Sources of Finance

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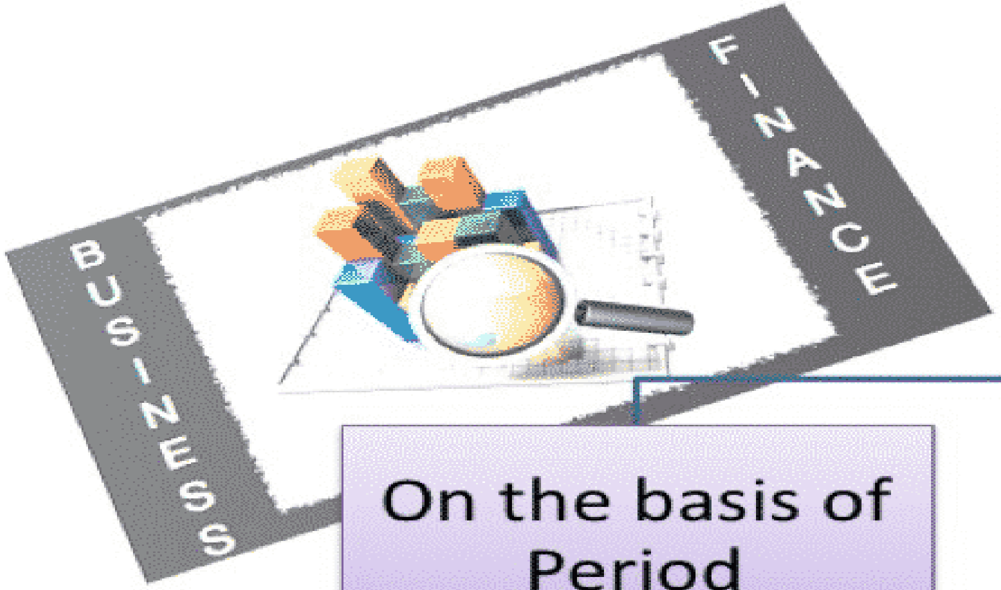
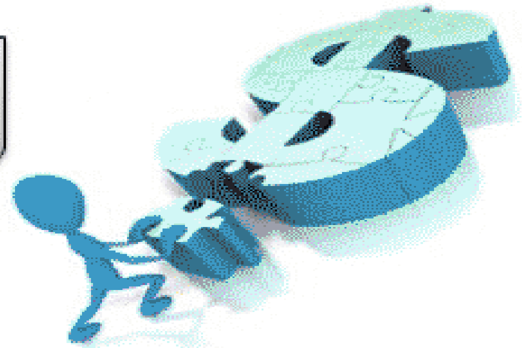


Classification of Source of Finance

- On the basis of Period
  - Long Term Period
  - Short Term Period
- On the basis of Ownership
  - Owners Fund
  - Borrowed Fund
- On the basis of Source of Generation
  - External Source
  - Internal Source



Internal Source of Finance :-

Where profits are used as a source of capital for new investment, rather than:- a) distributing them to firm's owners or other investors and

b) obtaining capital elsewhere.

External Source of Finance :-

External financing is the phrase used to describe funds that firms obtain from outside of the firm.

INTERNAL SOURCES OF FINANCE

The various sources of internal finance for the business includes:

- Owner's Investment
- Retained Earnings
- Sale of Stock
- Sale of Fixed Assets
- Utilizing Working Capital More Effectively
- Debt Collection

Internal Sources of Finance

- **Retained Earnings :-**

  - ✓ Retained profits can be defined as the profit left after paying a dividend to the shareholders or drawings by the capital owners.

  - ✓ Retained Earnings = Net Profits – Dividend / Drawings

Merits of Retained Earnings

- ✓ Nobody can ask for their payments.
- ✓ There is **no dilution of control** and ownership in the business.
- ✓ Retained earnings as an internal source of finance are **cost effective** considering the fact that there is no issue cost attached to it which ranges between 2–3%.
- ✓ Retained earnings **strengthen the financial position** of a company and appreciate the capital which ultimately increases the market value of shares.

Demerits of Retained Earnings

- ✓ Improper Utilization of Funds.
- ✓ Conservative dividend policy leads to huge accumulation of retained earnings leading to over-capitalization.
- ✓ Lower Rate of Dividend.
- ✓ Excessive use of retained earnings leads to monopolistic attitude of the company.
- ✓ Not available to new business.

Sale of Assets :-

- ✓ An asset can be categorized as any item owned by an individual or business that can be assigned monetary value. An asset can increase or decrease in value over time.

- ✓ Business when sells off its assets and the cash generated is used internally for financing the needs, we call it an internal source of finance by the sale of assets.

Merits of Sale of Assets

- ✓ It is a good idea to regularly screen the fixed_asset register and find assets which are **no longer in use** or are already obsolete etc.
- ✓ Another advantage of selling assets is that the proceeds can be used to reduce or **eliminate debt**.

Demerits of Sale of Assets

- ✓ A major drawback of this type of capital is when the assets are **sold before their useful life** i.e. loss of services and capital loss too.
- ✓ Some businesses are unlikely to have **surplus assets** to sell.
- ✓ When purchase an asset occurs and later sold at a profit, it is subject to **Capital Gains Tax**.

Reduction in Working Capital Needs :-

- ✓ Working capital has broadly 2 components. One, Current Assets, which include Stock/Inventory, Account Receivables – Debtors and Cash/Bank Balances. Second, Current Liabilities, which include Account Payables–Creditors and Bank Overdraft.

- ✓ Reduction in working capital can be achieved either by speeding up the cycle of account receivables and stock or by lengthening the cycle of account payables.

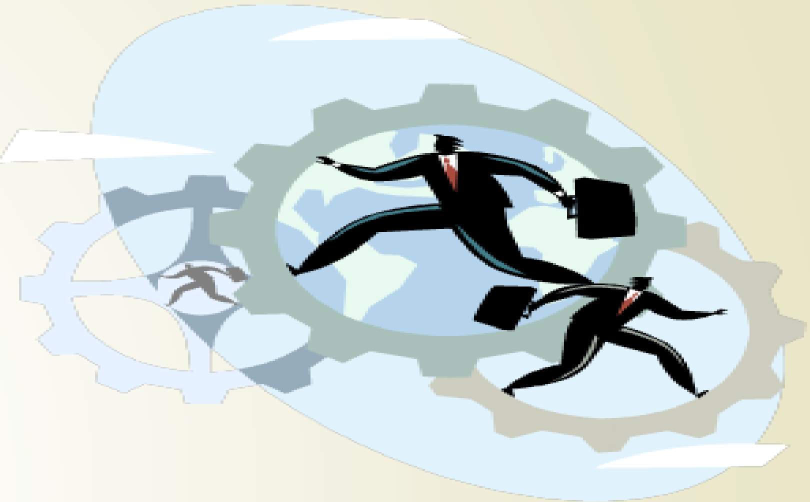
Merits of Reducing Working Capital

- ✓ The primary benefit is **savings on the interest** cost paid on working capital loans, bank overdrafts, cash credit, etc.
- ✓ Efficient overall working capital management.
- ✓ Liquidity can be ensured.
- ✓ Ability to face crisis as in times of depression there is much pressure on working capital.

Demerits of Reducing Working Capital

- ✓ Risk of **bankruptcy** rises in an attempt to minimize working capital to a very low level.
- ✓ A low working capital may jeopardize a company's ability to finance its **day to day operations**.
- ✓ Pressure to collect payments.
- ✓ Creditors' preference adversely affected.

Internal Sources of Finance are the sources of finance or capital for business which are generated by the business itself in its normal course of operations.



	Advantages	Disadvantages
Retained Earnings	Long-term finance, no dilution of control and ownership, cost effective.	Considering cost of equity capital, it is not so cost effective.
Sale of Asset	Can work as a short term or long term finance.	Drawback is that, assets are sold before there useful life.
Reduction in Working Capital	Savings on interest cost, streamlined operations, savings on bank charges	Risk of bankruptcy rises in an attempt to reduce the working capital to a very low level

External Sources of Finance

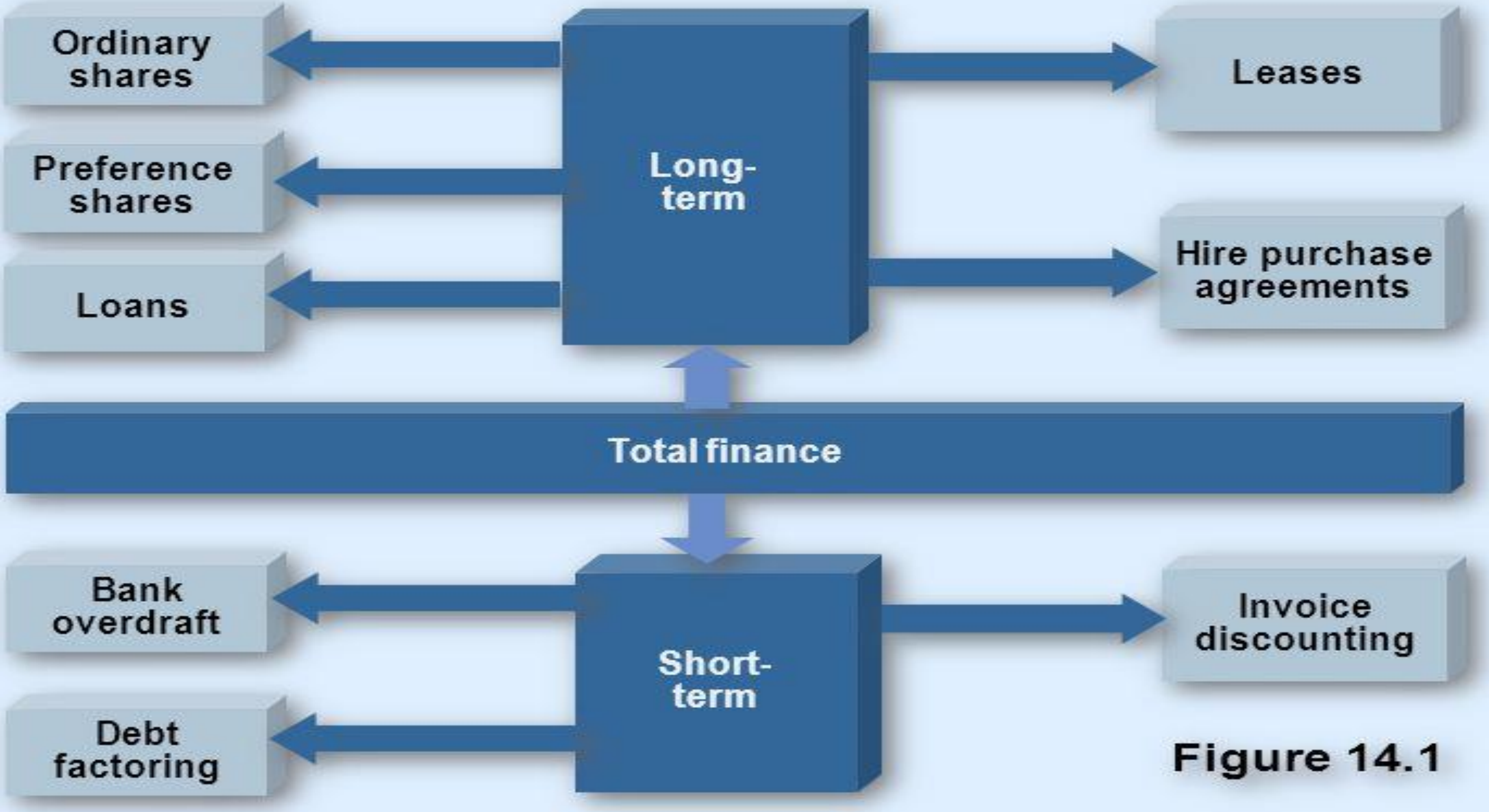


Figure 14.1

External Sources of Finance

- **Equity Share Capital :-**
  - ✓ Equity shares or Ordinary Shares represent the form of fractional or part ownership in which the holder undertakes maximum risk associated with business.
  - ✓ In simple language it is main source of finance for any company giving holders/investors right to vote at shareholder meetings & share company's profits.

Merits of Equity Capital

- They are a **permanent source** of capital and as such do not involve any repayment liability.
- They do not have any obligation regarding payment of **dividend**.
- Larger equity capital increases the **creditworthiness** of the company among the creditors and investors.
- Liquid in nature , therefore can be **easily sold** in the market.
- In case of high profit , shareholders get dividend at higher rate.
- Shareholders get benefit in two ways :- Yearly dividend,

  Appreciation in value of their investments

Demerits of Equity Capital

- Payment of dividend on equity shares is **not tax deductible**.
- As compared to other sources of finance , issue of equity shares involves **higher floatation expenses** of brokerage , underwriting commission , etc.
- Getting **dividend** on equity shares is **uncertain** every year.
- Equity shareholders bear **highest degree of risk** of the company.
- Issue of fresh shares reduces the earnings of existing shareholders.

Preference Share Capital :-

- ✓ A share which entitles the holder to a fixed dividend , whose payment takes priority over that of ordinary share dividends.

- ✓ Preference shares are shares that are owned by people who have the right to receive part of company's profit before the holders of ordinary shares are paid.

- ✓ If the company enters bankruptcy then such shareholders are to be paid first from the company's assets before ordinary shareholders.

Merits of Preference Capital

- Can be easily sold to investors who prefer reasonable safety of their capital and want a regular & **fixed return** on it.
- Company is not bound to pay **dividends** in a particular year if profits are insufficient. It can **postpone** it to the next year.
- Preference shares do **not create any mortgage** or charge on the assets of the company.
- Different types of preference shares can be issued depending on the needs of investors.
- No dilution of control.

Demerits of Preference Capital

- Company may have to offer a high rate of dividend to attract sufficient investors.
- In case of high profits, fixed dividend becomes unattractive.
- Preference shares generally do not carry voting rights.
- The **company may refund** their money whenever the money market is favourable. Despite the fact that they stood by the company in its hour of need, they are shown the door unceremoniously.

Debentures :-

- A **debenture** is a medium or long-term debt instrument used by large companies to borrow money, at a fixed rate of interest.

- Thus it is like a certificate of loan or a loan bond evidencing the fact that the company is liable to pay a specified amount with interest.

- In United Kingdom :- Secured,

  United States :- Unsecured,

  Asia :- Secured against property other than land.

Merits of Debentures

- ✓ Issue of debenture does **not result in dilution** of interest of equity shareholders as they do not have right either to vote or take part in the management of the company.
- ✓ Interest on debenture is a **tax deductible** expenditure and thus it saves income tax.
- ✓ **Cost of debenture** is relatively lower than preference shares and equity shares.
- ✓ Interest on debenture is payable even if there is a loss, so debenture holders bear **no risk**.
- ✓ A debenture is usually more liquid investment and an investor can **sell** or **mortgage** his instrument to obtain loans from financial institutions.

Demerits of Debentures

- ✓ Payment of interest on debenture is obligatory and hence it becomes burden if the company incurs loss.
- ✓ The use of debt financing usually increases the **risk perception of investors** in the firm.
- ✓ A company **can't raise further loans** against the security of assets already mortgaged to debenture-holders.

Long-term Loans

- ✓ A **long-term loan** runs for 3 to 25 years, uses company assets as collateral and requires monthly or quarterly payments from profits or cash flow.

- ✓ Obtaining a **long term loan** provides a business with working capital that it can use to purchase assets, inventory or equipment which can then be used to create additional income for the business.

- ✓ For example : A **loan** to a small business by bank with a floating interest rate to buy fixed assets, such as a factory, in order to operate payable within 10 years time frame.

Merits of Long Term Loans

- Interest on debt is **tax-deductible**, whereas the equity or preference dividends are paid out of profit after tax.
- There is **no dilution of control** of the management, since, in the debt financing, the lenders have no right to vote.
- **No distribution of profits** as lenders are only entitled to interest and principle amount.
- The **maturity** of the debt instrument can be **altered** with respect to the funds requirements in the firm.
- An issue cost of debt is **less expensive** as compared to the preference and equity capital.

Demerits of Long Term Loans

- ✓ At times of low inflation rates – proves a loss to the company.
- ✓ Assets could be at risk.
- ✓ Prepayments penalties and charges.
- ✓ Strict payment schedules.
- ✓ Security needs and creditworthiness.

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