Sources of Finance

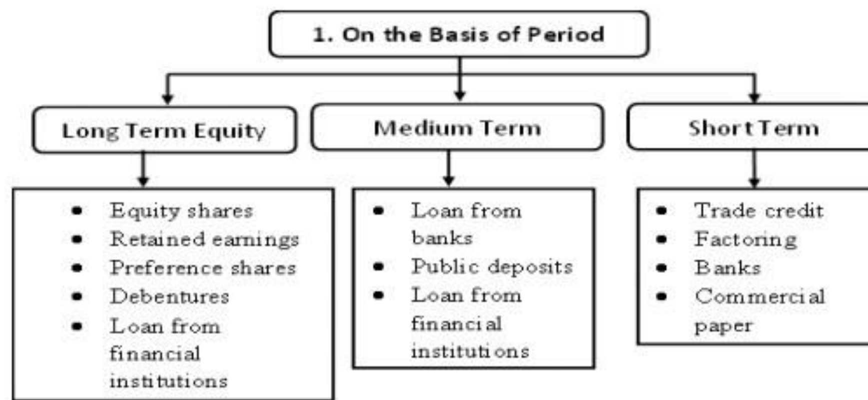
Submitted by:
Dr. Jaspreet Kaur

Finance

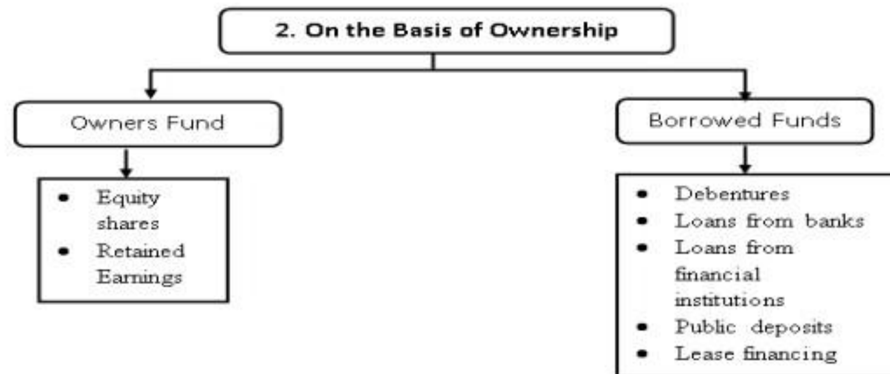
- Finance is the life line of every business, as no organization can exist without adequate finance. Finance is a broad term that describes activities associated with banking, leverage or debt, credit, capital markets, money, and investments. Basically, finance represents money management and the process of acquiring needed funds. Finance also encompasses the oversight, creation, and study of money, banking, credit, investments, assets, and liabilities that make up financial systems. Finance is defined as the management of money and includes activities like investing, borrowing, lending, budgeting, saving, and forecasting. There are three main types of finance: (1) personal, (2) corporate, and (3) public/government.

Sources of finance

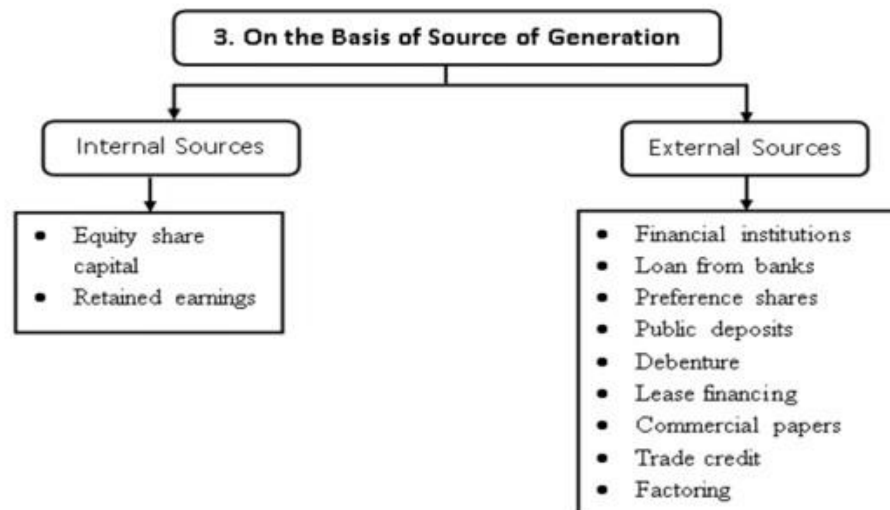
- Sources of finance for business are equity, debt, debentures, retained earnings, term loans, working capital loans, letter of credit, euro issue, venture funding etc. These sources of funds are used in different situations. They are classified based on time period, ownership and control, and their source of generation. It is ideal to evaluate each source of capital before opting for it.
- Sources of capital are the most explorable area especially for the entrepreneurs who are about to start a new business. It is perhaps the toughest part of all the efforts. There are various capital sources, we can classify on the basis of different parameters. Having known that there are many alternatives to finance or capital, a company can choose from. Choosing the right source and the right mix of finance is a key challenge for every finance manager. The process of selecting the right source of finance involves in-depth analysis of each and every source of fund. For analyzing and comparing the sources, it needs the understanding of all the characteristics of the financing sources. There are many characteristics on the basis of which sources of finance are classified.
- On the basis of a time period, sources are classified as long-term, medium term, and short term. Ownership and control classify sources of finance into owned and borrowed capital. Internal sources and external sources are the two sources of generation of capital. All the sources have different characteristics to suit different types of requirements. Let’s understand them in a little depth.



1. On the Basis of Period
Long Term Equity
Medium Term
Short Term
Equity shares
Retained earnings
Preference shares
Debentures
Loan from financial institutions
Loan from banks
Public deposits
Loan from financial institutions
Trade credit
Factoring
Banks
Commercial paper



2. On the Basis of Ownership
Owners Fund
Borrowed Funds
Equity shares
Retained Earnings
Debentures
Loans from banks
Loans from financial institutions
Public deposits
Lease financing



3. On the Basis of Source of Generation
Internal Sources
External Sources
Equity share capital
Retained earnings
Financial institutions
Loan from banks
Preference shares
Public deposits
Debenture
Lease financing
Commercial papers
Trade credit
Factoring

According to Time Period

Sources of financing a business are classified based on the time period for which the money is required. The time period is commonly classified into the following three:

LONG TERM SOURCES OF FINANCE / FUNDS	MEDIUM TERM SOURCES OF FINANCE / FUNDS	SHORT TERM SOURCES OF FINANCE / FUNDS
Share Capital or Equity Shares	Preference Capital or Preference Shares	Trade Credit
Preference Capital or Preference Shares	Debenture / Bonds	Factoring Services
Retained Earnings or Internal Accruals	Lease Finance	Bill Discounting etc.
Debenture / Bonds	Hire Purchase Finance	Advances received from customers
Term Loans from Financial Institutes, Government, and Commercial Banks	Medium Term Loans from Financial Institutes, Government, and Commercial Banks	Short Term Loans like Working Capital Loans from Commercial Banks
Venture Funding		Fixed Deposits (<1 Year)
Asset Securitization		Receivables and Payables
International Financing by way of Euro Issue, Foreign Currency Loans, ADR, GDR etc.		

Long-Term Sources of Finance

- Long-term financing means capital requirements for a period of more than 5 years to 10, 15, 20 years or maybe more depending on other factors. Capital expenditures in fixed assets like plant and machinery, land and building, etc of business are funded using long-term sources of finance. Part of working capital which permanently stays with the business is also financed with long-term sources of funds. Long-term financing sources can be in the form of any of them:

1. Share Capital or Equity Shares
2. Preference Capital or Preference Shares
3. Retained Earnings or Internal Accruals
4. Debenture / Bonds
5. Term Loans from Financial Institutes, Government, and Commercial Banks
6. Venture Funding
7. Asset Securitization
8. International Financing by way of Euro Issue, Foreign Currency Loans, ADR, GDR, etc

Medium Term Sources of Finance

Medium term financing means financing for a period of 3 to 5 years and is used generally for two reasons. One, when long-term capital is not available for the time being and second when deferred revenue expenditures like advertisements are made which are to be written off over a period of 3 to 5 years. Medium term financing sources can in the form of one of them:

1. Preference Capital or Preference Shares
2. Debenture / Bonds
3. Medium Term Loans from
   - Financial Institutes
   - Government, and
   - Commercial Banks
4. Lease Finance
5. Hire Purchase Finance

Short term sources of finance

- Short term financing means financing for a period of less than 1 year. The need for short-term finance arises to finance the current assets of a business like an inventory of raw material and finished goods, debtors, minimum cash and bank balance etc. Short-term financing is also named as working capital financing. Short term finances are available in the form of:
- Trade Credit
- Short Term Loans like Working Capital Loans from Commercial Banks
- Fixed Deposits for a period of 1 year or less
- Advances received from customers
- Creditors
- Payables
- Factoring Services
- Bill Discounting etc.

According to Ownership and Control: Sources of finances are classified based on ownership and control over the business. These two parameters are an important consideration while selecting a source of funds for the business. Whenever we bring in capital, there are two types of costs – one is the interest and another is sharing ownership and control. Some entrepreneurs may not like to dilute their ownership rights in the business and others may believe in sharing the risk.

OWNED CAPITAL	**BORROWED CAPITAL**
Equity	Financial institutions,
Preference	Commercial banks or
Retained Earnings	The general public in case of debentures.
Convertible Debentures	
Venture Fund or Private Equity	

Owned Capital

- Owned capital also refers to equity. It is sourced from promoters of the company or from the general public by issuing new equity shares. Promoters start the business by bringing in the required money for a startup. Following are the sources of Owned Capital:
- Equity
- Preference
- Retained Earnings
- Convertible Debentures
- Venture Fund or Private Equity
- Further, when the business grows and internal accruals like profits of the company are not enough to satisfy financing requirements, the promoters have a choice of selecting ownership capital or non-ownership capital. This decision is up to the promoters. Still, to discuss, certain advantages of equity capital are as follows:
- It is a long-term capital which means it stays permanently with the business.
- There is no burden of paying interest or installments like borrowed capital. So, the risk of bankruptcy also reduces. Businesses in infancy stages prefer equity for this reason.

Borrowed Capital

- Borrowed or debt capital is the finance arranged from outside sources. These sources of debt financing include the following:
- Financial institutions,
- Commercial banks or
- The general public in case of debentures
- In this type of capital, the borrower has a charge on the assets of the business which means the company will pay the borrower by selling the assets in case of liquidation. Another feature of the borrowed fund is a regular payment of fixed interest and repayment of capital. Certain advantages of borrowing are as follows:
- There is no dilution in ownership and control of the business.
- The cost of borrowed funds is low since it is a deductible expense for taxation purpose which ends up saving on taxes for the company.
- It gives the business the benefit of leverage.

ACCORDING TO SOURCE OF GENERATION:

Based on the source of generation, the following are the **internal and external sources of finance:**

INTERNAL SOURCES	**EXTERNAL SOURCES**
Retained profits	Equity
Reduction or controlling of working capital	Debt or Debt from Banks
Sale of assets etc.	All others except mentioned in Internal Sources

Internal Sources

The internal source of capital is the one which is generated internally by the business. These are as follows:

- Retained profits
- Reduction or controlling of working capital
- Sale of assets etc.
- The internal source of funds has the same characteristics of owned capital. The best part of the internal sourcing of capital is that the business grows by itself and does not depend on outside parties. Disadvantages of both equity and debt are not present in this form of financing. Neither ownership dilutes nor fixed obligation/bankruptcy risk arises.

External Sources

- An external source of finance is the capital generated from outside the business. Apart from the internal sources of funds, all the sources are external sources.

Long term financing

Equity Share Capital: They fall under long-term sources of finance- category because legally they are irredeemable in nature. For an investor, these shares are a certificate of ownership in the company by virtue of which investors are entitled to share the net profits and have a residual claim over the assets of the company in the event of liquidation. Investors have voting rights in the company and their liability to the company limits to the amount of issue price of the equity stock.\

- AUTHORIZED SHARE CAPITAL: It is the maximum amount of capital which a company can issue. The companies can increase it from time to time. For that we need to comply with some formalities also have to pay some fees to the legal bodies.
- ISSUED SHARE CAPITAL: It is that part of authorized capital which the company offers to the investors.
- SUBSCRIBED SHARE CAPITAL: It is that part of issued capital which an investor accepts and agrees upon.
- PAID UP CAPITAL: It is the part of the subscribed capital, which the investors pay. Normally, all companies accept complete money in one shot and therefore issued, subscribed and paid capital becomes one and the same. Conceptually, paid-up capital is the amount of money which a company actually invests in the business.

VARIOUS PRICES OF EQUITY SHARES

- **PAR OR FACE VALUE**: Par or face value is the value of shares which we record in the books of accounts.
- **ISSUE PRICE:** This price is the price which a company actually offers to the investors. Normally, the issue price and face value of a share are the same in the case of new companies.
- **SHARE/SECURITY PREMIUM AND SHARE AT DISCOUNT**: When issuance of shares is at a price higher than face value, we shall call this excess amount to be premium. Contrary to it, when the issuance of shares is at a price lower than face value, we shall call this deficit amount to be discount.
- **BOOK VALUE**: The calculation of the book value will be:
- **Paid up Capital + Reserves and Surplus – Any Loss / The total number of equity shares of the company**
- **This is the balance sheet value of shares. This is an important value in the case of Mergers and Acquisition**
- **MARKET VALUE:** In the case of companies listed on stock exchanges, the market value of the share is the price at which they are currently sold in the market. It is also called stock market value. It may happen that stock market value and value as per fundamental principles differ. Because there are a number of sentiments that affect the stock market value.
- **FUNDAMENTAL VALUE** : The number of times the fundamental value of the security is calculated for the purpose of the Merger or valuation. Its calculation is as per (i) Dividend Discount Model (ii) Price Earning Ratio Method (iii) Earning Capitalization Method (iii) Chop Shop method.

Apart from the above, there are other types of shares (equity) also.

- RIGHTS SHARES: These shares are those which a company issues to it’s existing shareholders. The company issues such kind of shares in order to protect the ownership rights of the existing investors.
- BONUS SHARES: When the company issues shares to its shareholders in the form of a dividend, we shall call them bonus shares. There are various advantages and disadvantages of bonus shares like dividend, capital gain, limited liability, high risk, fluctuation in the market, etc.
- SWEAT EQUITY SHARE: Sweat equity shares are issued to exceptional employees or directors of the company for their exceptional job in terms of providing know-how or intellectual property rights to the company.

Advantages

- DIVIDEND: An investor is entitled to receive a dividend from the company. It is one of the two main sources of return on his investment.
- CAPITAL GAIN: The other source of return on investment apart from dividend is the capital gains. Gains which arise due to rise in market price of the share.
- LIMITED LIABILITY: Liability of shareholder or investor is limited to the extent of the investment made. If the company goes into losses, the share of loss over and above the capital investment would not be borne by the investor.
- EXERCISE CONTROL: By investing in the company, the shareholder gets ownership in the company and thereby he can exercise control. In official terms, he gets voting rights in the company.
- CLAIM OVER ASSETS AND INCOME: An investor of equity share is the owner of the company and so is the owner of the assets of that company. He enjoys a share of the incomes of the company. He will receive some part of that income in cash in the form of dividend and remaining capital is reinvested in the company.
- RIGHTS SHARES: Whenever companies require further capital for expansion etc, they tend to issue 'rights shares'. By issuing such shares, ownership and control of existing shareholders are preserved and the investor receives investment priority over other general investors. Right Shares are issued at a price lower than current market price of the equity share. So, existing investor can take that advantage or otherwise can renounce right in some one's favor to get value of right.
- BONUS SHARES: At times, companies decide to issue bonus shares to its shareholders. It is also a type of dividend. Bonus shares are free shares given to existing shareholders and many times they are given in lieu of dividends.
- LIQUIDITY: The shares of the company which is listed on stock exchanges have the benefit of any time liquidity. The shares can very easily transfer ownership.
- STOCK SPLIT: Stock split means splitting a share into parts. How should an investor be benefited by this? By splitting of share, the per-share price reduces in the market which eventually increases the readability of share. At the end, stock split results in higher volumes with a number of investors leading to high liquidity of the share.

Disadvantages of equity shares

- DIVIDEND: The dividend which a shareholder receives is neither fixed nor controllable by investor. The management of the company decides how much dividend should be given. If there is a loss, there is no question of dividend. If there is a profit, unless Board of Directors propose dividend, investors will not receive dividend.
- HIGH RISK: Equity share investment is a risky investment as compared to any other investment like debts etc. The money is invested based on the faith an investor has in the company. There is no collateral security attached with it.
- FLUCTUATION IN MARKET PRICE: The market price of any equity share has a wide variation. It is always very difficult to book profits from the market. On the contrary, there are equal chances of losses.
- LIMITED CONTROL: An equity investor is a small investor in the company, therefore, it is hardly possible to impact the decision of the company using the voting rights.
- RESIDUAL CLAIM: An equity shareholder has a residual claim over both the assets and the income. Income which is available to equity shareholders is after the payment of all other stakeholders' viz. debenture holders etc.

Preference Shares

- Preference shares, also called preferred shares, are so-named because preferred shareholders have a higher claim on the issuing company's assets than common shareholders. In the most extreme case, this means that preferred shareholders must be paid for their interest in the company before common shareholders in the event of company bankruptcy and liquidation.
- The day-to-day implication of this claim is that preferred shares guarantee dividend payments at a fixed rate, while common shares have no such guarantee. In exchange, preferred shareholders give up the voting rights that benefit common shareholders.
- **KEY TAKEAWAYS**
- Preferred shares are a hybrid form of equity that includes debt-like features such as a guaranteed dividend.
- The four main types of preference shares are callable shares, convertible shares, cumulative shares, and participatory shares.
- Each type of preferred share has unique features that may benefit either the shareholder or the issuer.

Types of preference shares

- **Callable Shares:** Callable shares are preferred shares that the issuing company can choose to buy back at a fixed price in the future. This stipulation benefits the issuing company more than the shareholder because it essentially enables the company to put a cap on the value of the stock. If the company retains the right to repurchase callable shares at $45 a share, it may choose to buy out shareholders at this price if the market value of preferred shares looks like it might exceed this level. Callable shares ensure the company can limit its maximum liability to preferred shareholders.
- **Convertible Shares**: Convertible shares are preferred shares that can be exchanged for common shares at a fixed rate. This can be especially lucrative for preferred shareholders if the market value of common shares increases. Assume an investor purchases five shares of convertible preferred stock at $50 per share, and one share of preferred stock can be converted to three shares of common stock. Profit can be made on the initial $250 investment if the five preferred shares are converted to 15 common shares when the value of common shares moves above $17 ($17 * 15 = $255). Once the shares have been exchanged, the shareholder gives up the benefit of a fixed dividend and cannot convert common shares back to preferred shares.
- **Cumulative Shares**: Preference shares that include a cumulative clause protect the investor against a downturn in company profits. If revenues are down, the issuing company may not be able to afford to pay dividends. Cumulative shares require that any unpaid dividends must be paid to preferred shareholders before any dividends can be paid to common shareholders. If a company guarantees dividends of $10 per preference share but cannot afford to pay for three consecutive years, it must pay a $40 cumulative dividend in the fourth year before any other dividends can be paid.
- **Participatory Shares**: Participatory preference shares provide an additional profit guarantee to shareholders. All preference shares have a fixed dividend rate, which is their chief benefit. However, participatory shares guarantee additional dividends in the event that the issuing company meets certain financial goals. If the company has a particularly lucrative year and meets a predetermined profit target, holders of participatory shares receive dividend payments above the normal fixed rate.

Advantages

1. **Appeal to Cautious Investors:** Preference shares can be easily sold to investors who prefer reasonable safety of their capital and want a regular and fixed return on it.
2. **No Obligation for Dividends:** A company is not bound to pay dividend on preference shares if its profits in a particular year are insufficient. It can postpone the dividend in case of cumulative preference shares also. No fixed burden is created on its finances.
3. **No Interference:** Generally, preference shares do not carry voting rights. Therefore, a company can raise capital without dilution of control. Equity shareholders retain exclusive control over the company.
4. **Trading on Equity:** The rate of dividend on preference shares is fixed. Therefore, with the rise in its earnings, the company can provide the benefits of trading on equity to the equity shareholders.
5. **No Charge on Assets:** Preference shares do not create any mortgage or charge on the assets of the company. The company can keep its fixed assets free for raising loans in future.
6. **Flexibility:** A company can issue redeemable preference shares for a fixed period. The capital can be repaid when it is no longer required in business. There is no danger of over-capitalization and the capital structure remains elastic.
7. **Variety:** Different types of preference shares can be issued depending on the needs of investors. Participating preference shares or convertible preference shares may be issued to attract bold and enterprising investors. Preference shares can be made more popular by giving special rights and privileges such as voting rights, right of conversion into equity shares, right of shares in profits and redemption at a premium.

Disadvantages

1. **Fixed Obligation:** Dividend on preference shares has to be paid at a fixed rate and before any dividend is paid on equity shares. The burden is greater in case of cumulative preference shares on which accumulated arrears of dividend have to be paid.
2. **Limited Appeal:** Bold investors do not like preference shares. Cautious and conservative investors prefer debentures and government securities. In order to attract sufficient investors, a company may have to offer a higher rate of dividend on preference shares.
3. **Low Return:** When the earnings of the company are high, fixed dividend on preference shares becomes unattractive. Preference shareholders generally do not have the right to participate in the prosperity of the company.
4. **No Voting Rights:** Preference shares generally do not carry voting rights. As a result, preference shareholders are helpless and have no say in the management and control of the company.
5. **Fear of Redemption:** The holders of redeemable preference shares might have contributed finance when the company was badly in need of funds. But 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

Debentures are a debt instrument used by companies and government to issue the loan. The loan is issued to corporates based on their reputation at a fixed rate of interest. Debentures are also known as a bond which serves as an IOU between issuers and purchaser. Companies use debentures when they need to borrow the money at a fixed rate of interest for its expansion. Secured and Unsecured, Registered and Bearer, Convertible and Non-Convertible, First and Second are four types of Debentures.

- **Types of Debenture**

1. **Secured and Unsecured:** Secured debenture creates a charge on the assets of the company, thereby mortgaging the assets of the company. Unsecured debenture does not carry any charge or security on the assets of the company.
2. **Registered and Bearer:** A registered debenture is recorded in the register of debenture holders of the company. A regular instrument of transfer is required for their transfer. In contrast, the debenture which is transferable by mere delivery is called bearer debenture.
3. **Convertible and Non-Convertible:** Convertible debenture can be converted into equity shares after the expiry of a specified period. On the other hand, a non-convertible debenture is those which cannot be converted into equity shares.
4. **First and Second:** A debenture which is repaid before the other debenture is known as the first debenture. The second debenture is that which is paid after the first debenture has been paid back.

Advantages of debentures

- **1. Secured investments:** Debentures provide greatest security to the investors. They make a very good appeal to the conservative minds.
- **2. Fixed return:** Debentures guarantee a fixed rate of interest.
- **3. Stable prices:** Their prices are more stable as compared to shares because the changing monetary conditions affect the price movement of the debentures very little.
- **4. Non-interference in management:** The debenture holders do not interfere in the management of the company.
- **5. Economical:** It is a cheaper method of raising finance. Lower rate of interest further makes them more economical.
- **6. Availability of funds:** The companies can raise money through debentures easily compared to equity and preference shares.
- **7. Regular source of income:** The investors get fixed and regular interest, whether the company earns profit or not.

Disadvantages

- **1. Permanent burden of interest:** Interest on debentures is **always cumulative**. It is to be paid irrespective of the profits or otherwise of the company. During the period of depression, it becomes a heavy burden.
- **2. Limits company's credit:** Since in most of the cases, the assets of the company are mortgaged with the debenture holders as a security against their advances, the credit worthiness of the company falls in the eyes of the public as well as the banks. Borrowings from other sources becomes difficult.
- **3. No right to participate in company management:** Ordinarily debenture holder **do not enjoy any voting rights** in the companies. They have no interest in the election of directors. They do not have representation in the management of the affairs of the companies.
- **DEBENTURE TRUST DEED**

  When a company issues mortgage debentures, it is a common practice to secure them by means of a Trust Deed conveying the company's property to the trustees to be held in trust for the benefit of the debenture holders. The trust deed contains the conditions governing the rights of the debenture holders and the relationship between them and the company. The trustees hold the property in trust for the debenture holders and safeguard their interests. Besides, they are also vested with requisite powers to appoint a nominee director on the Board. The trustees must act diligently and honestly in the discharge of their duties. Any clause in the trust deed, which, exempts them from liability for breach of their duty as trustees, is void.

Term loan is a monetary loan that is repaid in regular payments over a set period of time. Term loans usually last between one and ten years, but may last as long as 30 years in some cases. A term loan usually involves an unfixed interest rate that will add

additional balance to be repaid.

(**a) Purpose**: It has already been stated above that the medium or long-term loans are required in order to set up new industrial units as also for renovation, modernization or extension and replacement etc. Generally, these loans are taken by the company for the acquisition of new plant and machinery, construction of factory shed and building, purchase of land etc., i.e., for the purpose of capital expenditure. Moreover, term loans are also sanctioned by financial institutions and commercial banks for the purpose of financing current asset, viz , to meet working capital requirement.

(b) Security: **Generally, the term loans are secured by**:

(i) A first legal mortgage of the fixed assets both existing and those which are to be acquired in future.

(ii) A first charge by hypothecating the movable assets subject to the prior charge created or to be created in favour of the banks of the company in order to secure finance for the purpose of working capital requirements.

(iii) Equitable mortgage, in appropriate cases, and a second charge on immovable property may also be made.

(iv) If necessary, unconditional and irrecoverable personal guarantee of the pro-moters or directors may also be secured. If it is found that the term loans are provided by a number of financial institutions, the charge and mortgage shall rank paripassu inter se.

(c) Period: Generally, term loans are repayable over a period of time by equal/unequal installments. Repayment may also be made in accordance with the specified terms and conditions imposed by the banks/financial institutions which may extend from 8 to 10 years. Usually, loans are repayable by half-yearly installments and amortization starts2 to 3 years after the loan is taken.

(d) Commitment Charge: A commitment charge is a charge which is imposed on the unutilized portion of the loan which has already been sanctioned from the date of execution of the loan agreement in addition to the interest payable on actual amount.

- **The said charge may be imposed at the following rates:**

-continued

(e) The Project-Oriented Approach: No doubt, the approach of the various lending institutions is project-oriented That is, the ability of the borrower for repayment of loan is considered by the flow of expected income from the said project and not on the liquidity position of the borrowing unit. As such, the various lending institutions examine thoroughly the viability and profitability of the project for the purpose of assessing the repayment capacity of the borrower. That is why, a thorough appraisal procedure is followed before sanctioning term loans which is granted to the borrowers.

(f) Follow-Up and Supervision: The term-lending institutions keep a constant watch over the functioning of the borrowing unit taking appropriate follow-up measures. For this purpose, they keep a close touch with the borrowing units till the whole amount of loan is repaid. At times, there may be an agreement between the borrowing unit and the financial institutions that the former will not declare and pay dividends till the entire amount (principal plus interest) is paid.

(g) Re-Finance Facility: The Industrial Development Bank (IDBI) provides with the refinance facility to the commercial banks on the basis of term loans which are sanctioned by them, i.e., the Commercial banks do not block their own funds to a greater extent in term loans. Of course, risk is to be borne by the lending banks.

(h) Convertibility Clause: A clause is being imposed on most of the term loans, i.e., the loan agreement take a convertibility clause. Under this clause, the lending institution will have the right to convert a certain sum of the rupee loan into fully paid up equity shares of the borrowing units at par. Such right can be exercised in one or more times within the specified period.

(i) Bridge Loan: We know that granting term loans requires some time. But the borrowing unit requires the immediate funds which will meet their immediate needs, for example, to make payment for an imported machinery or to meet the needs for working capital etc. The borrowing unit makes an arrangement with the commercial banks or lending financial institutions for temporary short-term loans from them for the purpose, which is known as 'Bridge Loan'. Such loans are secured by hypothecating movable assets of the borrowing unit or such loans are granted on the personal guarantee given by promoters or directors. These 'Bridge Loans' are repaid immediately after sanctioning the term loans.

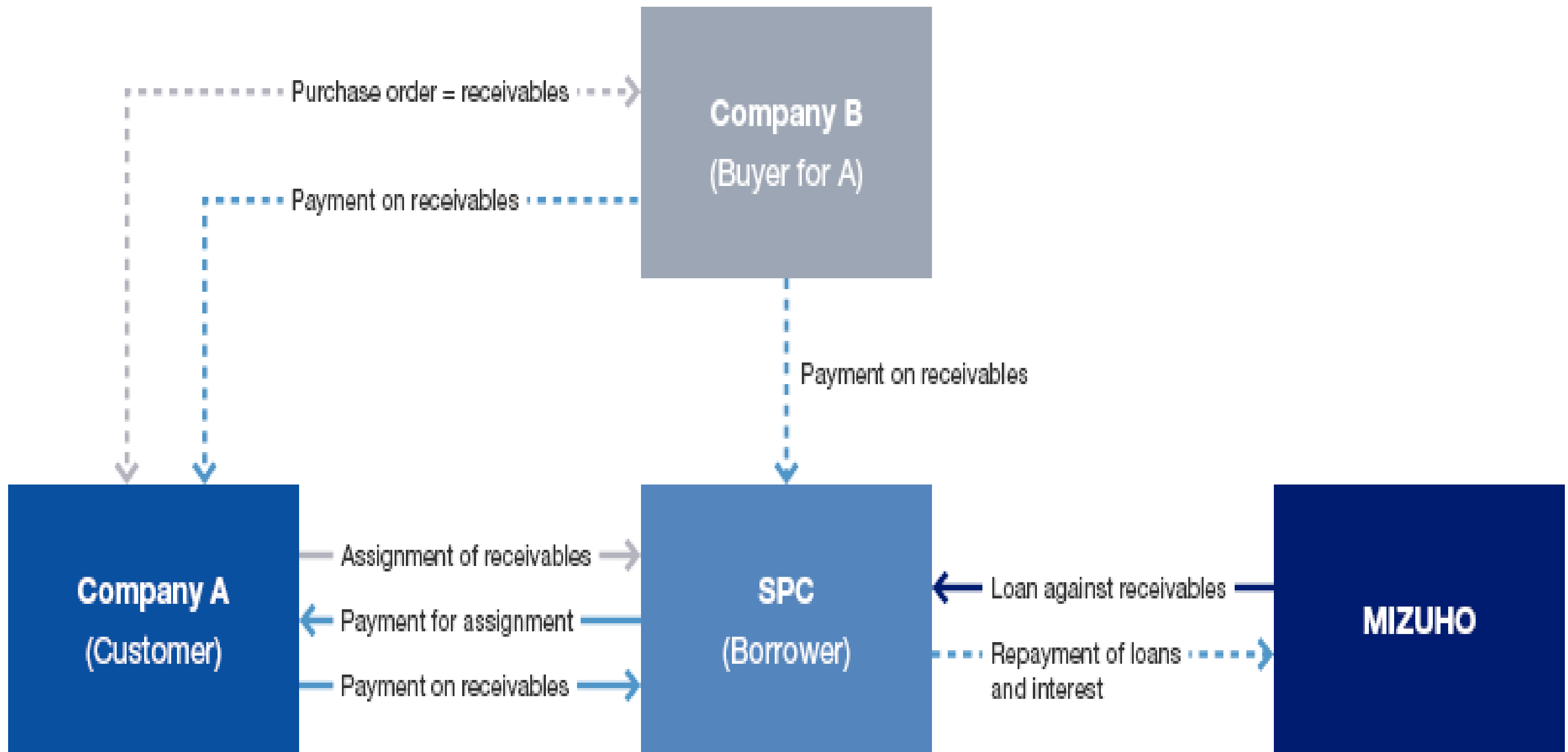
Venture capital funds

Venture capital funds are investment funds that manage the money of investors who seek private equity stakes in startup and small- to medium-sized enterprises with strong growth potential. These investments are generally characterized as high-risk/high-return opportunities. In the past, venture capital investments were only accessible to professional venture capitalists, although now accredited investors have a greater ability to take part in venture capital investments.

- Venture capital funds manage the money of investors who want private equity stakes in startup and small- to medium-sized enterprises.
- Unlike mutual funds and hedge funds, venture capital funds focus on early-stage investment, and high-growth firms that are risky, and have long investment horizons.
- Venture capital funds are considered seed money or early-stage capital.
- Investors make a return when a portfolio company exits, either through an IPO, merger, or acquisition.

Securitization

Securitization is a way of raising funds by selling receivables, which are then turned into asset–backed loan and securities. This method of financing brings various benefits such as diversification of funding sources and improvement of cash flow.



Key features of asset securitization

- The customer sells its receivables to the SPC on a true–sale basis along with necessary perfection.
- The SPC obtains loans from the bank in order to purchase the receivables.
- The SPC makes the payment to the customer as the proceeds for purchasing the receivables.
- The customer's buyer makes the payment regarding the receivables directly to the SPC on the due date. (The customer may be required to collect the payment from the buyer and deliver it to the SPC.)
- The SPC applies such payment/collection from the customer to repay the loan.

International financing

- International Financing is also known as International Macroeconomics as it deals with finance on a global level. There are various sources for organizations to raise funds. To raise funds internationally is one of them. With economies and the operations of the business organizations going global, Indian companies have an access to funds in the global capital market. International finance helps organizations engage in cross-border transactions with foreign business partners, such as customers, investors, suppliers and lenders. Various international sources from where funds may be generated include the following.

(i) Commercial Banks: Global commercial banks all over provide loans in foreign currency to companies. They are crucial in financing non-trade international operations. The different types of loans and services provided by banks vary from country to country. One example of this is Standard Chartered emerged as a major source of foreign currency loans to the Indian industry. It is the most used source of international financing.

(ii) International Agencies and Development Banks: Many development banks and international agencies have come forth over the years for the purpose of international financing. These bodies are set up by the Governments of developed countries of the world at national, regional and international levels for funding various projects. The more industrious among them include International Finance Corporation (IFC), EXIM Bank and Asian Development Bank.

(iii) International Capital Markets: Emerging organizations including multinational companies depend upon fairly large loans in rupees as well as in foreign currency. The financial instruments used for this purpose are

-continued

(a) American Depository Receipts (ADR's): This a tool often used for international financing. As the name suggests, depository receipts issued by a company in the USA are known as American Depository Receipts. ADRs can be 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 the United States of America.

(b) Global Depository Receipts (GDR's): 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 renowned Indian companies such as Infosys, Reliance, Wipro, and ICICI have raised money through issue of GDRs.

(c) Foreign Currency Convertible Bonds (FCCB's): Foreign currency convertible bonds are equity-linked debt securities that are to be converted into equity or depository receipts after a specific period. A holder of FCCB has the option of either converting them into equity shares at a predetermined price or exchange rate or retaining the bonds. The FCCB's are issued in a foreign currency and carry a fixed interest rate which is lower than the rate of any other similar nonconvertible debt instrument. FCCB's resemble convertible debentures issued in India. It is true that businesses need funds but the funds required in business are of different types — long term, short term, fixed and fluctuating. That is the reason why business firms resort to different types of sources for raising funds.

Medium term finance

- Lease financing is one of the important sources of medium- and long-term financing where the owner of an asset gives another person, the right to use that asset against periodical payments. The owner of the asset is known as lessor and the user is called lessee.
- The periodical payment made by the lessee to the lessor is known as lease rental. Under lease financing, lessee is given the right to use the asset but the ownership lies with the lessor and at the end of the lease contract, the asset is returned to the lessor or an option is given to the lessee either to purchase the asset or to renew the lease agreement.

Finance Lease: It is the lease where the lessor transfers substantially all the risks and rewards of ownership of assets to the lessee for lease rentals. In other words, it puts the lessee in the same con-dition as he/she would have been if he/she had purchased the asset. Finance lease has two phases: The first one is called primary period. This is non-cancellable period and in this period, the lessor recovers his total investment through lease rental. The primary period may last for indefinite period of time. The lease rental for the secondary period is much smaller than that of primary period.

Features of Finance Lease:

From the above discussion, following features can be derived for finance lease:

1. A finance lease is a device that gives the lessee a right to use an asset.
2. The lease rental charged by the lessor during the primary period of lease is sufficient to recover his/her investment.
3. The lease rental for the secondary period is much smaller. This is often known as peppercorn rental.
4. Lessee is responsible for the maintenance of asset.
5. No asset-based risk and rewards is taken by lessor.
6. Such type of lease is non-cancellable; the lessor's investment is assured.

Operating Lease: Lease other than finance lease is called operating lease. Here risks and rewards incidental to the ownership of asset are not transferred by the lessor to the lessee. The term of such lease is much less than the economic life of the asset and thus the total investment of the lessor is not recovered through lease rental during the primary period of lease. In case of operating lease, the lessor usually provides advice to the lessee for repair, maintenance and technical knowhow of the leased asset and that is why this type of lease is also known as service lease.

Features of Operating Lease:

Operating lease has following features:

1. The lease term is much lower than the economic life of the asset.
2. The lessee has the right to terminate the lease by giving a short notice and no penalty is charged for that.
3. The lessor provides the technical knowhow of the leased asset to the lessee.
4. Risks and rewards incidental to the ownership of asset are borne by the lessor.
5. Lessor has to depend on leasing of an asset to different lessee for recovery of his/her investment.

Advantages

a. To Lessor: The advantages of lease financing from the point of view of lessor are summarized below

- **Assured Regular Income:** Lessor gets lease rental by leasing an asset during the period of lease which is an assured and regular income.
- **Preservation of Ownership:** In case of finance lease, the lessor transfers all the risk and rewards incidental to ownership to the lessee without the transfer of ownership of asset hence the owner-ship lies with the lessor.
- **Benefit of Tax:** As ownership lies with the lessor, tax benefit is enjoyed by the lessor by way of depreciation in respect of leased asset.
- **High Profitability:** The business of leasing is highly profitable since the rate of return based on lease rental, is much higher than the interest payable on financing the asset.
- **High Potentiality of Growth:** The demand for leasing is steadily increasing because it is one of the cost efficient forms of financing. Economic growth can be maintained even during the period of depression. Thus, the growth potentiality of leasing is much higher as compared to other forms of business.
- **Recovery of Investment:** In case of finance lease, the lessor can recover the total investment through lease rentals.

- **b. To Lessee:** The advantages of lease financing from the point of view of lessee are discussed below:
- **Use of Capital Goods:** A business will not have to spend a lot of money for acquiring an asset but it can use an asset by paying small monthly or yearly rentals.
- **Tax Benefits:** A company is able to enjoy the tax advantage on lease payments as lease payments can be deducted as a business expense.
- **Cheaper:** Leasing is a source of financing which is cheaper than almost all other sources of financing.
- **Technical Assistance:** Lessee gets some sort of technical support from the lessor in respect of leased asset.
- **Inflation Friendly:** Leasing is inflation friendly, the lessee has to pay fixed amount of rentals each year even if the cost of the asset goes up.
- **Ownership:** After the expiry of primary period, lessor offers the lessee to purchase the assets— by paying a very small sum of money.

Disadvantages

a. To Lessor: Lessor suffers from certain limitations which are discussed below:

- **Unprofitable in Case of Inflation:** Lessor gets fixed amount of lease rental every year and they cannot increase this even if the cost of asset goes up.
- **Double Taxation (Sales tax may be charged twice):** First at the time of purchase of asset and second at the time of leasing the asset.
- **Greater Chance of Damage of Asset:** As ownership is not transferred, the lessee uses the asset carelessly and there is a great chance that asset cannot be useable after the expiry of primary period of lease.

b. To Lessee: The disadvantages of lease financing from lessee’s point of view are given below:

- **Compulsion:** Finance lease is non-cancellable and even if a company does not want to use the asset, lessee is required to pay the lease rentals.
- **Ownership:** The lessee will not become the owner of the asset at the end of lease agreement unless he decides to purchase it.
- **Costly:** Lease financing is more costly than other sources of financing because lessee has to pay lease rental as well as expenses incidental to the ownership of the asset.
- **Understatement of Asset:** As lessee is not the owner of the asset, such an asset cannot be shown in the balance sheet which leads to understatement of lessee’s asset.

Hire Purchase

- Under hire purchase system, the purchaser gets the possession of the goods without paying the full price for them. He makes the part payment at the time of purchase and the balance is paid in easy installments periodically. The important ingredient of this system is that the buyer becomes the owner of the goods only after full and final payment of all the installments, till then he hires the goods and every installment is treated as hiring charges paid by him.
- If the purchaser makes default in the payment of an installment, the seller can take back the possession of the goods. Some of the important definitions of hire purchase system are given here:
- “Hire Purchase System is a system under which money is paid for goods by means of periodical installments with the view of ultimate purchase. All money being paid in the mean time is regarded as payment of hire and the goods become the property of the buyers only when all the installments have been paid. “-— Carter
- “The hire-purchase is a form of trade in which credit is granted to the customer on the security of a lien on the goods.” —J. Stephenson

Advantages

(1) **Convenience in Payment:** The buyer is greatly benefited as he has to make the payment in installments. This system is greatly advantageous to the people having limited income.

(2) **Increased Volume Of Sales:** This system attracts more customers as the payment is to be made in easy installments. This leads to increased volume of sales.

(3) **Increased Profits:** Large volume of sales ensures increased profits to the seller.

(4) **Encourages Savings:** It encourages thrift among the buyers who are forced to save some portion of their income for the payment of the installments. This inculcates the habit to save among the people.

(5) **Helpful For Small Traders:** This system is a blessing for the small manufacturers and traders. They can purchase machinery and other equipment on installment basis and in turn sell to the buyer charging full price.

(6) **Earning Of Interest:** The seller gets the installment which includes original price and interest. The interest is calculated in advance and added in total installments to be paid by the buyer.

(7) **Lesser Risk:** From the point of view of seller this system is greatly beneficial as he knows that if the buyer fails to pay one installment, he can get the article back.

Disadvantages of hire purchase system

1) **Higher Price:** A buyer has to pay higher price for the article purchased which includes cost plus interest. The rate of interest is quite high.

(2) **Artificial Demand:** Hire purchase system creates artificial demand for the product. The buyer is tempted to purchase the products, even if he does not need or afford to buy the product.

(3) **Heavy Risk:** The seller runs a heavy risk under such system, though he has the right to take back the articles from the defaulting customers. The second hand goods fetch little price.

(4) **Difficulties in Recovery of Installments:** It has been observed that the sellers do not get the installments from the purchasers on time. They may choose wrong buyers which may put them in trouble. They have to waste time and incur extra expenditure for the recovery of the installments. This sometimes led to serious conflicts between the buyers and the sellers.

(5) **Break Up Of Families:** The system puts a great financial burden on the families which cannot afford to buy costly and luxurious items. Recent studies in western countries have revealed that thousands of happy homes and families have been broken by hire purchase buying's.

Short term finance

1. Trade Credit: Trade credit refers to credit granted to manufactures and traders by the suppliers of raw material, finished goods, components, etc. Usually business enterprises buy supplies on a 30 to 90 days credit. This means that the goods are delivered but payments are not made until the expiry of period of credit. This type of credit does not make the funds available in cash but it facilitates purchases without making immediate payment. This is quite a popular source of finance.
2. 2. Bank Credit: Commercial banks grant short-term finance to business firms which is known as bank credit. When bank credit is granted, the borrower gets a right to draw the amount of credit at one time or in installments as and when needed. Bank credit may be granted by way of loans, cash credit, overdraft and discounted bills.

(i) Loans When a certain amount is advanced by a bank repayable after a specified period, it is known as bank loan. Such advance is credited to a separate loan account and the borrower has to pay interest on the whole amount of loan irrespective of the amount of loan actually drawn. Usually loans are granted against security of assets.(ii) Cash Credit It is an arrangement whereby banks allow the borrower to withdraw money upto a specified limit. This limit is known as cash credit limit. Initially this limit is granted for one year. This limit can be extended after review for another year. However, if the borrower still desires to continue the limit, it must be renewed after three years. Rate of interest varies depending upon the amount of limit. Banks ask for collateral security for the grant of cash credit. In this arrangement, the borrower can draw, repay and again draw the amount within the sanctioned limit. Interest is charged only on the amount actually withdrawn and not on the amount of entire limit.

(ii) (iii) Overdraft When a bank allows its depositors or account holders to withdraw money in excess of the balance in his account upto a specified limit, it is known as overdraft facility. This limit is granted purely on the basis of credit-worthiness of the borrower. Banks generally give the limit upto Rs.20,000. In this system, the borrower has to show a positive balance in his account on the last friday of every month. Interest is charged only on the overdrawn money. Rate of interest in case of overdraft is less than the rate charged under cash credit.

(iii) (iv) Discounting of Bill Banks also advance money by discounting bills of exchange, promissory notes and hundies. When these documents are presented before the bank for discounting, banks credit the amount to cutomer’s account after deducting discount. The amount of discount is equal to the amount of interest for the period of bill.

-continued

3. Customers’ Advances : Sometimes businessmen insist on their customers to make some advance payment. It is generally asked when the value of order is quite large or things ordered are very costly. Customers’ advance represents a part of the payment towards price on the product (s) which will be delivered at a later date. Customers generally agree to make advances when such goods are not easily available in the market or there is an urgent need of goods. A firm can meet its short-term requirements with the help of customers’ advances.
4. Installment credit: Installment credit is now-a-days a popular source of finance for consumer goods like television, refrigerators as well as for industrial goods. You might be aware of this system. Only a small amount of money is paid at the time of delivery of such articles. The balance is paid in a number of installments. The supplier charges interest for extending credit. The amount of interest is included while deciding on the amount of instalment. Another comparable system is the hire purchase system under which the purchaser becomes owner of the goods after the payment of last installment. Sometimes commercial banks also grant instalment credit if they have suitable arrangements with the suppliers.
5. Loans from Co-operative Banks : Co-operative banks are a good source to procure short-term finance. Such banks have been established at local, district and state levels. District Cooperative Banks are the federation of primary credit societies. The State Cooperative Bank finances and controls the District Cooperative Banks in the state. They are also governed by Reserve Bank of India regulations. Some of these banks like the Vaish Co-operative Bank was initially established as a co-operative society and later converted into a bank. These banks grant loans for personal as well as business purposes. Membership is the primary condition for securing loan. The functions of these banks are largely comparable to the functions of commercial banks.

Internal source of finance

- The term internal sources of finance itself suggests the very nature of finance/capital. This is the finance or capital which is generated internally by the business unlike finances such as loan which is externally arranged by banks or financial institutions. The internal source of finance is retained profits, the sale of assets and reduction / controlling of working capital.
- Finance is a constant requirement for every growing business. There are several sources of finance from where a business can acquire finance or capital which it requires. But, the finance manager cannot just choose any of them indifferently. Every type of finance has different pros and cons in terms of cost, availability, eligibility, legal boundaries, etc. Choosing the right source of finance is a challenge. We need to have an in-depth understanding of the characteristics of the source of finance. Let us focus first on the internal source of finance/capital.
- Internal sources of finance are the sources of finance or capital for businesses which are generated by the business itself in its normal course of operations.

Retained earnings as internal source of finance

Retained profits/earnings are called the internal source of finance for a business for the simple reason that they are the end product of running a business. The phenomenon is also known as 'Ploughing Back of Profits'. Retained profits can be defined as the profit left after paying a dividend to the shareholders or drawings by the capital owners.

FORMULA FOR RETAINED PROFITS

It can be stated as below:

- Retained Profits / Retained Earnings = Net Profits – Dividend / Drawings

CHARACTERISTICS OF RETAINED PROFITS

- Retained earnings are a long-term source of finance for a company because there is no compulsory maturity like term loans and debentures.
- Retained profits are also not characterized by the fixed burden of interest or installment payments like borrowed capital

ADVANTAGES OF RETAINED EARNINGS AS AN INTERNAL SOURCE OF FINANCE

The advantage of having retained profits/earnings is clearly seen in its characteristics.

- First, they are long-term finance and nobody can ask for their payments.
- Secondly, since there is no additional equity to be issued, there is no dilution of control and ownership in the business.
- Thirdly, there is no fixed obligation of interest or installment payments.
- Fourthly, 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 %.
- Lastly, investing retained earnings in the projects, with IRR better than ROI of the business, will directly have a positive impact on the shareholder’s wealth and thereby the core objective of management will be served.

DISADVANTAGES OF RETAINED EARNINGS AS AN INTERNAL SOURCE OF FINANCE

- There is practically no disadvantage in generating or using retained earnings for financing the investments of the business. Assuming that the funds generated internally are not free as they are the funds belonging to the shareholders and the cost of these funds is equal to the cost of equity. There is only one alternative which can be explored i.e. debt financing sources. The purpose of exploring the option leads to thinking about two points. One, financial leverage that can be gained by introducing debt financing. Second, if the leverage is possible and practical, dividend decision regarding using the retained earnings to pay dividends to shareholders can be explored.

Depreciation as internal source of finance

Depreciation is the estimated money value of the reduction in working capacity or in the intrinsic value of an asset due to either use of the asset or due to mere efflux of time. It is allocated by charging a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. In other words, the allocation of the depreciable amount of an asset over its estimated useful life is depreciation. However, one thought is that, depreciation is source of fund.

Arguments in favour

- Depreciation is deducted from revenue to ascertain the profit. Hence a part of revenue in form of depreciation lies in the business and increases its working capital. Depreciation increases working capital of the concern expends, thus depreciation is a fund.
- As sale of any asset or its part is treated as source of fund. Depreciation (a part of fixed assets) is included in sale price thus it is also treated as fund.
- Depreciation realizes cost of fixed assets. As depreciation is included in cost of production, which increases the sale price, this in its turn increases the revenue. Such revenue increases the current assets of the business. Therefore, depreciation converts fixed assets into current assets and is a fund.
- Depreciation provides major source of fund in Fund Flow Statement. Fund from operation is obtained by adding depreciation to net profit.

Arguments against

- Money invested in the business goes out and flows back for generating income. Whereas, sources of fund are money, which comes from outside the business and increase its worth. Depreciation is mere recovery of money invested in the business and is not an addition to the business' worth. Hence, it is not a source of fund.
- Depreciation is not a process of generating revenue but a process of allocation of capital cost invested in the fixed assets. It is a mere circulation of money from fixed assets to current assets. Hence, it is not a source of fund.
- Depreciation (as an expense) is charged, even no sale occurs during the period. Hence, depreciation itself does not generate fund.
- Depreciation is added with profit from operation in Fund Flow Statement because it has been deducted to calculate the net profit. So, it cannot be treated as source of fund.
- A layman always tries to increase his fund. If depreciation is a source, then he can charge depreciation at higher rate to generate more fund but it is not practised as depreciation is not a source of fund.

Thank You