# E-Content for B.Com Part-I

## SUBJECT-BUSINESS ORGANISATION

## Paper-Subsidiary

## TOPIC-SOURCES OF BUSINESS FINANCE

PART-A

Sources of Long Term Business Finance

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Every business enterprises, whether big, medium or small needs capital to carry on its operations and to achieve its targets. In fact capital is indispensible today that it is rightly said it is the life blood of an enterprise without adequate capital no business can accomplish its objective.

In every business concern there are two methods of raising capital viz, (1) Raising of owned capital and (2) Raising of borrowed capital. These financial requirements may be long term, medium term or short term.

Long term business finance is that which is required in a business enterprise-either permanently or for a long period of time, say 20 or 25 years or so. Long term business finance is needed usually for investment in fixed assets such as land and building, plant and machinery etc., and for financing expansion programs.

Short term finance is a business is needed for a period-maximum up to 1 year. This type of finance is called working capital finance. The operating cycle of business is complete within a maximum period of 1 year i.e., purchase of raw materials, payment of wages to workers etc.

Medium term business finance which is neither permanently nor a period of short-period (upto 1 year). It may be needed for a period ranging from 2-5 or 7 years. Some example- modernization of plants, advertising campaign, development of a new product or innovation etc.

# Classification of Financial Requirement

A. **Long term**

1. Issue of shares
2. Issue of debentures
3. Ploughing -back of profits
4. Loans from specialized financial institutions

B. **Middle terms**

1. Issue of debentures
2. Issue of preference share
3. Term loans from Banks
4. Public Deposits
5. Loans from financial institutions

C. **Short term**

1. Commercial Banks
   - Loans
   - Cash-credits
   - Overdraft
   - Purchasing and Discounting of Bills
2. Indigenous Banking
3. Trade Credits
4. Installment Credit
5. Advances

## Preference shares

These shares have certain preferences as compared to other types of shares. These shares are given two preferences. There is a preference for payments of dividend. When the company has distributable profits, the dividend is first paid on preference share capital. Other shareholders are paid dividend only out of the remaining profits, if any. The second preference for preference share is repayment of capital at the time of liquidation of the company. After paying outside creditors, preference share capitals are returned. Equity shareholder will be paid only when preference share capital is paid in full. A fixed rate of dividend is paid on preference share capital. Preference shareholders do not have voting rights, so they have no say in the management of the company. However, they can vote if their own interests are affected. Those persons who want their money to fetch a constant rate of returns even if the earning is less prefer to purchase preference shares.

**Advantages**

- Fixed return in guaranteed.
- Long term funds.
- Restricted voting rights.
- Repayment of capitals
- No securities required
- Trading on equity

**Disadvantages**

- Burden of fixed dividend.
- No controlling rights of shareholders.
- Cost of raising capital is higher.

## Equity shares

Equity shares are earlier known as ordinary shares. The holders of these are the real owners of the company. They have voting rights in the meeting of the company. They have a control over the working of the company. Equity shareholders are paid dividend after paying it to preference shareholders. The rate of dividend on these share depend upon the profits of the company. They may be paid a higher rate of dividend or they may not get anything. These shareholders take more risk as compared to preference shareholders. Equity capital is paid after meeting all the claims including that of preference shareholders. They make risk both regarding the dividend and return of capital. Equity share capital cannot be redeemed during the lifetime of the company.

**Advantages**

- No fixed dividend
- No charge on assets
- Permanent sources
- Real owners of company
- More dividend

**Disadvantages**

- No trading on equity
- Danger of over-capitalization
- Obstacles for management
- Speculation

## Debentures

A company may raise long term finance through public borrowings. These loans are raised by the issue of debentures. A debenture is an acknowledgement of a debt. According to Thomas Evelyn, "A debentures is a document under the company's seal which provides for the payment of a principle sum and interest theron at regular intervals which is usually secured by a fixed or floating charge on the company's property or undertaking and which acknowledges a loan to the company". A debenture holder is a creditor of the company. A fixed rate of interest is paid on debentures. The interest on debentures is a charge on the profit and loss account of the company. When the debentures are secured, they are paid on priority in comparison to all other creditors.

### Advantages

- Control of company is not surrendered to debentureholders because they do not have any voting rights.
- Trading on equity is possible as debentureholders get a lower rate of return than the earning of the company.
- Interest on debentures is an allowable expenditure under Income Tax Act, hence, incidence of tax on the company is decreased.
- Debentures can be reduced when company has surplus funds.

### Disadvantages

- Cost of raising capital through debentures is high because of high stamp cost.
- Common people cannot buy debentures as they are of high denominations.

- They are not meant for companies earning greater than the rate of interest, which are paying on the debentures.

**Term Loans From Banks**

In recent years, commercial banks have started “Term Lending”. A term loan is a loan granted for a period ranging from 3 to 7 years.

**Public Deposits**

Another way of raising capitals by a company is to invite public deposits for a specified period at a fixed rate of interest. Usually companies inviting public deposits pay a higher rate of interest than the commercial banks for a similar time period. According to Sec.58 A of the companies (Amendment) Act.1974, the central government may prescribe the limits and the manner of accepting the deposits by a company from public. Before inviting such deposits, a company shall insert an advertisement in the principle dailies, showing its financial position over the last five years.

**Advantage**

- Not much of legal formalities are required.
- No charge has to be created on assets by public deposits.
- Better trading on equity as earnings of the company are greater than the rate of interest which it pays to its depositors.
- Capital remains elastic, as repayment of deposits money is easy.

## Loans from financial institution

Another important source of raising finance is from the financial institutions like the Industrial Financial Corporation of India (IFCI); the Industrial Development Bank of India (IDBI), the Industrial Credit and Investment Corporation of India (ICCI) etc. Such organizations provide medium and long-term loans on easy installments to big industrial houses.

**Advantages**

- Availability of finance for development schemes.
- Reasonable security requirements.
- Availability of finance during periods of depression.
- Easy repayment facility.
- Underwriting facility.

Such institutions help in promoting new companies; expansion and development of existing companies and meeting the financial requirements of companies during economic depression.

## Ploughing back of profits

The "Ploughing Back of Profits" is a technique of financial management under which all profits of a company are not distributed amongst the shareholders as dividend, but a part of the profit is retained or re-invested in the company. This process of retaining profits year after year and their utilization is also known as ploughing back of profits.

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**Points to remember:**

In fact, there is no fixed time period for intermediate finance. It may extend to any time period; but not a permanent period. It all depends on the nature and purpose of investment activity, for which medium term finance is needed.

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