[Academic Script]

Source of Finance

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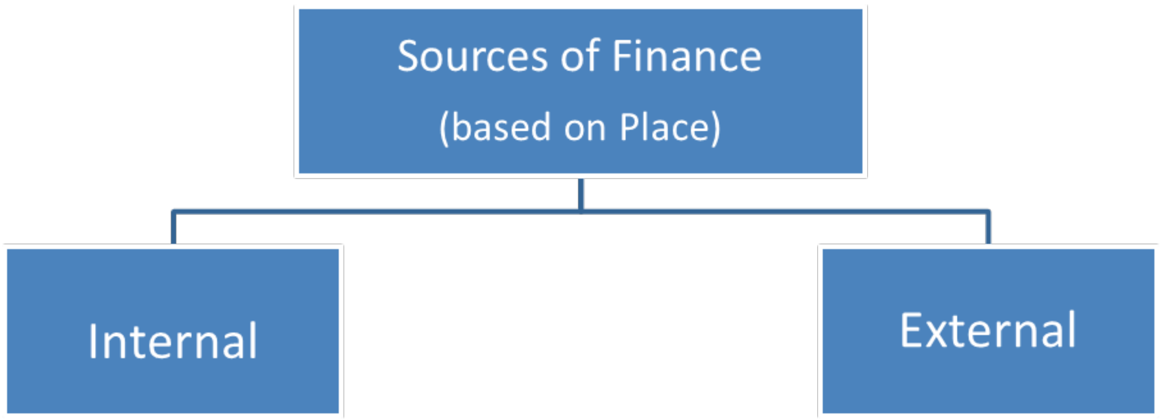
Academic Script

1. Introduction

The main finance decisions are financing decision, Investing decision, and Dividend decision. Financing decision relates to raising funds through various sources of funds, in this chapter, we are going to discuss various sources of finance for corporate world. Let us begin our discussion with various types of sources of funds.

2. Source of Finance based on place

According to environment or place from where one can get a source of finance, it can be classified into two types:



(1) **Internal Finance**

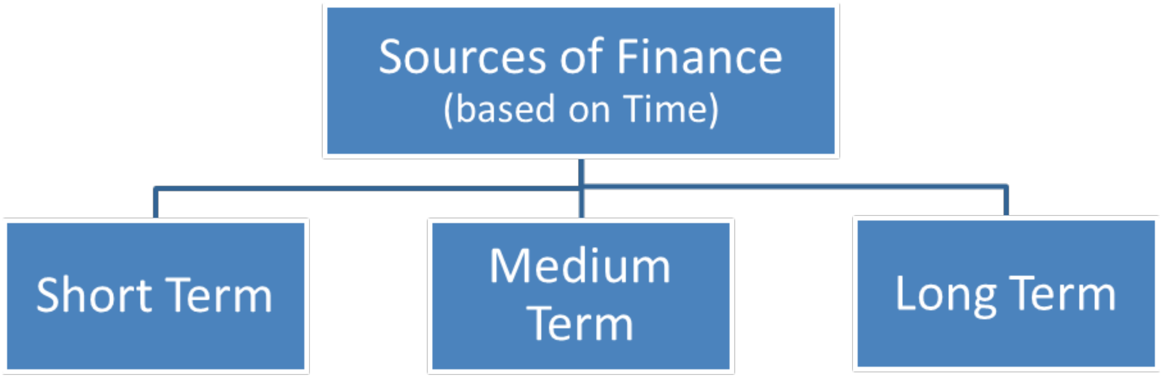
Internal finance means the sources of finance which we can found within the four wall of the business. Finance is raised through inside the business is called internal finance like family, friends, customers, creditors, sales etc.

(2) **External Finance**

External finance is exactly opposite to the internal finance, the finance which can be raised from out of the business parties like, shareholders, debenture holders, banks, financial institutions etc.

3. Source of Finance based on Time

According to the Time period, for how many days, or month, or years, one can get a Sources of Finance, it can be classified into three types:



(1) Short Term Finance

Short term refers to the finance, one may need for one day or one year. It covers all the types of finance which is available within one year period. All the sources which for up to one year, available from individual business, industry, and institutions are short term type of finance. Even the instruments prevailing in the money market is also a type of Short term finance.

(2) Medium Term Finance

Instruments which is for the period of not less than one year period of time and not more than five years period of time.

(3) Long Term Finance

Long term means the finance available for more than five years. Anyone investing or borrowing the money for more than five years period, in any instruments available for financing a long term, is called long term finance. Most of Term Loans and Industrial Finance and instruments of capital market are the source of long term finance.

4. Classification of Financial Sources

We can easily understand the combination of both the types of sources of finance with the help of a below mention graph:

Classification of Financial Sources			
Time / Type	Short Term Finance (0-1 year)	Medium Term Finance (1-5 year)	Long Term Finance (More than 5 Year)
Internal Finance	▪ Creditors ▪ Sales ▪ Increase in Working	▪ Receivables ▪ Divestment ▪ Loans from Friends and	▪ Sales of Assets ▪ Retained Earning ▪ Owners' Capital

	Capital ▪ Use of Different Provisions like Depreciation, Taxation, dividend etc.	Family	
External Finance	▪ Demand Deposits ▪ Cash Credit ▪ Bank Overdraft ▪ Treasury Bills ▪ Commercial Papers ▪ Trade Credit	▪ Term Loan from Bank ▪ Public Deposit ▪ Hire Purchase ▪ Leasing ▪ Bond	▪ Equity Shares ▪ Preference Shares ▪ Debentures ▪ Grants ▪ Loans from Financial Institution

5. Short Terms Sources of Finance

Now let us discuss the Short Term Sources of finance:

(1) Advances from Commercial Banks

Loans and Advances are the two terms which are used interchangeably. But the Term ‘Loan’ refers to the amount lending by a bank to the borrower for a specific purpose and specific period of time where the money is disbursed and it’s repayable in installments. While Advances on the other hand, is a credit facility within one year largely for short-term purpose to the borrower on the condition of repayment.

According to the section 29 of banking regulation act, 1949, Advances are to be shown in three major groups,

(i) Demand Loan, Cash Credits, and Overdrafts

(ii) Bills Purchased and Discounted

(iii) Term Loan

A **Demand Loan** is a loan which is repayable on demand either in lumpsum in one time or as agreed by the bank at a short-notice. Demand loans is a short term loans which can be raised for the purpose of payment of short term liabilities or maintaining liquidity or working capital.

Term loan on the other hand is a medium and long term loans granted for a longer period for the special purpose and repayable in installments of a fixed amount. Housing loan, car loan, educational loan, loan to purchase Assets, renovation, expansion loans are the term loans.

Cash credit is generally granted on the pledging or hypothecation of stock of goods. The borrower is allowed to withdraw according to his requirements and interest is charged on the actual amount withdrawn.

Overdraft is a temporary arrangement, in which the customer is allowed to overdraw his current account up to specified limit. Interest is charged only on the actual amount overdrawn.

(2) Public Deposits

The main function of the bank are to accept deposits from the public and to grant advances to the needy persons. The deposits are classified as

(i) Fixed deposits or Term Deposits,

(ii) Savings bank Deposits and

(iii) Current Accounts or Demand Deposits.

Fixed Deposits or Term Deposits are the deposits which cannot be withdrawn before a fixed period. Naturally, a higher rate of interest is allowed on such deposits. A Deposit Receipt is issued to the depositor, when he deposits the money under this scheme.

Savings Bank Deposit is meant for salaried persons or small business-men. Interest is naturally at a lower rate on such deposits. Withdrawal are allowed either by withdrawal form or by cheques with the certain amount of restriction.

Current Accounts or Demand Deposits are generally for businessmen who require to deposits and withdrawal facility frequently and require no restrictions to deposits or withdrawal without money. Interest on current deposits is lowest among all the three types of deposits

(3) Treasury Bills

Treasury bill is promissory note issued by RBI on behalf of government upto a period of one year. It is generally issued at discount and repayable at par. Therefore margin between the discounted value and par value is the income of the investors. Presently RBI issue treasury bills for 91 days, 182 days and 364 days maturity period. Though the treasury bill is short term money market instrument, it is source of finance for government.

(4) Commercial Papers

Commercial paper can issue in the form promissory note. When corporates or financial institutions are in need of short term money, they issue commercial paper for a period of minimum 7 day to maximum upto one year. Though commercial paper is a money market, short term instrument, it is traded in secondary Over The Counter market and all the reporting related with Commercial Papers are presented to Fixed Income Money Market and Derivatives Association of India.

(5) Advances from Customers

Advances from customers are received when any goods or services ordered but not yet rendered or delivered. The cash or cheque received in advance is referred as a current liability if it is for a period upto one year. If customers are not using the cash on delivery option in online shopping, they have to pay advance money prior to receive goods or services through debit card or credit card or net banking. In case of face-to-face shopping, when customers wants to book their orders of the goods or services, they want to purchase, they give the advance cash to seller.

(6) Trade Creditors:

All the times Goods or services may not be possible to sell for cash, sometimes to increase the business profit, businessmen have to deal with the supplier or creditors to provide some grace time period for the payment of Purchase. In the same way businessmen also have to provide certain time period to their customer or debtors for the payment of Sale. In this case a Seller become the Trade Creditor for the purchaser.

In this transaction, till the credit period is not over there will no interest is charged by the supplier but the purchaser also not get the benefit of the cash discount at the same time.

6. Medium Term Sources
Now let us see what the Medium Term Sources are:

Medium term sources are Bills Receivable, Account Receivable, Hire Purchase and Leasing

(1) Bills/Notes Receivable:

Bill is a small chit written by seller who sold the goods on credit, and buyer agreed with all the matters written in the same chit with his signature. Bills is a legal documents with a stamp and seller can claim the money after the maturity period of the bill or expiry of credit period allowed to the customer. In the same way if there is promise given by the customer himself from his own side in writing on same type of chit, it is known as promissory notes.

Most seller prefer to write bill or take a promissory note when they are not sure about the customers' financial position and want to minimize their bad debts.

(2) Accounts Receivable:

It is the outstanding receivable from day to day transaction. It is a normal receivable of the money that occurs from the regular credit sales to customers. Accounts receivables is short term source of finance.

(3) Hire Purchase:

When a buyer purchase any assets by making payment in instalment, it is called Hire Purchase. Under Hire Purchase User are Buyer and he intends to get the ownership of the asset but the ownership of the assets transfers immediately only after purchasing an assets by paying a full price. Individuals or small business use the way of Hire Purchase for purchasing an electronics or mechanical items like refrigerator, washing machines, Air conditioner, two or four wheelers etc. by paying some percentage of cash price advance payment as a down payment and remaining amount in instalments with interest as agreed.

(4) Leasing:

In Leasing, the user of the assets undertakes the assets on rent which is known as lease of an assets, under the agreement of lease, the owner of the asset gives right to use the asset for specified period of time against payment of lease. In case of leasing the owner of the assets is called Lessor while the user of the assets is called Lessee. Lease Financing is most popular for leasing expensive assets like business machineries, building, computers etc.

7. Long Term Sources

Now let us discuss Long Term Sources of Finance:

Main sources of Long term finance are Shares, Retained earnings, Debentures and Loan.

(1) Shares

Term Shares refers here sharing the source of fund in terms of Capital. In the business of sole-proprietorship, owner of the business himself provide a capital for his business, in the business of partnership, partners jointly provide a capital for their business. But in the company form of business, promoters request to provide capital to number of persons called public. Each part of that capital called "shares" is a contribution of public towards capital of the company.

When the total capital of a company is divided into uniform units of small denominations and each such standard unit is called a share.

"**A share is a fractional part of the capital of the company which forms the basis of ownership and interest of a subscriber in the company."**

There are two types of shares widely used by companies.

(i) **Equity Shares:** by investing a money in terms of shares, if holders of the share become the owner of the company, then it is known as Equity types of shares. Equity shares holders are the real owners of the company as they contributes to the capital of the company. That is the reason that equity share holders have right to receive a benefit from remaining all the reserves and surplus of the company.

(ii) **Preference Shares:** other than equity shares, company also prefer to issue preference share as a source of finance. Investors of preference share also receive dividend as a return on investment just like equity shareholder. The only difference is preference share holder receive dividend with fixed rate of return and preferential rights of receiving their money at time of winding of the company than equity share holders but they can not claim as the owners of the company.

(2) Retained Earning

Retained earning is internal source of finance. When company uses the amount of its own Reserves and Surplus for certain period in its own business is popularly known Retained Earning used as source of finance. In this type of source of finance, company do not need to go outside to collect the fund but it uses its own money that is retained apart from the business profit every year.

(3) Debentures

Debentures is a borrowed source of finance for the company. When company wants to raise the capital by paying the lower cost of capital than shares, the company uses the way of issuing Debenture in borrowed terms. Debenture is a borrowed security, issue by making payment of fixed interest as cost of collecting the capital just like fixed rate of dividend payment in case of Preference share.

(4) Long Term Loans

In the same way of Debenture, Loan is the capital raised by a company by borrowing the money from the bank or any other financial institution for a limited period of time on fixed or variable type of interest. Though long-term loan is an easy way of source of finance, company have to provide some security in terms of assets, investments or securities.