Chapter 8 – Sources of Business Finance Notes

Meaning and Nature of Business Finance

Business finance is the management and raising of funds by commercial organisations. The money required to launch, run, and expand a business is business finance. In addition to intangible assets like patents, technical expertise, and trademarks, funds are required to purchase tangible assets like furniture, machinery, buildings, offices, and factories.

The goal of every business endeavour is long-term financial success and societal benefit. Additionally, a business is founded on a going-concern principle, which calls for carrying out all operations with the expectation that they will last for a considerable amount of time and make a profit.

Entrepreneurs who engage in the activity invest a certain amount of money, known as capital. One must continually invest money in the company to support its growth, known as business financing. A company's ability to raise the capital it needs to function is what is known as business finance.

Significance of Business Finance

The points below highlight the significance of Business Finance:

- A company with adequate business financing will launch its venture with fewer delays and hassles.
- With business financing, the owners can purchase raw materials as needed for production.
- With the aid of business finance, the business firm can easily make its dues and other payments.
- The right business finance will help manage uncertain risks and contingencies.
- A business with strong financial standing will be able to attract talented employees and access highly effective technology.

Financing Needs of the Business:

Fixed Capital Requirements:

Fixed capital requirements are the sums of money needed by a business to buy real estate, structures, equipment, furniture, and fixtures, among other things. Different amounts of fixed capital are required depending on the organisation's size and the level of operations. Fixed capital remains invested in the business for a long period.

Working Capital Requirements:

The money needed to maintain the regular operations of a business is known as working capital. It holds current assets like material stock, debtors, and other liabilities. The amount of working capital needed depends on several variables, including the type of business, size, operational cycle, etc.

Classification of Sources of Funds

A. Basis of Period

1. Short Term: These funds are utilised for short-term projects that last one year or less. For example, trade credit, loans from commercial banks and commercial papers.
2. Medium Term: These funds are needed between one and five years. For example, public deposits, lease financing, and loans from financial institutions.
3. Long Term: These funds have been meeting the company's needs for more than five years. For example, shares, debentures and long-term borrowings.

B. Basis of Ownership

1. Owners' Funds: Owners' funds are contributions from the organisation's founders. It includes earnings that are put back into the company. These funds remain invested in the business for a longer duration and are not required to be refunded through the life of the business. The significant funding sources for owners have retained profits and released equity shares.
2. Borrowed Funds: These sums of money are acquired through borrowing and loans. A few examples of this source of funding are issues of debentures, bank loans, public deposits, trade credit, etc.

C. Basis of Generation

Internal Sources: An organisation's funds are referred to as internal sources. However, this source can only meet temporary or small needs. For example, reinvesting profits, eliminating excess inventory, etc.

External Sources: External funding sources are used to meet large financial requirements. Compared to internal sources of funding, these are more expensive sources. These are carried out through bank loans from commercial institutions, receiving public deposits, raising debentures, etc.

Factors Affecting the Choice of the Source of Funds

Cost

An organisation must take into account the cost incurred while acquiring funds. Cost is a significant factor because it directly impacts an enterprise. As a result, when choosing the funds that an organisation will use, the cost of obtaining and using the funds are considered.

Financial Strength and Stability of Operations

A company's financial position and strength are important factors to consider when choosing the source of funds. A business must be financially stable because money must be returned to the source from which it was borrowed. When the company's financial situation is unstable, purchasing preference shares or debentures with fixed charges is not advisable.

Form of Business Organisation

The way a company is organised affects how much money it can raise. For instance, it cannot issue equity shares if it is a sole proprietorship.

Time Period

A business or organisation must decide whether the funds are needed for a short-term or long-term project before raising them from the market.

Risk Factor

Each source of funding should have a thorough analysis of the risk involved. It is best to choose the source with the lowest risk. For instance, equity is less risky than loans when it comes to the financial risk brought on by fixed interest rates and repayment issues.

Dilution of Control

The decision of what source of financing needs to be obtained also depends on how prepared the firm is for the loss of control. The company may issue financing from sources other than equity share capital, for instance, if existing equity shareholders are unwilling to give up the control they currently hold.

Credit Worthiness

The type of sources the company uses to raise capital affects how creditworthy it is. The company should therefore pick sources that won't harm its marketability as a lender.

Ease of Issuing Finance

The choice of source of financing is also influenced by the firm's flexibility and ease in obtaining funding. Excessive paperwork, legal requirements, extensive investigation, and other factors may deter a company from using a specific funding source.

Tax Advantages

Different sources provide the organisation with various tax advantages. The interest paid on debentures and loans is tax-deductible, but the dividend on preference shares is not deductible from taxable income.

A business needs money to be built, run, improved, expanded, or changed. Working and fixed capital requirements are two different categories of a business's financial needs.

Classification of Sources of Funds

Companies can raise capital from various sources, divided into three levels.

1. **Period Basis**

Three categories into which the various sources of funding can be divided are:

– Long-term sources,

– Medium-term sources, and

– Short-term sources

Long-Term Sources: Long-term funds are used for longer than five years. The fund is managed using equity shares, debentures, and other options. It comes from the stock market.

Medium-Term Sources: Funds raised for a duration greater than one year but less than five years are referred to as medium-term sources. Loans from financial institutions, commercial paper, commercial banks, and lease financing are just a few funding options.

Short-Term Sources: For a year, short-term funds are needed. Some examples of these sources include working capital loans from commercial banks or trade credit companies.

2. **Ownership Basis**

There are two categories of ownership sources.

Owner's Funds: The money that the business owners finance is referred to as the owner's fund. It also goes by the name "owner's capital." Retained earnings, preferred shares, or equity shares are distributed to raise the necessary funds. These long-term capital resources serve as the foundation on which owners can assert ownership of the company's management and operations.

Borrowed Funds: The borrowed funds are gathered using loans or borrowings for a specific time. Among businesses, this funding source is the most well-known and widespread.

3. **Generation Basis**

There are two categories for the generation basis.

Internal Sources: Owners who produce money within the company are considered internal sources. The illustration for this example entails the disposition of assets and profits.

External Source: External Source refers to money obtained from sources other than the company. For instance, the issuance of equity shares, debentures, or a loan from a public or commercial bank.

Factors Affecting the Choice of the Sources of Fund

The following are the factors that affect the choice of sourcing funds:

- Cost
- Financial Strength and Stability of Operations
- Form of Business Organisation
- Time Period
- Risk Factor
- Dilution of Control
- Credit Worthiness
- Ease of Issuing Finance
- Tax Advantages