SOURCES OF FINANCE

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EQUITY SHARES

- Equity shares represent the ownership position in the organization and are a source of permanent capital for the firm.
- **FEATURES OF EQUITY CAPITAL**
- Claim on income
- Claim on assets
- Right to control
- Pre-emptive right
- Limited liability

EQUITY SHARES

- **ADVANTAGES OF EQUITY SHARES TO THE FIRM**
- Permanent Capital
- No legal obligation to pay dividends

- **DISADVANTAGES OF EQUITY SHARES**
- Costlier source of finance
- Perceived as a risky investment by the investor due to uncertain dividends and capital gains.
- Dilution of ownership

DEBENTURES

- Debenture: A long-term promissory note for raising loan capital.
- **FEATURES**
- Fixed interest payment
- Fixed maturity period
- Indenture
- Security
- Yield
- Claims on assets and income
- **Types of debentures**:
- Non-Convertible Debentures (NCDs)
- Fully-Convertible Debentures (FCDs)
- Partly-Convertible Debentures (PCDs)

DEBENTURES

- **ADVANTAGES OF DEBENTURES TO THE ISSUING FIRM**
- Lower cost and lower risk compared to equity capital
- No dilution in ownership
- Debenture-holders do not participate in the extraordinary earnings of the company
- Useful in periods of inflation due to reduced obligation in real terms.
- **DISADVANTAGES**
- Payment of interest is a legal obligation
- Increases the financial risk of the firm
- Results in substantial cash outflows on redemption.
- Inclusion of restrictive covenants may limit firm's flexibility

PREFERENCE SHARES

- Preference shares: A hybrid security having features of both equity shares and debentures.

FEATURES SIMILAR TO EQUITY SHARES

- Payment of dividends is not a legal obligation
- Dividend payments are not tax-deductible.
- No maturity period for irredeemable preference shares

FEATURES SIMILAR TO DEBENTURES

- Fixed dividend payment
- No share in the residual earnings
- Prior claim on income and assets relative to equity shares.
- Creation of sinking fund for redemption
- Convertibility

PREFERENCE SHARES

- **ADVANTAGES TO THE ISSUING FIRM**
- Preference dividend payment is restricted to the stated amount.
- No dilution of ownership
- Dividend payment can be postponed in case of cumulative preference shares.
- **DISADVANTAGES TO THE ISSUING FIRM**
- Preference dividends are not tax-deductible
- Non-payment of preference dividends may adversely affect the image of the company.

METHODS OF ISSUING SECURITIES

- PUBLIC ISSUE
- RIGHTS ISSUE
- PRIVATE PLACEMENT
- BOUGHT-OUT DEALS
- EURO-ISSUES

TERM LOANS

- Long-term debt with a maturity of more than one year, obtained from banks and financial institutions.
- **FEATURES**
- Maturity period > one year
- Lower costs of financing
- Security
- Presence of restrictive covenants
- Repayment schedule

TERM LOANS

- **ADVANTAGES TO THE FIRM**
- Lower post-tax cost of funds.
- No dilution of control

- **DISADVANTAGES TO THE FIRM**
- Payment of interest charges and principal is legal obligation.
- Restrictive covenants hinder firm's flexibility.

RETAINED EARNINGS

- A company generally does not distribute all its earnings amongst the shareholders as dividends. A portion of the net earnings may be retained in the business for use in the future. This is known as retained earnings.
- It is a source of internal financing or self-financing or 'ploughing back of profits'. The profit available for ploughing back in an organization depends on many factors like net profits, dividend policy and age of the organization.

OTHER LONG-TERM SOURCES OF FINANCE

- INTERNAL ACCRUALS
- GOVERNMENT SUBSIDIES
- DEFERRED CREDIT
- SALES TAX DEFERMENTS AND EXEMPTIONS
- LEASING AND HIRE PURCHASE

SHORT-TERM SOURCES

- Funds which are required for a period not exceeding one year are called short-term sources.
- Trade credit, loans from commercial banks and commercial papers are the examples of the sources that provide funds for short duration.

- Short-term financing is very common for the financing of present assets such as inventories and account receivables.
- Seasonal businesses that must build inventories in terms of future prospects of selling requirements often need short-term financing for the interim period between seasons.
- Wholesalers and manufacturers with a major portion of their assets used in inventories or receivables also require a large number of funds for a short period.

TRADE CREDIT

- Trade credit is the credit extended by one trader to another for the purchase of goods and services. Trade credit facilitates the purchase of supplies without immediate payment. Such credit appears in the records of the buyer of goods as **'sundry creditors' or 'accounts payable'.**
- Trade credit is commonly used by business organizations as a source of short-term financing. It is granted to those customers who have reasonable amount of financial standing and goodwill. The volume and period of credit extended depends on factors such as reputation of the purchasing firm, financial position of the seller, volume of purchases, past record of payment and degree of competition in the market.
- Terms of trade credit may vary from one industry to another and from one person to another. A firm may also offer different credit terms to different customers.

FACTORING

- Factoring is a financial service under which the 'factor' renders various services which includes:
- (a) Discounting of bills (with or without recourse) and collection of the client's debts. Under this, the receivables on account of sale of goods or services are sold to the factor at a certain discount.
- (b) Providing information about credit worthiness of prospective client's etc.

LEASE FINANCING

- A lease is a contractual agreement whereby one party i.e., the owner of an asset grants the other party the right to use the asset in return for a periodic payment. In other words it is a renting of an asset for some specified period. The owner of the assets is called the
- ‘lessor’ while the party that uses the assets is known as the ‘lessee’. The lessee pays a fixed periodic amount called lease rental to the lessor for the use of the asset.

COMMERCIAL PAPER (CP)

- Commercial Paper emerged as a source of short term finance in our country in the early nineties. Commercial paper is an unsecured promissory note issued by a firm to raise funds for a short period, varying from 90 days to 364 days.
- It is issued by one firm to other business firms, insurance companies, pension funds and banks. The amount raised by CP is generally very large. As the debt is totally unsecured, the firms having good credit rating can issue the CP.
- Its regulation comes under the purview of the Reserve Bank of India.

COMMERCIAL BANKS

- Commercial banks occupy a vital position as they provide funds for different purposes as well as for different time periods.
- Banks extend loans to firms of all sizes and in many ways, like, **cash credits, overdrafts, term loans, purchase/discounting of bills, and issue of letter of credit.**
- The rate of interest charged by banks depends on various factors such as the characteristics of the firm and the level of interest rates in the economy. The loan is repaid either in lump sum or in installments.

- Bank credit is not a permanent source of funds. Though banks have started extending loans for longer periods, generally such loans are used for medium to short periods.
- The borrower is required to provide some security or create a charge on the assets of the firm before a loan is sanctioned by a commercial bank.

END OF SESSION

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