SOURCES OF BUSINESS FINANCE

Class 11

BUSINESS STUDIES

CONCEPT OF BUSINESS FINANCE

SOURCES OF BUSINESS FINANCE

CONCEPT OF BUSINESS FINANCE

Business finance refers to capital funds and credit funds invested in the business. Financing means making money available when it is needed.

DEFINITION OF FINANCE BY DIFFERENT AUTHORS

"Finance is that business activity which is concerned with the acquisition and conservation of capital fund in meeting the financial needs and overall objectives of business enterprise."

- B.O. Wheeler

NATURE & SIGNIFICANCE OF BUSINESS FINANCE

No one can start a business or run an enterprise without adequate funds. Every business requires some money to start which is called initial capital. The amount of capital required depends upon the nature and size of the business.

SOURCES OF BUSINESS FINANCE

Business enterprise requires capital and finance for the following purposes:

1. **While starting a business, finance is required to procure fixed assets and also for meeting day-to-day expenses.**
2. **To meet the working capital requirement when production process is lengthy.**
3. **To finance the growth and expansion projects of the company. We need fixed capital.**

SOURCES OF BUSINESS FINANCE

Adequate finance provides the following benefits to a business concern:

1. **The firm can meet its liabilities on time.**
2. **The firm can carry on its business smoothly.**
3. **The firm can adopt latest technology and new innovative methods of production.**
4. **The firm can make use of its business opportunities.**

SOURCES OF BUSINESS FINANCE

Adequate finance provides the following benefits to a business concern:

5. **The firm can face competition more strongly.**
6. **The firm can replace its assets and machinery whenever necessary.**
7. **The firm can face recession and depression period of trade cycle.**

SOURCES OF BUSINESS FINANCE

Class 11

BUSINESS STUDIES

SOURCES OF FINANCE ON THE BASIS OF OWNERSHIP

SOURCES OF BUSINESS FINANCE

SOURCES OF FINANCE ON THE BASIS OF OWNERSHIP -

For every business enterprise, there are two sources of business finance. These are:

- **Owners' Fund**
- **Borrowed Fund**

SOURCES OF BUSINESS FINANCE

OWNERS' FUND

Owners' fund refers to the funds contributed by owners as well as the accumulated profit of the company. This fund remains with the company and it has no liability to return this fund. For example, equity shares, retained earnings.

FEATURES OF OWNER'S FUND

1. **No Security Required :**

   No security has to be offered against ownership capital.

2. **Sources of Owners' Fund :**

   The owners' fund comprises of share capital, retained earnings (accumulated profit)

SOURCES OF BUSINESS FINANCE

3. Provision of Risk Capital :

- ✓ The owners' fund is also known as the risk capital of the business, as the return on this capital depends upon the rate of earning of the company. In case company is incurring loss then it is not compulsory to pay any return on owners' fund.

SOURCES OF BUSINESS FINANCE

- ✓ If loss continues owners may be unable to recover even their original investment. In times of prosperity high level of return is given on owners' fund.
- ✓ The return on owners' fund varies with the profit earning of the company, that is why it is called risky capital.

BORROWED FUND

Borrowed fund refers to the borrowing of the firm. It includes all funds available by way of loans or credit.

SOURCES OF BUSINESS FINANCE

FEATURES OF BORROWED FUND

1. **Fixed Time :**

   The borrowed fund is raised by business firms for specified periods. These funds may be raised for short-term, medium-term or long-term.

2. **Security :**

   Generally firms can get borrowed funds against the securities of assets. Banks and financial institutions offer loans on different terms against the security of assets.

3. Regular Payment of Interest :

It is a legal compulsion on business firms to pay a regular amount of interest on borrowed fund. The principal amount also has to be paid within a fixed time period. The payment of interest as well as principal amount is a legal liability of a company irrespective of its earnings

4. Control :

The borrowed fund security holders do not get the right to control and manage the activities of the business firm. They have the right to sue the firm in case there is default in payment of interest or repayment of loan amount.

Different between Owners’ Fund and Borrowed Fund

	Owners’ Fund	Borrowed Fund
1. Meaning	It refers to the funds contributed by owners as well as retained earnings.	It refers to the borrowing of the fund. It includes all funds available by way of loans or credit.
2. Time Period	Owners' fund is a source of permanent capital	Borrowed fund is for a fixed period of time.
3. Security	No security is required with owner fund	Generally firms get borrowed fund against the security of assets.
4. Control	Owners' fund contributors control the company	The borrowed fund security holder do not get the right to control.
5. Risk Bearer	Owners’ fund security holders are Primary Risk bearer of the company.	Borrowed fund security holders bear no Risk.

SOURCES OF BUSINESS FINANCE

Class 11

BUSINESS STUDIES

SOURCES OF RAISING FINANCE – OWNERS' FUND - I

SOURCES OF RAISING FINANCE

SOURCES OF RAISING FINANCE

On the Basis of Ownership

Owners' Fund

- Equity share
- Preference share
- Retained earning
- GDR (Global depository receipt)
- ADR (American depository receipt)
- IDR (International depository receipt)

Borrowed Fund

- Debentures
- Loan from financial institutions
- Loan from commercial banks
- Public deposit
- Trade credit
- Inter corporate deposit (ICD)

SOURCES OF BUSINESS FINANCE

ISSUE OF SHARES

(OWNERS' FUND – LONG – TERM SOURCE OF FINANCE)

Share is the smallest unit in which owner's capital of the company is divided. A share is the interest of the shareholder in the company measured by a sum of money for the purpose of liability and interest.

According to Companies Act, a public company can issue two types of shares:

1. Equity Shares

2. Preference Shares.

EQUITY SHARES

What is Share?

- **Share means smallest unit in which share capital of a company is divided and includes stock.**

What is Equity Share?

- **The equity shares are those shares which do not carry any special or preferential rights in the payment of annual dividend or repayment of capital.**

SOURCES OF BUSINESS FINANCE

- **At the time of winding up also capital of equity shareholders is returned only after every claim has been settled.**
- **Prior to the year 2000, the companies were allowed to issue equity shares with equal rights only.**
- **In the year 2000, an amendment was made in (Companies Act permitting companies to issue two categories of equity shares:**

1. **Equity shares with equal rights**
2. **Equity shares with differential rights as to dividend.**

Features of Equity Shares

1. Primary Risk Bearers :

The equity shareholders are the primary risk bearers of the company. In case the company suffers losses then equity shareholders have to bear the loss.

2. Claim over Residual Income :

The equity shareholders have claim over the left- over income of the company only. They get share in the income left after satisfying the claims of all creditors, outsiders and preference shareholders.

3. Control :

Equity shareholders have control over the activities of the company. The equity shareholders have voting rights. The equity shareholders cast vote to select the Board of Directors who control and manage the affairs of the company.

4. Higher Profit :

The rate of interest for debenture holders and the rate of dividend for preference shareholders are fixed. At the time of profit the debenture holders and preference shareholders get fixed income only but equity shareholders enjoy a higher profit.

5. Permanent Capital :

Equity shareholders provide the permanent funds of a company. There is no fixed commitment to return the money or pay a fixed rate of dividend

PREFERENCE SHARES

(OWNERS' FUND – LONG TERM FINANCE)

Preference shares are those shares which get preference over equity shares in respect to:

1. **The payment of dividend ,**
2. **The repayment of investment amount during winding up.**

FEATURE OF PREFERENCE SHARES

1. **Fixed rate of Dividend :**

   Preference shareholders get a fixed rate of dividend before paying dividend to equity shareholders.

2. **No Security :**

   Companies do not offer any security against preference shares. The preference share capital is a part of the owners' fund capital.

3. Voting Rights :

The preference shareholders do not get voting rights under general conditions. However, the preference shareholders get voting rights if the dividends are not paid for two years or more.

SOURCES OF BUSINESS FINANCE

4. Hybrid Security :

- **Preference shares are called hybrid securities, as these shares have the features of equity shares as well as features of debentures.**
- **Like equity shares, preference shares get dividend only when company is earning profit and like debentures preference shares get a fixed rate of return.**

5. No Fixed Liability :

Dividend to preference shareholders is paid only when the company is earning profit. During loss period, there is no fixed liability to pay dividend as in the case of loans and borrowings.

DIFFERENCE BETWEEN EQUITY SHARES AND PREFERENCE SHARES

Point of Difference	Equity Shares	Preference Shares
1. Face Value	The face value of equity share is generally low	The face value of preference share is generally high.
2. Dividend	The dividend is paid to equity shareholders after paying dividend to all shares.	Preference shareholders get a fixed rate of dividend before equity shareholders.
3. Voting Rights	Equity shareholders get all the voting rights in a company	No voting rights under normal conditions. They get voting right when dividend is not paid for two years.

DIFFERENCE BETWEEN EQUITY SHARES AND PREFERENCE SHARES

Point of Difference	Equity Shares	Preference Shares
4. Risk	The equity shareholders are the primary risk bearers of the company.	The risk involved in preference shares is relatively less.
5.Refund of Capital	At the time of winding up the equity shareholders are refunded only after preference shares are paid.	At the time of winding up preference shares get priority over equity shares for refund of capital.
6. Redemption	The equity shares are never redeemed , or paid back during the lifetime of the company.	Preference shares may be redeemed on expiry of a fixed period of time or at the option of the company.

SOURCES OF BUSINESS FINANCE

Class 11

BUSINESS STUDIES

SOURCES OF RAISING FINANCE – OWNERS' FUND - II

SOURCES OF RAISING FINANCE

SOURCES OF RAISING FINANCE

On the Basis of Ownership

Owners' Fund

- Equity share
- Preference share
- Retained earning
- GDR (Global depository receipt)
- ADR (American depository receipt)
- IDR (International depository receipt)

Borrowed Fund

- Debentures
- Loan from financial institutions
- Loan from commercial banks
- Public deposit
- Trade credit
- Inter corporate deposit (ICD)

Retained Profits / Earnings (Owners' Fund – long – term Finance)

- Retained earning refers to undistributed profits after payment of dividend and taxes. It provides the basis of expansion and growth of companies.
- It is considered the most important source of finance; since it is internally generated, this method of financing is known as self - financing.

Features of Retained Earnings

1. **Cushion of Security :**

   The retained earnings are considered as a cushion of security because they provide support in times of adversity, when a company finds it difficult to arrange finances from any other source.

2. **Funds for New and Innovative Projects :**

   The retained earnings are a common source of funds for financing risky and innovative projects. This fund is generally used for research work, expansion projects etc.

3. Medium and Long-term Finance :

Retained profit is considered as an ownership fund. It serves the purpose of medium-and long-term finance.

4. Conversion into Ownership Fund :

The surplus retained earnings can be converted into share capital by issue of bonus shares. In issue of bonus shares, there is no outflow of cash. Investors too are benefited by the issue of shares free of cost.

SOURCES OF BUSINESS FINANCE

5. Most Dependable Source :

As an internal source, this is more dependable than the external source of finance. The external source depends upon the preference of investors, market conditions etc.

6. No Interference :

With retained earning there is no increase in the number of shareholders. Retained earnings involve no risk of dilution of control.

Global Depository Receipt

[(GDR), (Owners' Fund- Long-term finance)]

- **The local currency shares of a company are delivered to the depository bank. The depository bank issues depository receipts against these shares. Such depository receipts denominated in US dollars are known as Global Depository Receipts (GDR). GDR is a negotiable instrument and can be traded freely like any other security.**

Global Depository Receipt

[(GDR), (Owners' Fund- Long-term finance)]

- **In the Indian context, a GDR is an instrument issued abroad by an Indian company to raise funds in some foreign currency and is listed and traded on a foreign stock exchange. A holder of GDR can at any time convert it into the number of shares it represents. The holders of GDRs do not carry any voting rights but only dividends and capital appreciation. Many Indian companies such as Infosys, Reliance, Wipro and ICICI have raised money through issue of GDRs.**

American Depository Receipt [(ADR), (Owners' Fund- Long - term Finance)]

- The depository receipts issued by a company in the USA are known as American Depository Receipts. ADRs are bought and sold in American markets, like regular stocks. It is similar to a GDR except that it can be issued only to American citizens and can be listed and traded on a stock exchange of USA.

SOURCES OF BUSINESS FINANCE

Indian Depository Receipt

[(IDR), (Owners' Fund- Long-term Finance)]

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

Indian Depository Receipt
[(IDR), (Owners' Fund- Long-term Finance)]

- **The IDR is a specific Indian version of the similar global depository receipts. The foreign company issuing IDR deposits shares to an Indian Depository (custodian of securities registered with the Securities and Exchange Board of India). In turn, the depository issues receipts to investors in India against these shares.**

Indian Depository Receipt [(IDR), (Owners' Fund- Long-term Finance)]

- **According to SEBI guidelines, IDRs are issued to Indian residents in the same way as domestic shares are issued. The issuer company makes a public offer in India, and residents can bid in exactly the same format and method as they bid for Indian shares.**
- **'Standard Chartered PLC' was the first company that issued Indian Depository Receipt in Indian securities market in June 2010.**

SOURCES OF BUSINESS FINANCE

Class 11

BUSINESS STUDIES

SOURCES OF RAISING FINANCE – BORROWED FUND - I

SOURCES OF RAISING FINANCE

SOURCES OF RAISING FINANCE

On the Basis of Ownership

Owners' Fund

- Equity share
- Preference share
- Retained earning
- GDR (Global depository receipt)
- ADR (American depository receipt)
- IDR (Indian depository receipt)

Borrowed Fund

- Debentures
- Loan from financial institutions
- Loan from commercial banks
- Public deposit
- Trade credit
- Inter corporate deposit (ICD)

DEBENTURES / BONDS

(Borrowed Fund-Long-term Source of Finance)

What is a Debenture?

Debentures are common securities issued under borrowed fund capital. Debentures are instruments for raising long-term debt capital.

Definition of Debenture

"A document or a certificate, issued by a company under its seal as an acknowledgement of its debt." Holder of debenture certificate is called debentureholder.

Features / Characteristics of Debentures

1. **Borrowed Fund :**

   Debentures are part of borrowed fund capital as debenture- holders are considered as the creditors of the company.

2. **Fixed Rate of Interest :**

   The interest on debentures is paid at a fixed rate. The rate of interest is decided in the annual general meeting of the company.

3. **Compulsory Payment of Interest :**

   Payment of regular and fixed rate of interest is a legal obligation of the company. Company has to pay interest to its debenture-holders irrespective of its profit-earning capacity.

Features / Characteristics of Debentures

4. Security :

Most of the time debentures are issued against the charge of some fixed assets of the company.

5. Redeemable :

Debentures are always redeemed or paid back on expiry of a fixed period of time.

6. No Voting Rights :

Debenture holders have no say in the management as they are never granted voting rights in the company.

DIFFERENCE BETWEEN SHARES AND DEBENTURES

Point of Difference	Shares	Debentures
1. Nature	Shares are considered as a part of owner's fund	Debentures are part of borrowed fund.
2. Voting rights	Shareholders get voting rights.	Debenture holders do not get voting rights.
3. Control	The control of the company lies in the hands of equity shareholders.	Debentureholders have no control over the affairs of the company.

DIFFERENCE BETWEEN SHARES AND DEBENTURES

Point of Difference	Shares	Debentures
4.Right to return	Equity shareholders have no right to get regular return in case of loss.	Debenture holders have legal right to get regular amount of interest even when company is not earning profit.
5. Security	No assets of the company are mortgaged as security against the issue of shares.	Company has to mortgage some its assets as a security against the debentures.

Different between Shares and Debentures

Point of Difference	Shares	Debentures
6. Redemption	Except redeemable preference shares no other shares are redeemable. They are paid back at the time of winding up only, after settling the claim of all the claimants.	Debentures are generally redeemed on expiry of a fixed period of time.
7. Risk	Shareholders are the primary risk bearers of the company.	There is a minimum risk in case of debentures.

LOAN FROM FINANCIAL INSTITUTIONS
(Borrowed Fund- Long-term Finance)

- Public financial institutions are referred to as lending institutions, development banks or financial institutions.
- After Independence, the government of India realised that for economic development of a country only commercial banks are not sufficient.
- There must be financial institutions to provide financial assistance and guidance to industries and business enterprises. The need for public financial institutions was felt due to the following reasons:

Features of Financial Institutions

I. **Long - term Finance :**

Financial institutions provide long-term finance.

II. **Managerial Advice :**

Financial institutions provide managerial as well as financial advice on various matters.

III. **Medium and Long-term Finance :**

Public financial institutions provide medium and long term finance to industrial enterprise at a reasonable rate of interest.

Features of Financial Institutions

IV. Subscribers of Securities :

Financial institutions often subscribe to the shares and debentures of companies.

V. Loan in Foreign Currency :

Financial institutions provide loan in foreign currency to import machinery. These institutions provide guarantee also for purchase of capital goods from foreign countries.

SOURCES OF BUSINESS FINANCE

Class 11

BUSINESS STUDIES

SOURCES OF RAISING FINANCE – BORROWED FUND - II

SOURCES OF RAISING FINANCE

SOURCES OF RAISING FINANCE

On the Basis of Ownership

- **Owners' Fund**
  - Equity share
  - Preference share
  - Retained earning
  - GDR (Global depository receipt)
  - ADR (American depository receipt)
  - IDR (Indian depository receipt)
- **Borrowed Fund**
  - Debentures
  - Loan from financial institutions
  - Loan from commercial banks
  - Public deposit
  - Trade credit
  - Inter corporate deposit (ICD)

COMMERCIAL BANKS

(Borrowed Fund - Short & Medium - term Finance)

- **Commercial banks occupy a very important position as they provide funds for different purposes and different periods. Firms of all sizes can approach commercial banks.**

- **Generally commercial banks provide short-term and medium-term loans but nowadays they have started giving long-term loans against security.**

Features of Commercial Banks

1. **Banks provide funds to firms as and when required.**

SOURCES OF BUSINESS FINANCE

Features of Commercial Banks

1. **Banks provide funds to firms as and when required.**
2. **The banks keep the information of borrower confidential and business can maintain its secrecy.**
3. **No formalities of issue of prospectus etc. are required. So it is very easy and economical source of funds.**
4. **It is a very flexible source as loan amount can be increased as well as decreased.**

SOURCES OF BUSINESS FINANCE

5. **Funds are generally available for a short period.**

6. **Banks make detailed investigation of the company's affairs and financial structure before issue of loan.**

7. **In some cases, banks many put restriction and difficult terms and conditions.**

SOURCES OF BUSINESS FINANCE

PUBLIC DEPOSITS

(Borrowed Fund-Medium-term Finance)

- **Public deposits refers to unsecured deposits invited from the public.**
- **A company wishing to invite public deposits places an advertisement in newspapers.**
- **Any member of the public can fill up the prescribed form and deposit money with the company.**

Features / Characteristics of Public Deposits

1. **Unsecured :**

   Companies mortgage no assets against the public deposit raised from general public.

2. **Finance of Working Capital :**

   The amount raised from public deposits is generally used by the company for meeting the requirements of working capital. Through they are a primary source of short – term finance but by renewing these can be used for medium – term also.

SOURCES OF BUSINESS FINANCE

3. Time Period :

Public deposits can be invited by companies for a period of six months to three years.

4. Simple Procedure to Raise :

Public deposits are simple to raise. A company simply has to place an advertisement in the newspaper. Any member of the public can deposit money with the company by filling a prescribed from. The company issues a deposit receipt in return and on the reverse of the receipt the terms and conditions of the deposits are printed.

SOURCES OF BUSINESS FINANCE

5. Repayment :

A company which has public deposits is required to set aside 10% of the deposits maturing by the end of the year. The amount so set aside can be used for repaying public deposits.

6. Limited Amount :

The amount of funds that can be raised by way of public deposits is limited, because of legal restrictions. Public deposits exceed 25% of share capital and free reserves.

SOURCES OF BUSINESS FINANCE

Class 11

BUSINESS STUDIES

SOURCES OF RAISING FINANCE – BORROWED FUND - III

SOURCES OF BUSINESS FINANCE

SOURCES OF RAISING FINANCE

SOURCES OF RAISING FINANCE

On the Basis of Ownership

Owners' Fund

- Equity share
- Preference share
- Retained earning
- GDR (Global depository receipt)
- ADR (American depository receipt)
- IDR (Indian depository receipt)

Borrowed Fund

- Debentures
- Loan from financial institutions
- Loan from commercial banks
- Public deposit
- Trade credit
- Inter corporate deposit (ICD)

TRADE CREDIT

(Borrowed Fund-Short-term Finance)

- **Trade credit refers to an arrangement whereby a manufacturer is granted credit from the supplier of raw materials, inputs, spare parts etc. The suppliers allow their customers to pay their outstanding balance within a credit period. Generally the duration of trade credit is three to six months and thus it is a short-term financing facility. The availability of trade credit depends upon:**

(a) Nature of the firm

(b) Size of the firm

(c) Status or creditworthiness of the firm.

Features of Trade Credit

1. **Readily Available :**

   Trade credit is available without any special efforts on the part of a manufacturer or trader.

2. **Flexible :**

   There are no rigid rules and regulations involved in trade credit. It can be easily adjusted with the changing needs of purchases as time of payment is generally adjusted in view of past dealings.

3. **No Floatation Cost :**

   No floatation cost is involved in arranging trade credit.

4. **Increase in Prices :**

Sometimes, the supplier may increase the price of commodity or raw material supplied if he is selling goods on credit.

5. **Legal Action :**

In trade credit, the buyer generally issues a promissory note and in case he fails to meet his commitment, the supplier can take legal action.

INTER-CORPORATE DEPOSITS (ICD)
(Borrowed Fund-Short-term Source of Finance)

- **It is the deposits made by one company with another company. This option of using finance is available to all public companies whether having share capital or not. It includes:**

1. **When a company acquires security of another company**
2. **When a company gives loan to another company**
3. **When a company gives guarantee to any person or institution who provides loan to another company. In general, we can say when companies arrange funds from another company it is known as Inter-corporate Deposits.**

SOURCES OF BUSINESS FINANCE

There are three types of Inter-corporate Deposits:

1. **Three Months' Deposits :**

   This is the most common deposits to overcome the short-term finance problem. The annual rate of interest given for three months' deposits is 12% p.a.

2. **Six Months' Deposits :**

   These are made with first class borrowers. The annual interest rate is 15%.

3. **Call Deposits :**

   This can be withdrawn by lender by giving one-day notice. The rate of interest is 10%. The biggest advantage of ICD is that transactions are free from legal and bureaucratic hassles.

FEATURES OF ICD

1. The broker in this market never reveal their list of lenders and borrowers.
2. These deposits are suitable for borrowing company to solve their short term funds problems immediately.
3. Free from Bureaucratic and legal problems.
4. Not suitable for Long Term Finance.
5. High Risk as ICD are unsecured deposits.
6. High rate of Interest than Bank.


THANKS
FOR
WATCHING