UNIT-2

FUND REQUIREMENTS

- Finance is the lifeblood of business concern, because it is interlinked with all activities performed by the business concern.
- Quantum of finance may be depending upon the **nature and situation** of the business concern. But, the requirement of the finance may be broadly classified into two parts:

SOURCES OF FINANCE

- **Sources of finance mean the ways for mobilizing various terms of finance to the industrial concern.** Sources of finance state that, how the companies are mobilizing finance for their requirements. The companies belong to the existing or the new which need sum amount of finance to meet the long-term and short-term requirements such as purchasing of fixed assets, construction of office building, purchase of raw materials and day-to-day expenses.
- Sources of finance may be classified under various categories according to the following important heads:

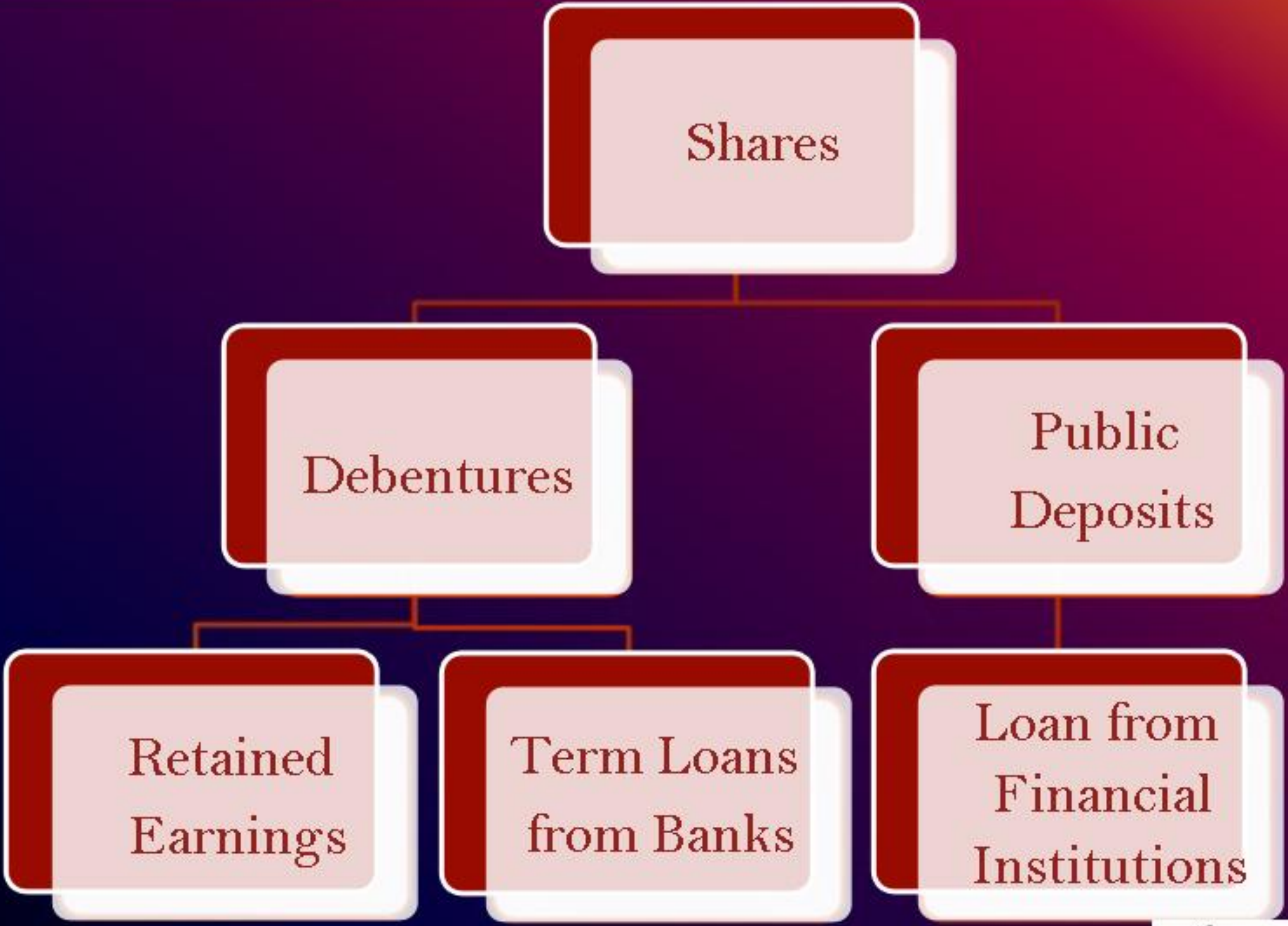
Long-term Financial Requirements or Fixed Capital Requirement

- Financial requirement of the business differs from firm to firm and the nature of the requirements on the basis of terms or period of financial requirement, it may be long term and short-term financial requirements. Long-term financial requirement means the finance needed to acquire land and building for business concern, purchase of plant and machinery and other fixed expenditure.
- Longterm financial requirement is also called as **fixed capital requirements.**

Purpose of long term finance:

- 1. To Finance fixed assets
- 2. To finance the permanent part of working capital
- 3. To finance growth and expansion of business

Sources of Long Term Financing



Shares

- Issue of shares is the main source of long term finance. Shares are issued by joint stock companies to the public. A company divides its capital into units of a definite face value, say of Rs. 10 each or Rs. 100 each. Each unit is called a share. A person holding shares is called a shareholder.

- **EQUITY SHARES**
- Equity shares are shares which do not enjoy any preferential right in the matter of payment of dividend or repayment of capital. The equity shareholder gets dividend only after the payment of dividends to the preference shares.
- Equity shareholders are the real owners of the company. They have a control over the management of the company. Equity shareholders are eligible to get dividend if the company earns profit.

- **PREFERENCE SHARES**
- Preference Shares are the shares which carry preferential rights over the equity shares. These rights are (a) receiving dividends at a fixed rate, (b) getting back the capital in case the company is wound-up. Investment in these shares are safe, and a preference shareholder also gets dividend regularly.

WRITE THE DIFFERENCE BETWEEN EQUITY AND PREFERENCE SHARES

- **CREDITORSHIP SECURITIES**
- Creditorship Securities also known as debt finance which means the finance is mobilized from the creditors. Debenture and Bonds are the two major parts of the Creditorship Securities.
- **Debentures**
- A Debenture is a document issued by the company. It is a certificate issued by the company under its seal acknowledging a debt. According to the Companies Act 1956, "debenture includes debenture stock, bonds and any other securities of a company whether constituting a charge of the assets of the company or not."

DEBENDTURES

- Whenever a company wants to borrow a large amount of fund for a long but fixed period, it can borrow from the general public by issuing loan certificates called Debentures.
- These are offered to the public to subscribe in the same manner as is done in the case of shares. A debenture is issued under the common seal of the company. It is a **written acknowledgement** of money borrowed. It specifies the terms and conditions, such as rate of interest, time repayment, security offered, etc.

- Types of Debentures :
- Debentures may be classified as:
- a) Redeemable Debentures and Irredeemable Debentures
- b) Convertible Debentures and Non-convertible Debentures.

WRITE THE DIFFERENCE BETWEEN SHARES AND DEBENTURES

- **Retained Earnings (Internal source of finance)**
- Like an individual, companies also set aside a part of their profits to meet future requirements of capital.
- The portion of the profits which is not distributed among the shareholders but is retained and is used in business is called retained earnings or ploughing back of profits. As per Indian Companies Act., companies are required to transfer a part of their profits in reserves. The amount so kept in reserve may be used to buy fixed assets. This is called internal financing.

Public Deposits

- It is a very old source of finance in India. When modern banks were not there, people used to deposit their savings with business concerns of good repute. Even today it is a very popular and convenient method of raising medium term finance. The period for which business undertakings accept public deposits ranges between six months to three years.

- Any member of the public can fill up the prescribed form and deposit the money with the company. The company in return issues a deposit receipt. This receipt is an acknowledgement of debt by the company. The terms and conditions of the deposit are printed on the back of the receipt.

Borrowing From Commercial Banks :

- Traditionally, commercial banks in India do not grant long term loans. They grant loans only for short period not extending one year. But recently they have started giving loans for a long period. Commercial banks give term loans i.e. for more than one year.
- Commercial banks give loans to organizations in either cash credits, overdrafts, term loans, purchase/discounting of bills, or issue of letter of credit. Banks help enterprises by providing loans to produce goods and contribute towards industrial growth and generate employment opportunities.

- **Financial Institutions**
- The economic development of any country depends on the growth of the business sector. The well developed financial system helps the business to achieve growth by making funds available to them. For which, the government has established financial institutions all over the country to provide finance to businesses.

- Special Financial Institutions
- *1. Industrial Finance Corporation of India (IFCI)*
- *2. State Financial Corporations (SFC)*
- *3. Industrial Credit and Investment Corporation of India (ICICI)*

Short-term Financial Requirements or Working Capital Requirement

- Apart from the capital expenditure of the firms, the firms should need certain expenditure like **procurement of raw materials, payment of wages, day-to-day expenditures, etc.**
- This kind of expenditure is to meet with the help of short-term financial requirements which **will meet the operational expenditure of the firms.** Short-term financial requirements are popularly known as **working capital**.

- **Short-term source of finance include:**
- ● Bank Credit ● Customer Advances ● Trade Credit ● Factoring ● Public Deposits ● Money Market Instruments

- **Trade Credit**
- **Trade credit refers to the credit extended by the supplier of goods or services to his/her customer in the normal course of business.** Trade credit occupies a very important position in short term sources financing due to the competition**. Almost all the traders and manufacturers are required to extend credit facility (a portion), without which there is no possibility of staying back in the business.**
- Trade credit is a spontaneous source of finance that arises in the normal business transactions of the firm without specific negotiations (automatic source of finance). In order to get this source of finance, the buyer should have acceptable and dependable creditworthiness and reputation in the market.

- **Factoring**
- Cash lubricates the wheels of trade, business and industry. Cash flow is necessary to meet commitments – statutory or otherwise. But, unfortunately for the sellers of goods and services, credit sale is the order of the day, worldwide. The most vulnerable segments are the small and medium sector enterprises. Delayed realisation of the sales receivables elongates their working capital cycles. Poor bookkeeping and collection mechanisms along with inadequate and delayed institutional credit hasten their untimely sickness.

- **Public Deposits**
- Public deposits or term deposits are in the nature of unsecured deposits, have been solicited by the firms (both large and small) from general public primarily for the purpose of financing their working capital requirements.

- **Commercial Papers (CPs)**
- Commercial paper represents a short term sources unsecured promissory note issued by firms that have a fairly high credit (standing) rating. It was first introduced in the USA and it was an important money market instruments. In India, Reserve Bank of India introduced CP on the recommendations of the Vaghul Working Group on the money market. CP is a source of short term sources finance to only large firms with sound financial position.

CAPITALIZATION

- Capitalization refers to the **valuation of the total business**.
- It is the sum total of owned capital and bor-rowed capital. Thus it is nothing but the valuation of long-term funds invested in the business.
- It refers to the way in which **its long-term obligations are distributed between different classes of both owners and creditors.**

TYPES OF CAPITALIZATION

- **Over Capitalisation:**
- Many have confused the term 'over-capitalisation' with abundance of capital and 'under-capitalisation' with shortage of capital. An enterprise becomes over-capitalised **when its earning capacity does not justify the amount of capitalisation.**
- Over-capitalisation has nothing to do with redundance of capital in an enterprise.
- Overcapitalization occurs when a company **has issued more debt and equity than its assets are worth.** The market value of the company is less than the total capitalized value of the company. An overcapitalized company might be paying more in interest and dividend payments than it has the ability to sustain long-term.

Causes of over-capitalization:

- Acquiring assets at inflated prices:
- Over-issue of capital:
- Formation during the boom period:
- Over estimation of earnings:
- Shortage of capital
- Liberal Dividend Policy

- **Under-Capitalisation:**
- Generally, under-capitalisation is regarded equivalent to the inadequacy of capital but it should be considered as the reverse of over-capitalisation i.e. it is a condition when the **real value of the corporation** is more than the book value.

- A company is said to be under-capitalised when it is earning exceptionally higher profits as compared to other companies or the value of its assets is significantly higher than the capital raised.

- **The following are the causes for under-capitalization:**
- Acquisition of Assets during Recession
- Underestimation of earnings
- Unforeseeable increase in earnings
- Conservative dividend policy
- Efficient Management

A FINANCIAL SECURITY is a document of a certain monetary value. It refers to stocks and bonds which are negotiable. Derivatives are also considered as a common type of financial security, with its growing popularity in recent years

Features of Financial Securities

Types of Financial Securities

Equity Securities	Holding an equity interest means contributing to the capital of the co.
Debt Securities	Different types of debt securities such as bonds, debentures, etc.
Derivative Securities	Derivative securities are those securities whose value is derived from an underlying asset.