Chapter 8: Sources of Business Finance

Exercises — Exercises

Q1 What is business finance? Why do businesses need funds? Explain.

Business finance means the funds a business requires to start and run its activities; money is called the life blood of any business. Funds are needed for: (a) Fixed capital, to buy long-lived assets such as land and building, plant and machinery, furniture and fixtures. (b) Working capital, for day-to-day operations such as raw materials, stock, bills receivable, salaries, wages, taxes and rent. (c) Growth and expansion, including upgrading technology to cut costs, building higher inventories for the festive season, meeting current debts or shifting to a new location. The owner's initial capital is rarely enough, so other sources must be found.

Q2 List sources of raising long-term and short-term finance.

Long-term sources (funds needed for more than 5 years, mainly for fixed assets): issue of shares (equity and preference), debentures, long-term borrowings and loans from financial institutions, and retained earnings. Medium-term sources (over 1 year but under 5 years): bank borrowings, public deposits, lease financing and loans from financial institutions. Short-term sources (not exceeding 1 year): trade credit, loans from commercial banks, commercial paper and factoring. International sources such as GDRs, ADRs, IDRs and FCCBs can also supply long-term funds.

Q3 What is the difference between internal and external sources of raising funds? Explain.

Internal sources are generated from within the business, for example by speeding up collection of receivables, disposing of surplus inventories and ploughing back profits (retained earnings). They can meet only limited needs, but they carry no explicit cost and give operational freedom. External sources lie outside the organisation, such as suppliers, lenders and investors; examples are debentures, bank loans, loans from financial institutions and public deposits. They are used when large sums are required, may be costlier than internal funds, and sometimes require the firm to mortgage its assets as security.

Q4 What preferential rights are enjoyed by preference shareholders. Explain.

Preference shareholders have a preferential position over equity shareholders in two ways. First, they receive a fixed rate of dividend out of net profits before any dividend is declared for equity shareholders. Second, at the time of liquidation, they get their capital back after the claims of the company's creditors are settled but before equity shareholders. Hence they have a preferential claim over both dividend and repayment of capital. In return, they generally do not enjoy voting rights, and the dividend is payable only out of profit after tax at the directors' discretion.

Q5 Name any three special financial institutions and state their objectives.

Three special financial institutions are IFCI, SIDBI and EXIM Bank. (1) Industrial Finance Corporation of India (IFCI), set up in 1948, provides medium and long-term finance to industrial concerns and encourages new entrepreneurs and balanced regional development in priority sectors. (2) Small Industries Development Bank of India (SIDBI) is the apex institution for the small-scale sector; it finances and refinances small enterprises and promotes their growth, credit flow and entrepreneurship. (3) Export-Import Bank of India (EXIM Bank) finances, facilitates and promotes foreign trade by giving loans to exporters and importers and supporting Indian project exports. Together they supply long-term funds, which commercial banks seldom offer, for industrial growth.

Q6 What is the difference between GDR and ADR? Explain.

A Global Depository Receipt (GDR) is issued when an Indian company's local-currency shares are delivered to a depository bank, which issues receipts against them, denominated in US dollars. It is a negotiable instrument, listed and traded on a foreign stock exchange, and can be converted into the shares it represents; holders have rights to dividend and capital appreciation. An American Depository Receipt (ADR) is a depository receipt issued by a company in the USA. It is similar to a GDR except that it can be issued only to American citizens and can be listed and traded only on a stock exchange of the USA, like regular stocks.

Q7 Explain trade credit and bank credit as sources of short-term finance for business enterprises.

Trade credit is credit extended by one trader to another for purchase of goods and services, allowing supplies to be bought without immediate payment; it appears as sundry creditors or accounts payable in the buyer's books. It is given to customers with reasonable financial standing and goodwill. Merits: convenient and continuous source, readily available when the buyer's creditworthiness is known, promotes sales, helps build inventory, and creates no charge on assets. Limitations: easy credit may induce overtrading, only limited funds can be raised, and it is generally costly.

Bank credit: commercial banks give loans to firms of all sizes through cash credits, overdrafts, term loans, discounting of bills and letters of credit. Interest depends on the firm's characteristics and the economy's interest rates; repayment is in lump sum or instalments, and security is required. Merits: timely assistance, confidentiality, no prospectus or underwriting formalities, and flexibility to increase or prepay the loan. Limitations: funds are usually for short periods with uncertain renewal, detailed investigation and security make it difficult, and strict conditions may be imposed.

Q8 Discuss the sources from which a large industrial enterprise can raise capital for financing modernisation and expansion.

A large enterprise needing long-term funds has many options. Internally, it can plough back profits as retained earnings. Externally, it can issue equity shares (permanent owner's capital, no compulsory dividend), preference shares (fixed return, no voting rights) and debentures (fixed interest, tax-deductible, no dilution of control). Financial institutions, also called development banks, are considered especially suitable for large funds for longer duration for expansion, reorganisation and modernisation; they supply owned and loan capital, funds even in depression, and managerial and technical advice. Commercial banks give term loans, and lease financing helps acquire equipment such as computers without large investment. Public deposits and commercial paper can supply medium and short-term funds. Internationally, it can use foreign currency loans from commercial banks, agencies such as IFC, EXIM Bank and Asian Development Bank, and instruments such as GDRs, ADRs, IDRs and FCCBs. Since no source is free of limitations, a combination should be chosen on cost, risk, control, tax benefit and flexibility.

Q9 What advantages does issue of debentures provide over the issue of equity shares?

Debentures offer several advantages over equity shares. (i) Investors who want a fixed income at lesser risk prefer them, since interest is paid at fixed intervals. (ii) Debenture holders have no voting rights, so financing through debentures does not dilute the control of equity shareholders over management. (iii) They are fixed charge funds and do not participate in the company's profits, so equity holders keep the whole surplus. (iv) They are less costly than equity or preference capital because interest on debentures is tax deductible, while dividend is not. (v) They suit situations where sales and earnings are relatively stable. Equity, by contrast, dilutes voting power and earnings, costs more and involves more formalities. The drawbacks are a permanent burden of interest and a reduced borrowing capacity.

Q10 State the merits and demerits of public deposits and retained earnings as methods of business finance.

Public deposits are funds raised directly from the public, with a deposit receipt issued as acknowledgment. Merits: simple procedure without restrictive loan conditions; cost generally lower than bank and institutional borrowings; no charge on company assets, which stay free as security for other loans; and depositors have no voting rights, so control is not diluted. Demerits: new companies find it difficult to raise funds; it is unreliable because the public may not respond when money is needed; and collecting large deposits may be difficult.

Retained earnings are the part of net profits kept back instead of being paid as dividends. Merits: a permanent source; no explicit cost of interest, dividend or floatation; greater operational freedom and flexibility; greater capacity to absorb unexpected losses; and possible rise in the market price of equity shares. Demerits: excessive ploughing back may dissatisfy shareholders through lower dividends; it is an uncertain source because profits fluctuate; and its opportunity cost is often not recognised, leading to sub-optimal use of funds.