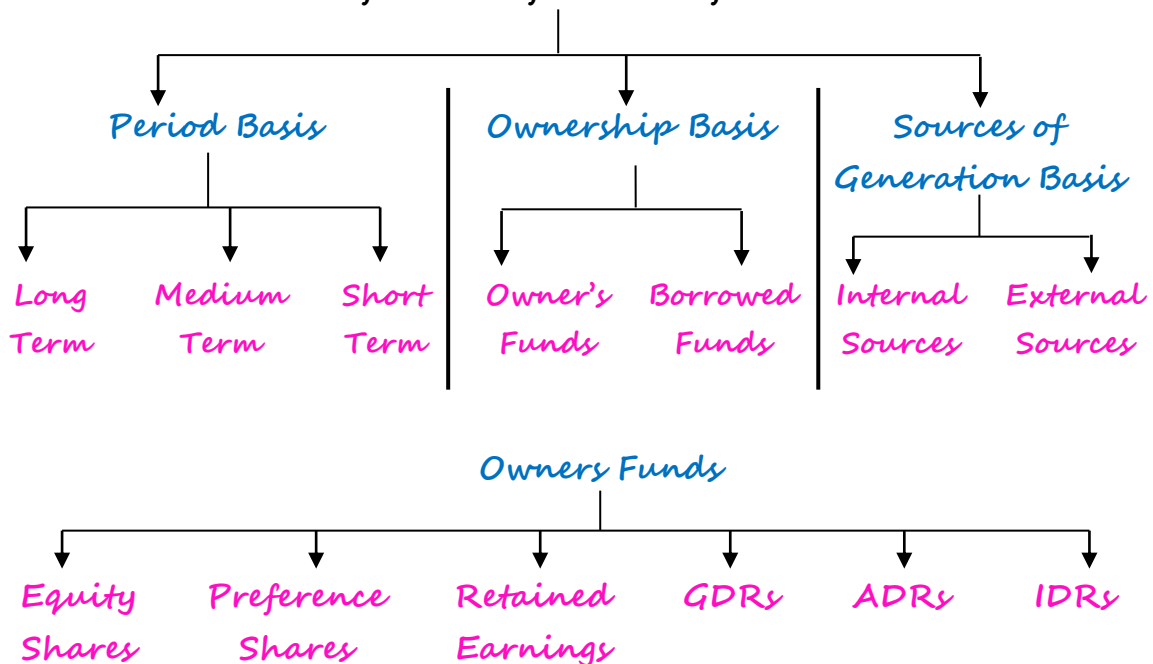
1. To start and establish a business
2. To run day-to-day activities
3. To modernize, expand and diversify the business
4. To purchase assets

### Classification of Financial Needs of a Business



## 2.

### Classification of Sources of Funds



### 3. Equity Shares

These shares do not carry any special or preferential rights in respect of payment of annual dividend and repayment of capital.

#### 3.1 Features of Equity Shares

**MT: Risk Return VL City**

1. Risk bearer capital
2. Return
3. Voting rights
4. Limited Liability
5. Claim over residual income
6. Maturity

#### 3.2 Merits of Equity Shares

**MT: C C**

1. Ideal for adventurous investors  
[Risk]
2. Source of fixed capital  
[Maturity]
3. No obligation as to dividend  
[Claim over residual income]
4. Democratic Management  
[Voting rights]
5. Provides credit standing
6. No charge on assets

#### 3.3 Limitations of Equity Shares

**MT: DeaF**

1. Risk of Fluctuating returns  
[Risk]
2. High cost of capital  
[Return]
3. Dilution of Control  
[Voting rights]

4. Danger of over capitalization
5. Legal formalities

#### 4. Preference Shares

Preference shares are those shares, which enjoy certain priorities regarding the payment of dividend at a fixed rate and return of the capital.

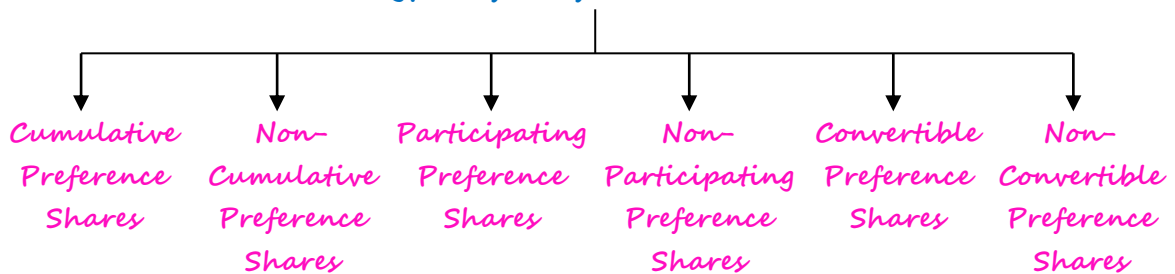
$$\text{Preference Shares} = \text{Equity Shares} + \text{Debentures}$$

↓  
 Dividend

↓  
 Fixed rate of return

##### 4.1

#### Types of Preference Shares



##### 4.2 Features of Preference Shares

**MT: Definition No No**

1. Fixed rate of dividend
2. Repayment of capital
3. No voting rights
4. No charge on assets

##### 4.3 Merits of Preference Shares

1. Reasonable safety of returns  
[Fixed rate of dividend]
2. Repayment of principal amount  
[Repayment of capital]
3. No interference in management  
[No voting rights]
4. No charge on assets  
[No charge on assets]
5. Trading on equity

#### 4.4 Limitations of Preference Shares

1. Limited appeal
2. Dilutes claim of equity shareholders
3. Unreliable and low returns
4. No tax benefits

#### 5. Retained Earnings

It refers to that part of profits which is kept as reserve for use in the future.

##### Important Points

1. Also known as 'Internal Financing', 'Self Financing' or 'Ploughing back of profits'.
2. Shareholders' funds and there is no external liability.
3. Not for newly established company.
4. Amount depends on many factors like net profits dividend policy, age of the organisation etc.

#### 5.1 Merits of Retained Earnings

##### MT: DAD free C M

1. Dependent Source
2. Ability to absorb shocks in business
3. Stability of dividend
4. More freedom
5. Economical
6. Enhances market value of shares

#### 5.2 Limitations of Retained Earnings

1. Dissatisfaction among shareholders.
2. Uncertain
3. Ignores opportunity cost
4. Danger of over capitalization

**6. Global Depository Receipts [GDRs]**

It is an instrument issued abroad by a company to raise funds in some foreign currency and is listed and traded at a foreign stock exchange.

**7. American Depository Receipts [ADRs]**

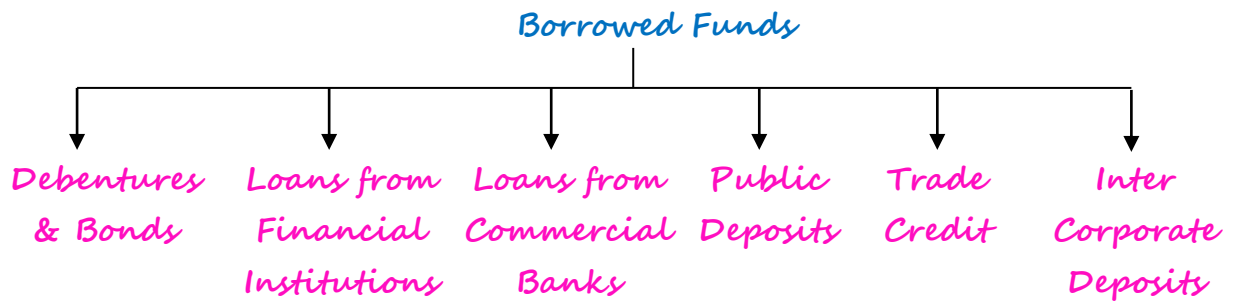
The depository receipts issued by a company in the USA are known as American Depository Receipts.

**Important Points about GDRs and ADRs**

1. The shares of an Indian company are delivered to the overseas depository. The depository is generally a bank located in the country in which GDRs shall be treated.
2. This depository appoints another intermediary, known as custodian for keeping the physical possession of such shares. The custodian is generally selected by the depository rather than the issuer company.
3. Depository issues GDRs/ADRs to foreign citizens, which certifies that shares of Indian company are held by custodian.
4. Dividends on such shares, notices and reports about the Indian company are received by the depository.
5. Dividend is received in ₹ [or home currency of the issuing company] while depository pays the dividend in pounds or \$ to the GDR or ADR holders.

**8. Indian Depository Receipts [IDRs]**

IDR is a financial instrument denominated in Indian Rupees in the form of a Depository Receipt created by an IDR to enable a foreign company to raise funds from the Indian securities market.



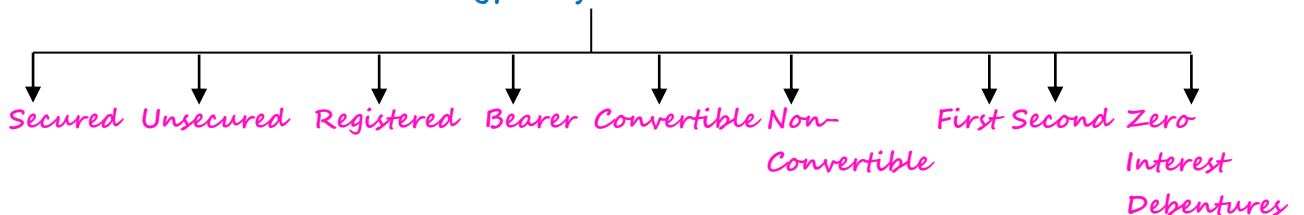
### 9. Debentures and Bonds

As per section 2(30) of The Companies Act, 2013, "Debenture includes debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not."

A debenture is a document or certificate which is issued under the common seal of the company.

#### 9.1

#### Types of Debentures



#### 9.2 Features of Debentures

**MT: BCD No Interest Interest**

1. Borrowed fund
2. Charge against assets
3. Redemption of Debentures
4. No voting rights
5. Periodic interest payment
6. Compulsory payment of interest

#### 9.3 Merits of Debentures

1. Ideal for safe investors  
[Compulsory & Periodic interest payment]
2. No loss of control  
[No voting rights]

3. Flexibility  
[Redemption of Debentures]
4. Economical  
[Less risk less return]
5. Suitable during stable earnings  
[Compulsory & periodic interest payment]
6. Tax benefits
7. Trading on equity

#### 9.4 Limitations of Debentures

1. Permanent burden of interest  
[Compulsory payment of interest]
2. Adverse impact on borrowing capacity
3. Repayment obligation  
[Redemption of Debentures]
4. Charge on assets  
[Charge against assets]

### 10. Loan from Financial Institutions

The CG and SG have established various financial institutions in the country to provide finance to business.

#### 10.1 Merits of Loan from Financial Institutions

1. Medium and long term finance
2. Assistance in Business
3. Source of goodwill
4. Easy repayment scheme
5. Finance even during depression

#### 10.2 Limitations of Loan from Financial Institutions

1. Difficult Procedure
2. Restrictive clauses
3. Interference in Management

## 11. Loans from Commercial Banks

Commercial banks are an important source of raising funds for different purposes as well as for different time periods.

### 11.1 Merits of Loans from Commercial Banks

1. Economical
2. Maintains business secrecy
3. Less formalities
4. Flexible source

### 11.2 Limitations of Loans from Commercial Banks

1. Difficult procedure
2. Restrictive Procedures
3. Interference in Management

## 12. Public Deposits

These are the deposits raised by organisations directly from the public.

### 12.1 Merits of Public Deposits

1. Simple Procedure
2. Economical
3. No charge over assets
4. No loss of control

### 12.2 Limitations of Public Deposits

1. Unsuitable for new companies
2. Unreliable Source
3. Not suitable for long term financing
4. Limited Funds

## 13. Trade Credit

It is the credit extended by one trader to another for the purchase of goods and services. It facilitates the purchase of supplies without immediate payment.

It is also known as 'Mercantile Credit'

### 13.1 Merits of Trade Credit

1. Convenient Source
2. Ready availability
3. Promotes sales
4. Helps in raising inventory level
5. No charge on assets

### 13.2 Limitations of Trade Credit

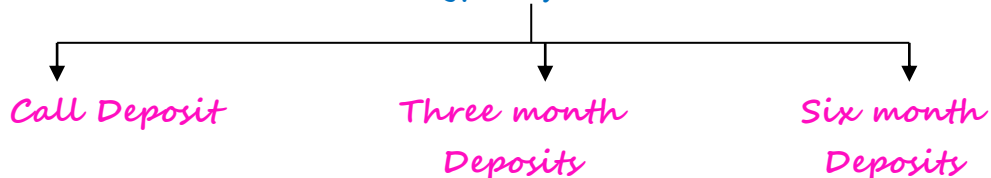
1. Risk of overtrading
2. Limited funds
3. Costly

## 14. Inter Corporate Deposits [ICD]

It is an unsecured borrowing by companies from other corporate entities registered under The Companies Act.

### 14.1

#### Types of I C D's



### 14.2 Merits of ICD's

1. Free from bureaucratic and legal problems
2. Secrecy is maintained
3. Meeting working capital requirements

### 14.3 Demerits of ICD's

1. Not suitable for long term financing
2. Unsecured
3. High interest rates

## 15 Factoring

It is a financial service under which a factor renders the following services:

Discounting of bills and collection of the client debts

Providing information about credit worthiness of prospective clients

### Methods of Factoring

Recourse Factoring

Non-recourse Factoring

### Merits of Factoring

1. Economical
2. Facilitates financial commitments on time
3. Flexible source
4. Safety of debts
5. No charge over assets
6. More attention to core issues

### Limitations of Factoring

1. It is an expensive source when there are numerous invoices, which are smaller in amount
2. High commission charged by factor
3. Customer may not be comfortable in dealing with factor.

## 16. Lease Financing

It is contractual agreement in which the owner of the asset grants the other party the right to use the asset, in return for a periodic payment, but retains the title over the property.

Owner —————→ Lessor

The party who uses the asset —————→ Lessee

Fixed periodic amount —————→ Lease Rent

### Merits of Lease Financing

1. Prevents huge investments
2. Less Formalities
3. Tax benefits
4. No loss of control
5. No effect on borrowing capacity
6. No risk of change in technology

### Limitations of Lease Financing

1. Certain restriction on use of asset
2. Problems due to non-renewal of lease on time
3. Premature termination of the lease agreement leads to huge payment to lessor
4. Lessee never becomes the owner of the asset

## 17. Commercial Paper

It is an unsecured promissory note issued by a firm to raise funds for a short period varying from 90 days to 364 days.

### Merits of Commercial Paper

1. No charge on assets
2. High liquidity
3. Cost of issuing commercial paper is generally Low
4. Continuous source of fund
5. Companies can invest excess funds in commercial paper and can earn good returns on the same.

### Limitations of Commercial Paper

1. Can be issued only by financially sound and highly credit worthy firms
2. Limited funds can be raised
3. Its maturity cannot be extended, if the firm is unable to redeem its paper.

**18. Factors affecting choice of Source of Funds**

1. Cost
2. Financial Strength and Stability of operations
3. Form of organisation and Legal Status
4. Purpose of time period
5. Risk Profile
6. Control
7. Effect on Credit Worthiness
8. Flexibility and Ease
9. Tax Benefits