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Chapter 8. Sources of Business Finance

Meaning of Business Finance:

1. **Definition:** Business finance is the management of funds to support various activities involved in the production and distribution of goods and services to meet the needs of society.
2. **Importance:** Finance is referred to as the lifeblood of any business, highlighting its essential role in sustaining business operations.

Nature of Business Finance:

1. **Continuous Requirement:** Business finance is an ongoing need, starting from the establishment of a business and continuing through its various stages of growth and expansion.
2. **Diverse Financial Needs:** Businesses require funds for different purposes, such as acquiring fixed assets (fixed capital requirements) and meeting day-to-day operational expenses (working capital requirements).

Significance of Business Finance:

1. **Vital for Functioning:** Adequate funds are crucial for the proper functioning of a business. The initial capital contributed by the entrepreneur may not be sufficient to fulfill all financial needs.
2. **Assessment and Identification:** A clear assessment of financial needs and the identification of various sources of finance are critical aspects of managing a business organization.

Types of Financial Needs:

1. **Fixed Capital Requirements:**
   - **Purpose:** To purchase fixed assets like land, buildings, plant machinery, furniture, etc.
   - **Duration:** Funds remain invested in the business for an extended period.
2. **Working Capital Requirements:**
   - **Purpose:** For day-to-day operations, including the purchase of raw materials, payment of salaries, and other current expenses.
   - **Variability:** Varies based on factors such as the nature of the business and sales turnover.

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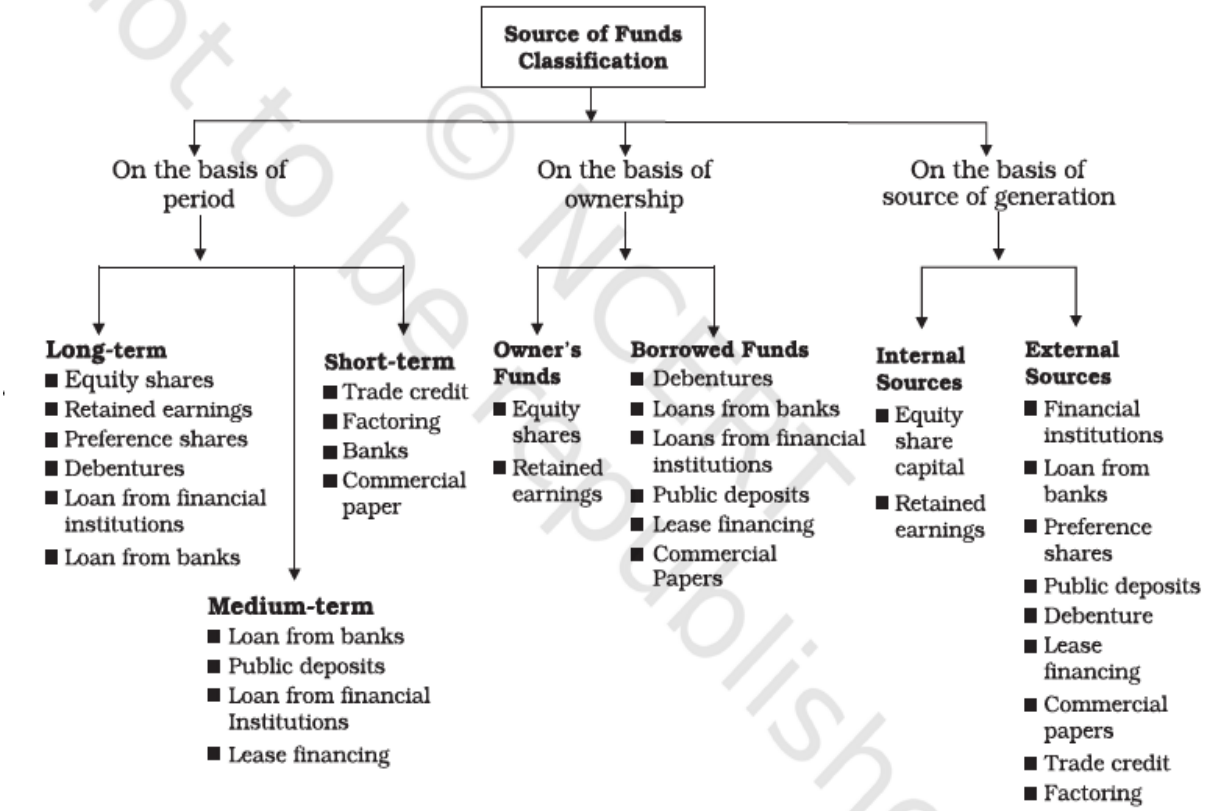
Table 8.1 Classification of Sources of Funds



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Classification of Sources of Funds:

Classification of sources of funds is based on the period for which funds are needed, ownership structure, and whether funds are generated internally or externally. Each source has its own characteristics, advantages and considerations allowing businesses to tailor their financing strategies to meet specific needs.

Period Basis:

1. **Long-term Sources:**
    - **Purpose:** Fulfill financial requirements exceeding 5 years.
    - **Examples:** Shares, debentures, long-term borrowings, and loans from financial institutions.
    - **Usage:** Typically used for acquiring fixed assets like equipment and plants.
2. **Medium-term Sources:**
    - **Purpose:** Meet funds requirement for a period of more than one year but less than five years.

- **Examples:** Borrowings from commercial banks, public deposits, lease financing, and loans from financial institutions.

3. **Short-term Sources:**
    - **Purpose:** Required for a period not exceeding one year.
    - **Examples:** Trade credit, loans from commercial banks, and commercial papers.
    - **Usage:** Common for financing current assets such as accounts receivable and inventories.

Ownership Basis:

1. **Owner's Funds:**
    - **Definition:** Funds provided by owners, including sole traders, partners, or shareholders.
    - **Components:** Capital, profits reinvested in the business.
    - **Duration:** Invested for a longer period, not required to be refunded during the business's lifespan.
    - **Sources:** Issue of equity shares, retained earnings.
2. **Borrowed Funds:**
    - **Definition:** Funds raised through loans or borrowings.
    - **Sources:** Loans from commercial banks, financial institutions, debenture issuance, public deposits, and trade credit.
    - **Duration:** Provided for a specified period, with repayment obligations and fixed interest rates.
    - **Considerations:** May impose a financial burden, especially when earnings are low.

Source of Generation Basis:

1. **Internal Sources:**
    - **Definition:** Funds generated from within the business.
    - **Examples:** Accelerating collection of receivables, selling surplus inventories, and reinvesting profits.
    - **Limitation:** Can fulfill only limited business needs.
2. **External Sources:**
    - **Definition:** Funds obtained from sources outside the organization.
    - **Examples:** Debenture issuance, borrowing from banks and financial institutions, and public deposits.

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- **Usage:** Employed when a large amount of money is required.
- **Considerations:** May be costlier than internal sources, and may require asset mortgaging as security.

Sources of Finance:

Retained Earnings:

Definition: Portion of net earnings kept within the business for future use.

Merits:

1. **Permanent Source:** Retained earnings are a continuous and permanent source of funds for an organization.
2. **Cost Advantage:** No explicit cost is involved, such as interest, dividends, or flotation costs.
3. **Operational Freedom:** Since funds are generated internally, there is greater operational freedom and flexibility in their utilization.
4. **Risk Absorption:** Enhances the business's capacity to absorb unexpected losses.
5. **Market Price Impact:** May lead to an increase in the market price of the company's equity shares.

Limitations:

1. **Shareholder Dissatisfaction:** Excessive retention may lead to dissatisfaction among shareholders who receive lower dividends.
2. **Uncertain Source:** The fluctuating nature of business profits makes retained earnings an uncertain source of funds.
3. **Opportunity Cost:** Some firms may not recognize the opportunity cost associated with retained earnings, leading to sub-optimal use of funds.

Trade Credit:

Definition: Credit extended by one trader to another for the purchase of goods and services.

Characteristics:

1. **Facilitates Purchases:** Allows the buyer to obtain goods without making an immediate payment.
2. **Record Keeping:** Appears in the buyer's records as 'sundry creditors' or 'accounts payable.'
3. **Short-term Financing:** Commonly used by business organizations as a source of short-term financing.

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4. **Credit Approval:** Typically granted to customers with a reasonable financial standing and goodwill.
5. **Factors Influencing Credit Terms:**
    - Reputation of the purchasing firm.
    - Financial position of the seller.
    - Volume of purchases.
    - Past payment record.
    - Degree of competition in the market.
6. **Variability:** Terms of trade credit may vary between industries and customers, and a firm may offer different credit terms to different customers.

Merits:

1. **Convenience and Continuity:** Trade credit is a convenient and continuous source of funds.
2. **Readily Available:** If the creditworthiness of the customers is known, trade credit may be readily available.
3. **Promotes Sales:** Trade credit is used to promote the sales of an organization.
4. **Inventory Financing:** Can be utilized to finance an increase in inventory levels to meet expected rises in sales.
5. **No Charge on Assets:** It does not create any charge on the assets of the firm while providing funds.

Limitations of Trade Credit:

1. **Risk of Overtrading:** Easy and flexible availability of trade credit facilities may lead a firm to indulge in overtrading. Overtrading can increase the risks for the firm, potentially impacting its financial stability.
2. **Limited Fund Generation:** Only a limited amount of funds can be generated through trade credit. This limitation may restrict the firm's ability to meet larger financing needs solely through trade credit.
3. **Comparative Cost:** Trade credit is generally considered a costly source of funds compared to many other sources of raising money. The higher cost associated with trade credit may affect the overall cost-effectiveness of the firm's financing strategies.

Trade credit, therefore, serves as a flexible and accessible financing option, particularly for short-term needs, and its availability and terms depend on various factors related to the buyer and seller.

Factoring:

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Definition: Factoring is a financial service where a 'factor' provides various services, including the discounting of bills and collection of client debts. The factor may also provide information about the creditworthiness of prospective clients.

Services Provided by Factors:

1. **Discounting of Bills:**
    - **Recourse Factoring:** The client is not protected against the risk of bad debts.
    - **Non-recourse Factoring:** The factor assumes the entire credit risk, and the full amount is paid to the client in the event of a bad debt.
2. **Credit Information:**
    - Factors offer information about the creditworthiness of prospective clients.
    - Factors may provide consultancy services in areas such as finance and marketing.

Merits:

1. **Cost Advantage:**
    - Obtaining funds through factoring is considered cheaper than financing through other means, such as bank credit.
2. **Improved Cash Flow:**
    - Cash flow is accelerated through factoring, enabling the client to meet liabilities promptly.
3. **Flexibility:**
    - Factoring ensures a definite pattern of cash inflows from credit sales and is a flexible source of funds.
4. **Security:**
    - Provides security for a debt that a firm might otherwise be unable to obtain.
5. **No Charge on Assets:**
    - Factoring does not create any charge on the assets of the firm.
6. **Focus on Business Functions:**
    - The client can concentrate on other functional areas of business as the responsibility of credit control is shouldered by the factor.

Limitations:

1. **Expense with Numerous Invoices:**
    - Factoring can be expensive when dealing with numerous and smaller invoices.
2. **Higher Interest Cost:**

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- The advance finance provided by the factor is generally available at a higher interest cost than the usual rate of interest.

3. **Third-Party Involvement:**
    - The factor is a third party to the customer, and some may not feel comfortable dealing with it.

Lease Financing:

Definition: Lease financing is a contractual agreement where the owner of an asset (lessor) grants another party (lessee) the right to use the asset in exchange for periodic payments.

Key Components:

- **Lessor:** The owner of the asset.
- **Lessee:** The party using the asset.
- **Lease Rental:** Fixed periodic payment made by the lessee to the lessor for the use of the asset.
- **Lease Period:** Specified duration of the lease agreement.
- **Lease Contract:** Document specifying the terms and conditions of the lease arrangement.

Merits of Lease Financing:

1. **Lower Investment:**
    - Enables the lessee to acquire the asset with a lower initial investment.
2. **Simple Documentation:**
    - Simple documentation makes it easier to finance assets through leasing.
3. **Tax Deductibility:**
    - Lease rentals paid by the lessee are deductible for computing taxable profits.
4. **Ownership and Control:**
    - Provides finance without diluting the ownership or control of the business.
5. **Debt Capacity:**
    - The lease agreement does not affect the debt-raising capacity of the enterprise.
6. **Risk of Obsolescence:**
    - The risk of obsolescence is borne by the lessor, allowing greater flexibility for the lessee to replace the asset.

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Limitations of Lease Financing:

1. **Restrictions on Use:**
    - Lease arrangements may impose restrictions on the use of assets, preventing the lessee from making alterations or modifications.
2. **Impact on Operations:**
    - Normal business operations may be affected if the lease is not renewed.
3. **Higher Payout Obligation:**
    - Premature termination of the lease agreement, especially if the equipment is not found useful, may result in a higher payout obligation.
4. **No Ownership:**
    - The lessee never becomes the owner of the asset, depriving them of the residual value.

Lease financing is particularly popular for acquiring assets like computers and electronic equipment due to their rapid obsolescence. Businesses need to carefully consider the merits and limitations of lease financing before making decisions, especially regarding ownership, tax implications, and potential restrictions on asset use.

The Lessors:

1. **Specialized Leasing Companies:**
    - Description: Approximately 400 large companies with a dedicated focus on leasing.
    - Role: These companies primarily engage in leasing operations.
2. **Banks and Bank Subsidiaries:**
    - RBI Regulation Change (February 1994): RBI allowed banks to directly enter leasing, changing the previous restriction that only bank subsidiaries could engage in leasing.
    - Role: Banks and their subsidiaries are involved in leasing operations.
3. **Specialized Financial Institutions:**
    - Role: Various financial institutions at both Central and State levels in India utilize lease instruments alongside traditional financing methods. Notably, ICICI is one of the pioneers in Indian leasing.
4. **Manufacturer-Lessors:**
    - Description: Manufacturers, faced with competition, add value to sales by offering products on lease.
    - Role: Manufacturer-lessors, through vendor leasing, form alliances or joint ventures with leasing companies to provide lease finance for their products. This is particularly common in the automotive and consumer durables sectors.

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The Lessees:

1. **Public Sector Undertakings:**
    - Growth: The leasing market within public sector undertakings has experienced significant growth.
    - Usage: Both centrally and State-owned entities increasingly resort to lease financing.
2. **Mid-Market Companies:**
    - Description: Mid-market companies, characterized by reasonably good creditworthiness but lower public profiles.
    - Usage: These companies turn to lease financing as an alternative to traditional bank or institutional financing.
3. **Consumers:**
    - Consumer Focus: Due to recent negative experiences with corporate financing, attention has shifted toward retail funding of consumer durables.
    - Example: Car leasing has become a substantial market in India.
4. **Government Departments and Authorities:**
    - Entry into Leasing Markets: Government entities have recently entered the leasing markets.
    - Example: The Department of Telecommunications of the central government took the lead by floating tenders for lease finance worth about ₹1000 crores.

The dynamics of leasing involve a diverse range of organizations, including specialized leasing companies, banks, financial institutions, manufacturers, public sector undertakings, mid-market companies, consumers, and government departments.

Public Deposits:

Definition: Public deposits refer to the funds raised directly from the public by organizations. Depositors receive higher interest rates compared to bank deposits. Companies issue deposit receipts as acknowledgment of the debt.

Merits of Public Deposits:

1. **Simplicity:**
    - Procedure for obtaining deposits is simple without restrictive conditions.
2. **Cost Advantage:**
    - Cost of public deposits is generally lower than borrowings from banks and financial institutions.
3. **No Charge on Assets:**

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- Public deposits usually don't create any charge on the company's assets, allowing them to be used as security for loans from other sources.

4. **No Dilution of Control:**
    - Since depositors don't have voting rights, the control of the company is not diluted.

Limitations of Public Deposits:

1. **Difficulty for New Companies:**
    - New companies may find it challenging to raise funds through public deposits.
2. **Unreliable Source:**
    - Public response may be uncertain when the company needs funds.
3. **Difficulty in Collection:**
    - Collection of public deposits, especially for large amounts, may prove challenging.

Commercial Paper (CP):

Definition: Commercial Paper is an unsecured money market instrument in the form of a promissory note. It provides highly rated corporate borrowers with short-term financing options.

Merits of Commercial Paper:

1. **Unsecured Basis:**
    - CP is sold on an unsecured basis without restrictive conditions.
2. **High Liquidity:**
    - It is a freely transferable instrument, ensuring high liquidity.
3. **Cost Advantage:**
    - Cost of CP is generally lower than commercial bank loans, providing more funds.
4. **Continuous Source of Funds:**
    - CP provides a continuous source of funds, and its maturity can be tailored to suit the issuing firm's requirements.
5. **Excess Fund Utilization:**
    - Companies can park excess funds in commercial paper, earning a good return.

Limitations of Commercial Paper:

1. **Limited to Highly Rated Firms:**
    - Only financially sound and highly rated firms can raise money through commercial papers.
2. **Size Limitation:**

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- The size of money raised through commercial paper is limited to the excess liquidity available with fund suppliers at a particular time.

3. **Impersonal Method:**
    - Commercial paper is an impersonal method of financing, making it challenging to extend maturity if a firm faces financial difficulties.

Issue of Shares:

Definition: The capital obtained through the issuance of shares is referred to as share capital. A company's capital is divided into small units called shares, each with a nominal value. There are two main types of shares: equity shares and preference shares.

Types of Shares:

(a) Equity Shares:

Description: Equity shares are a significant source of long-term capital for a company, representing ownership. The capital raised through equity shares is termed equity share capital.

Characteristics:

1. Ownership Capital: Equity shares represent ownership or owner's funds.
2. Dividend Basis: Equity shareholders do not receive a fixed dividend but are paid based on the company's earnings.
3. Residual Owners: Referred to as "residual owners" as they receive what remains after settling all other claims on the company's income and assets.
4. Liability: Limited liability, up to the extent of the capital contributed.
5. Voting Rights: Equity shareholders have the right to participate in the management of the company through voting rights.

Merits of Raising Funds through Equity Shares:

1. **Risk and Return:** Suitable for investors willing to assume risk for higher returns.
2. **Dividend Flexibility:** No compulsory payment of dividends, relieving the company of a financial burden.
3. **Permanent Capital:** Equity capital is repaid only at the company's liquidation, providing a cushion for creditors.
4. **Creditworthiness:** Enhances the company's creditworthiness and instills confidence in prospective loan providers.
5. **Asset Freedom:** Funds can be raised without creating a charge on company assets.
6. **Democratic Control:** Equity shareholders have voting rights, ensuring democratic control over company management.

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Limitations of Raising Funds through Equity Shares:

1. **Fluctuating Returns:** Investors seeking steady income may not prefer equity shares due to fluctuating returns.
2. **Cost Factor:** The cost of equity shares is generally higher compared to other funding sources.
3. **Dilution of Ownership:** Issuing additional equity shares dilutes the voting power and earnings of existing equity shareholders.
4. **Formalities and Delays:** Involves more formalities and procedural delays compared to other funding methods.

Preference Shares:

Definition: Preference shares represent a form of capital raised by a company, known as preference share capital. Preference shareholders enjoy a preferential position over equity shareholders in terms of receiving fixed dividends before equity shareholders and having a preferential claim on capital repayment during liquidation.

Characteristics:

1. **Dividend Preference:**
    - Receive a fixed rate of dividend before any dividend is declared for equity shareholders.
2. **Capital Repayment Preference:**
    - Receive their capital after settling the claims of the company's creditors during liquidation.
3. **Hybrid Characteristics:**
    - Resemble debentures with a fixed rate of return and some characteristics of equity shares.
4. **Voting Rights:**
    - Preference shareholders generally do not have voting rights.
5. **Types of Preference Shares:**
    - Companies can issue different types of preference shares.

Merits of Preference Shares:

1. **Steady Income:**
    - Provides reasonably steady income through a fixed rate of return.
2. **Safety of Investment:**
    - Attracts investors seeking fixed returns with lower risk.

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3. **Control Preservation:**
    - Does not impact the control of equity shareholders as preference shareholders lack voting rights.
4. **Dividend Flexibility:**
    - Payment of fixed dividend to preference shares may allow the company to declare higher rates of dividend for equity shareholders.
5. **Preferential Repayment:**
    - Preference shareholders have a preferential right of repayment over equity shareholders during liquidation.
6. **No Asset Charge:**
    - Preference capital does not create any charge against the company's assets.

Limitations of Preference Shares:

1. **Risk and Returns:**
    - Not suitable for investors seeking risk and higher returns.
2. **Dilution of Equity Claims:**
    - Dilutes the claims of equity shareholders over the company's assets.
3. **Higher Dividend Rates:**
    - The rate of dividend on preference shares is generally higher than the rate of interest on debentures.
4. **Assured Returns Issue:**
    - No assured return for investors as dividends are paid only when the company earns a profit.
5. **Non-Deductible Dividend:**
    - The dividend paid on preference shares is not deductible from profits, resulting in no tax-saving as in the case of interest on loans.

Types of Preference Shares:

1. Cumulative and Non-Cumulative:

- **Cumulative Preference Shares:**
    - **Definition:** These shares have the right to accumulate unpaid dividends in future years if not paid during a specific year.
    - **Characteristics:**

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        - Unpaid dividends are carried forward and accumulated.
        - Accumulated dividends must be paid in the future before equity shareholders receive dividends.
- **Non-Cumulative Preference Shares:**
    - **Definition:** Dividends are not accumulated if not paid in a particular year.
    - **Characteristics:**
        - Unpaid dividends do not accumulate for future payment.
        - Any unpaid dividends in a specific year are not carried forward.

2. Participating and Non-Participating:

- **Participating Preference Shares:**
    - **Definition:** These shares have the right to participate in the further surplus of the company after a certain rate of dividend has been paid on equity shares.
    - **Characteristics:**
        - Shareholders can receive additional dividends beyond the specified rate.
        - Participate in surplus profits after paying dividends to equity shareholders.
- **Non-Participating Preference Shares:**
    - **Definition:** These shares do not have the right to participate in the additional profits of the company.
    - **Characteristics:**
        - Shareholders do not enjoy participation in surplus profits beyond the fixed rate of dividend.

3. Convertible and Non-Convertible:

- **Convertible Preference Shares:**
    - **Definition:** These shares can be converted into equity shares within a specified period.
    - **Characteristics:**
        - Holders have the option to convert their preference shares into equity shares.
        - Conversion is typically allowed within a predetermined time frame.
- **Non-Convertible Preference Shares:**
    - **Definition:** These shares cannot be converted into equity shares.
    - **Characteristics:**

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- Holders do not have the option to convert their preference shares into equity shares.
- They remain as preference shares until redemption or other specified events.

Debentures:

Definition: Debentures are financial instruments used to raise long-term debt capital by companies. A company issues debentures, acknowledging the borrowing of a specific amount that it promises to repay at a future date. Debenture holders are considered creditors of the company and receive a fixed rate of interest at specified intervals. Debentures may be rated by credit rating agencies based on factors such as the company's track record, profitability, debt-servicing capacity, creditworthiness, and perceived risk.

Characteristics:

1. **Interest Payment:**
   - Debenture holders receive a fixed stated amount of interest at regular intervals.
2. **Creditor Status:**
   - Debenture holders are considered creditors of the company.
3. **Rating Requirement:**
   - Public issues of debentures often require rating by credit rating agencies.
4. **Types of Debentures:**
   - Companies can issue different types of debentures, including Zero Interest Debentures (ZID).

Merits of Debentures:

1. **Fixed Income Preference:**
   - Attracts investors seeking fixed income with lower risk.
2. **Fixed Charge Funds:**
   - Debentures are fixed charge funds and do not participate in the profits of the company.
3. **Suitable for Stable Earnings:**
   - Suitable when sales and earnings are relatively stable.
4. **No Voting Rights:**
   - Financing through debentures does not dilute control of equity shareholders as debentures do not carry voting rights.
5. **Tax Deductibility:**

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- Financing through debentures is less costly as interest payments are tax-deductible.

Limitations of Debentures:

1. **Fixed Charge Burden:**
    - Debentures put a permanent burden on the company's earnings, posing a greater risk during earnings fluctuations.
2. **Redemption Provisions:**
    - Companies with redeemable debentures must make provisions for repayment on specified dates, even during financial difficulties.
3. **Reduced Borrowing Capacity:**
    - Issuing debentures reduces a company's capacity to further borrow funds.

Types of Debentures:

1. Secured and Unsecured:

- **Secured Debentures:**
    - **Definition:** These debentures create a charge on the assets of the company, providing security to debenture holders.
    - **Characteristics:**
        - Assets of the company are mortgaged to secure repayment.
        - In the event of default, debenture holders have a claim on the specified assets.
- **Unsecured Debentures:**
    - **Definition:** These debentures do not carry any charge or security on the assets of the company.
    - **Characteristics:**
        - No specific assets are pledged as security.
        - In case of default, debenture holders do not have a specific claim on company assets.

2. Registered and Bearer:

- **Registered Debentures:**
    - **Definition:** These debentures are recorded in the register of debenture holders maintained by the company.
    - **Characteristics:**

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        - Ownership is recorded in the company's register.
        - Transfer requires a formal instrument of transfer.
- **Bearer Debentures:**
    - **Definition:** These debentures are transferable by mere delivery, and ownership is not recorded in a register.
    - **Characteristics:**
        - Ownership is transferred by delivering the physical debenture.
        - No formal registration of ownership is maintained.

3. Convertible and Non-Convertible:

- **Convertible Debentures:**
    - **Definition:** These debentures can be converted into equity shares after a specified period.
    - **Characteristics:**
        - Holders have the option to convert debentures into equity shares.
        - Conversion typically occurs after a predetermined time.
- **Non-Convertible Debentures:**
    - **Definition:** These debentures cannot be converted into equity shares.
    - **Characteristics:**
        - No provision for conversion into equity shares.
        - Repaid as debentures without conversion.

4. First and Second:

- **First Debentures:**
    - **Definition:** These debentures are repaid before other debentures in the event of liquidation.
    - **Characteristics:**
        - Priority in repayment over other debentures.
        - Senior claim on company assets during liquidation.
- **Second Debentures:**
    - **Definition:** These debentures are repaid after the first debentures have been settled.
    - **Characteristics:**
        - Lower priority in repayment compared to first debentures.

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- Settled after satisfying claims of first debenture holders.

Commercial Banks

Commercial banks play a crucial role in providing funds to businesses for various purposes and durations. Here are the merits and limitations of raising funds from commercial banks:

Merits:

1. **Timely Assistance:**
    - Banks offer timely financial assistance to businesses, providing funds when needed.
2. **Confidentiality:**
    - Information shared with banks is usually kept confidential, allowing businesses to maintain secrecy.
3. **Simplicity:**
    - Raising funds from banks involves fewer formalities compared to methods like issuing prospectuses or underwriting.
4. **Flexibility:**
    - Bank loans are flexible, allowing businesses to adjust the loan amount based on changing needs. Early repayments are also possible.

Limitations:

1. **Short-Term Funding:**
    - Funds from banks are typically available for short periods, and the extension or renewal is uncertain and challenging.
2. **Stringent Requirements:**
    - Banks conduct thorough investigations into a company's affairs and may require security on assets and personal sureties, making the funding process more complex.
3. **Difficult Terms and Conditions:**
    - Banks may impose difficult terms and conditions for granting loans, such as restrictions on selling mortgaged goods, which can hinder normal business operations.

In summary, while commercial banks offer timely and flexible financial assistance, businesses must navigate challenges such as short-term availability, stringent requirements, and potentially difficult terms and conditions when relying on banks as a source of finance.

Financial Institutions

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Financial institutions, established by both central and state governments, play a significant role in providing finance to businesses. Here are the merits and limitations of raising funds from financial institutions:

Merits:

1. **Long-Term Finance:**
    - Financial institutions provide long-term finance, addressing the need for funds beyond what commercial banks typically offer.
2. **Comprehensive Support:**
    - Many financial institutions offer not only funds but also financial, managerial, and technical advice, along with consultancy services.
3. **Enhanced Goodwill:**
    - Borrowing from financial institutions can enhance the goodwill of a company in the capital market, making it easier to raise funds from other sources.
4. **Flexible Repayment:**
    - Repayment of loans from financial institutions is often structured in easy instalments, reducing the burden on the business.
5. **Availability During Depressions:**
    - Financial institutions continue to provide funds even during economic downturns when other sources of finance might be scarce.

Limitations:

1. **Rigid Loan Criteria:**
    - Financial institutions typically follow rigid criteria for granting loans, involving numerous formalities that make the process time-consuming and expensive.
2. **Imposed Restrictions:**
    - Borrowing companies may face restrictions, such as limitations on dividend payments, imposed by financial institutions.
3. **Nominee Representation:**
    - Financial institutions may have their nominees on the board of directors of the borrowing company, potentially limiting the company's decision-making powers.

Inter Corporate Deposits (ICD):

Overview: Inter Corporate Deposits (ICD) are unsecured short-term deposits made by one company with another company. This serves as a method for short-term cash management, usually employed by large corporations. Here are the three types of Inter Corporate Deposits:

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1. **Three Months Deposits**
2. **Six Months Deposits**
3. **Call Deposits**

Key Points:

- The minimum period for ICDs, as per RBI guidelines, is 7 days, extendable to one year.
- Interest rates on ICDs may be fixed or floating, and they are generally higher than those offered by banks.
- These deposits are utilized by borrower companies to address short-term fund insufficiencies.

International Sources of Funds:

Organizations today have various avenues to raise funds internationally. With the globalization of economies and businesses, Indian companies can access funds in the global capital market. Here are some international sources of funds:

1. **Commercial Banks:**
    - Commercial banks worldwide extend foreign currency loans for business purposes.
    - They play a crucial role in financing non-trade international operations.
    - The types of loans and services vary across countries.
2. **International Agencies and Development Banks:**
    - Various international agencies and development banks have emerged to finance global trade and business.
    - They provide long and medium-term loans and grants to promote development in economically backward areas.
    - Notable institutions include the International Finance Corporation (IFC), EXIM Bank, and Asian Development Bank.
3. **International Capital Markets:**
    - Modern organizations, including multinational companies, depend on significant borrowings in both rupees and foreign currency.
    - Prominent financial instruments used for this purpose include:
        - **Global Depository Receipts (GDRs):**
            - Local currency shares of a company are delivered to a depository bank.

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- The depository bank issues negotiable depository receipts against these shares, denominated in US dollars.
- GDRs are traded freely on foreign stock exchanges.

- **American Depository Receipts (ADRs):**
  - Depository receipts issued by a company in the USA and traded in American markets.
  - Similar to GDRs, but can only be issued to American citizens and traded on a US stock exchange.
- **Indian Depository Receipts (IDRs):**
  - Denominated in Indian Rupees, IDRs are created by an Indian Depository to allow a foreign company to raise funds from the Indian securities market.
  - IDR holders receive benefits from the underlying shares.
- **Foreign Currency Convertible Bonds (FCCBs):**
  - Equity-linked debt securities convertible into equity or depository receipts after a specific period.
  - Issued in a foreign currency, they carry a fixed interest rate lower than other non-convertible debt instruments.
  - Traded on foreign stock exchanges, similar to convertible debentures issued in India.

Companies Utilizing GDRs for Fundraising

In the financial landscape, Global Depository Receipts (GDRs) are gaining significant traction, especially among small and medium-sized enterprises. Here's a snapshot of recent trends:

Current Scenario:

1. **Rapid Growth:**
   - Five firms have already raised $464 million (~₹2,040 crore) through GDR offerings this year.
   - This amount nearly doubles the $228.6 million raised by nine companies in 2004 and the $63.09 million mobilized by four companies in 2003.
2. **Upcoming Offerings:**
   - Approximately 20 companies are gearing up to launch GDR issues worth over $1 billion in the coming months.

Noteworthy Companies and Figures:

1. **Opto Circuits:**

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- Opto Circuits has decided to pursue a GDR issue of $20 million, with a green-shoe option of $5 million.
- The share price of the company witnessed a remarkable surge, rising by 370% from ₹34 on May 17, 2004, to around ₹160 on the Bombay Stock Exchange (BSE).

2. **Diverse Participants:**
    - Various companies, including Videocon Industries, Lyka Labs, Indian Overseas Bank, Jubilant Organosys, Maharashtra Seamless, Moschip Semiconductors, and Crew BOS, are planning GDR issues.
3. **Banks in the Mix:**
    - Two banks, UTI Bank ($240 million) and Centurion Bank ($70 million), have successfully raised funds from the GDR market.

Decision Drivers:

1. **Preference Over FCCBs:**
    - Companies are opting for GDRs over Foreign Currency Convertible Bonds (FCCBs) due to the prevailing rise in interest rates abroad.
2. **Lax Rules and Disclosure Norms:**
    - Despite a decline in the number of companies opting for FCCB issues, some continue to explore this avenue due to perceived leniency in rules and disclosure norms.

Market Dynamics:

1. **Market Momentum:**
    - The GDR market is experiencing increased momentum, not limited to the IPO market, indicating a diversified approach to fundraising.
2. **Global Access:**
    - GDRs offer companies global access to funds, allowing them to tap into international markets for capital.

Factors Influencing the Choice of Funding Sources

The decision on choosing the right combination of funding sources for a business is influenced by several factors, making it a complex decision. Here are key factors affecting the choice of the source of funds:

1. **Cost:**
    - **Procurement Cost:** The cost of obtaining funds, including interest rates and fees.
    - **Utilization Cost:** The cost associated with using the funds for business operations.
2. **Financial Strength and Operational Stability:**

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- The financial strength of the business is crucial for repaying borrowed amounts and interest.
- Stable earnings are essential for managing fixed charged funds effectively.

3. **Form of Organization and Legal Status:**
    - The business structure and legal status impact the available funding options.
    - For instance, only joint-stock companies can issue equity shares.
4. **Purpose and Time Period:**
    - The time duration for which funds are required influences the choice of source.
    - Short-term needs may be met with trade credit or commercial paper, while long-term plans may involve issuing shares and debentures.
5. **Risk Profile:**
    - Each funding source is evaluated based on the level of risk involved.
    - Equity poses the least risk as repayment is tied to the company's winding up, while loans have a fixed repayment schedule.
6. **Control:**
    - The choice of a funding source can impact the control and power of owners over the management.
    - Issuing equity shares may result in dilution of control, especially if financial institutions are involved.
7. **Effect on Credit Worthiness:**
    - Dependence on certain funding sources can affect the creditworthiness of a business.
    - For example, issuing secured debentures may impact the willingness of unsecured creditors to extend further loans.
8. **Flexibility and Ease:**
    - The flexibility and ease of obtaining funds play a role in the decision-making process.
    - Businesses may prefer options with less restrictive provisions and documentation.
9. **Tax Benefits:**
    - Different funding sources may offer varying tax benefits.
    - For instance, while the dividend on preference shares is not tax-deductible, interest paid on debentures and loans is, making them attractive for organizations seeking tax advantages.

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