| Class Notes | |
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| **Class: XI** | **Topic: Sources of Business Finance** |
| **Subject: BUSINESS STUDIES** | |

**Meaning of Business Finance**

The funds required by the business to carry out its various activities are called Business Finance.

The financial needs of a business can be categorised as follows:

a. Fixed Capital Requirements:
- The funds required by the business to purchase fixed assets are called Fixed Capital.
- Fixed capital funds remains invested in the business for a long period of time.
- Fixed capital requirement varies from business to business depending on nature of business, size of business, scale of business etc.

b. Working Capital Requirements:
- The funds required by the business for its day to day operations are called working capital.
- Working capital is used for holding current assets and for meeting current expenses.
- Working capital requirement varies from business to business depending on nature of business, size of business, scale of business, credit period offered/ availed etc.

**Sources of Finance**

**Retained Earnings:**

- The portion of net earnings which is not distributed amongst the shareholders but is retained in the business for future use is called Retained earnings.
- When retained earnings are reinvested back into the business it is called Ploughing back of Profits.
- The availability of retained earnings depends on many factors like net profits, dividend policy and age of the organisation**.**

**Merits**

1. Permanent source of funds
2. Does not involve any explicit costs.
3. Greater degree of operational freedom and flexibility.
4. It enables the business to absorb unexpected losses.
5. It increases the market price of the equity shares.

**Demerits**

1. May cause dissatisfaction amongst the shareholders.
2. Depends on the earnings of the firm hence uncertain source of fund.
3. As the funds are generated internally it may lead to sub- optimal use of the funds.

**Equity Shares**

- Equity shares are long term source of finance and it represents the ownership capital of the company.
- Equity shareholders are referred to as Residual owners.
- They are paid at the last after all other obligations of the company are settled.
- They are the recipient of profits as well as bear risk.
- They have the right to participate in the management of the company.
- Their liability is limited to the unpaid amount on shares held by them.

**Merits**

- It is a permanent source of finance as it is to be repaid at the time of liquidation of the company.
- Issue of equity shares does not create any charge on the assets of the company. Hence the assets can be mortgaged for raising loans.
- Equity shares do not create any fixed obligation on the company as dividends are to be paid only when the company earns profit.
- Equity shares increases the credit worthiness of the company.
- It is suitable for those investors who are willing to take risk for higher returns.
- All equity shareholders have equal voting rights. Thus it ensures democratic control over the management of the company.

**Demerits**

- Issue of equity shares involves a lot of formalities and procedural delays.
- Issue of additional equity shares dilutes the voting power and earnings of existing shareholders.
- The cost of issuing equity shares is more as compared to the cost of other sources of finance.
- Equity shares are not preferred by those investors who want steady returns.

**Preference Shares**

- Preference shares are shares issued to preference shareholders who enjoy a preferential position over equity shareholders.
- They get a preferential claim over dividend and repayment of capital.
- It resembles debentures as the preference shareholders get a fixed rate of return.
- It resembles equity shares in the sense that dividend will be paid only out of profits.

**Merits**

- It is beneficial for those investors who want a fixed rate of return.
- The issue of preference shares does not dilute the control of the equity shareholders over the management of the company.
- Preference shareholders get a preferential claim over dividend and repayment of capital.
- Preference shares do not create any charge against the assets of the company.

**Demerits**

- It is not beneficial for those investors who want a higher rate of return.
- As the dividend is to be paid only when the company earns profit hence it is not attractive to the investors.

- The dividend paid on preference shares is higher than the interest paid on debentures; hence it is not beneficial for the company.
- Dividend paid on preference is not deductible from the taxable income of the company, hence there is no tax saving.

**Debentures**

- Debenture is an acknowledgement that the company has borrowed a certain amount of money which it promises to repay back at a future date.
- It is an important instrument for raising long term debt capital.
- Debenture holders are termed as creditors of the company.
- Public issue of debentures require ratings by a credit rating agency.

**Merits**

- Debentures are preferred by those investors who want a fixed return less risk.
- Debenture holders do not participate in the earnings of the company.
- Issue of debentures do not dilute the control of the equity shareholders on the management of the company.

**Demerits**

- Issue of Debentures put permanent burden on the earnings of the company as it is a fixed charge instrument.
- With the issue of debentures the capacity of the company to borrow further funds reduces.

**Types of Debentures**

1. Secured and Unsecured: Secured debentures create a charge on the assets of the company whereas unsecured debentures do not carry any charge on the assets of the company.
2. Registered and Bearer: Registered debentures are recorded in the register of debenture holders and can be transferred through a regular instrument of transfer whereas Bearer debentures are transferable by mere delivery.
3. Convertible and Non- Convertible: Debentures that can be converted into equity shares after the expiry of certain period.
   Non- Convertible debentures are those which cannot be converted into equity shares.
4. First and Second: Debentures that are repaid first are known as First Debentures.
   Second debentures are repaid after the second debentures.