Class: 11th Business studies Chapter: Business finance

**Business finance: Definition**

Refers to the credit and capital employed in business firms and is concerned with the activities employed in arrangement of credit or capital for the business firm.

Business finance is concerned with the process of acquisition and proper utilisation of funds in meeting the financial needs of the business and thus meeting the overall objective of the firm.

Financing is the term used to define the raising of funds from different sources of finance to meet overall objective of the firm.

**Nature of Business Finance:**

1. Includes all types of capital or funds used in business both short term and long term.
2. Business finance is needed in all types of business irrespective of the size, large, medium or small whether manufacturing or trading etc.
3. It has wide scope i.e involves estimation of funds, managements of cash/credit and utilisation of funds and controlling of funds.
4. The requirement of finance varies from business to business depending on nature of business and size as well, also varies from one time period to another. Thus a business firm may need large amount of capital on one year and may need different amount on next year depending on the needs of the business.
5. The availability of finance determines the extent and scale of operations in a business and has direct relation with each other.

**Significance of Finance:**

Finance is the life blood of the business firm and is useful to carry out the daily and long term activities of the firm smoothly and successfully. The availability of right amount of finance at right cost is crucial for any business and thus creating a successful organisation.

The significance is defined in three aspects:

1. Business finance is importance for establishing any enterprise irrespective of size, any business needs finance to establish.
2. To purchase the fixed assets like machinery, establish plant and building, purchase land and also in purchasing current assets like raw material, salary and cash in hand.
3. Finance is significant for expansion and modernisation of business, if a firm needs to purchase new machinery, it needs finance and if a firm wants to open a new outlet in some other geographical area there also finance is important.

**Financial requirements:**

Financial requirement of a business is classified in two parts a) long term b) short term.

1. **Long term Finance (Fixed capital requirement)**

* Refers to the part of finance which is raised for long period of time generally more than 5 years. This part of finance is invested in long term assets like plant and machinery, land and building etc.
* Fixed capital is required for the permanent needs of the business and used regularly to generate revenue for the business.
* Long term finance is raised from long term sources like equity and preference shares, debentures, financial institutions, loans and retained earnings.

1. **Short term Finance (working capital requirement)**

* Refers to the finance raised for short period of time mostly within one year, this part of capital is invested in short term assets like inventory, raw material, cash in hand etc.
* This capital is also known as working capital as it is required to maintain daily operations of the business firm.
* Working capital is required to meet daily needs of the business like rent, wages, taxes, freight etc.
* Short term finance is raised through public deposits, trade credit, commercial banks.

**Sources of raising Finance:**

Business finance can be raised from two sources

1. Owners fund or insiders fund
2. Outsiders fund or borrowed fund

Owners fund refers to the fund provided by the owners themselves like in sole proprietorship, in partnership the funds are contributed by the partners.

Borrowed fund refers to the borrowings of a business firm from the outsiders like debenture holders and creditors.

**Business finance**

Owners Fund Borrowed Fund

Equity shares Debentures Preference shares Public deposits Retained earnings Financial inst. Banks Trade credit

**Shares:**

Share is the interest of the shareholder in a company measured by the sum of capital invested for the purpose of liability, share is the part of the capital in which total capital is divided and the holder of a share is called as shareholder.

1. Share is indivisible part of capital
2. Shares confer rights like voting and dividend to its holder
3. Creates certain liability for the holder
4. Share has nominal value or face value for which it is distributed
5. It is movable property and can change hands in public company and in private company if mentioned in MOA

Shares are of two types Equity and preference; explanation detailed below

**Equity share:**

They are also referred as owners fund, these shares carry voting rights in AGM but do not carry any preferential rights in payment of dividend. Equity holders are the real owners of the company. Dividend paid to the equity holders is from residual profits only after repayment to debenture holders, banks and preference holders.

Features:

1. Equity holders are the real risk bearers and owners of the business.
2. Their return is not fixed and it increases or decreases as per the profits.
3. They have residual claim over profits after payment to outsiders, whatever left is taken up by equity holders.
4. Equity part is responsible for the credit worthiness of the firm, the more the equity the more the company can be credit worthy.
5. Equity holders have right to appoint directors and management of the company.

**Advantages;**

1. *Permanent capital*: The equity shares are for the lifetime of the company and no need to redeem them before the closure of the business.
2. *No obligation on dividend*: Equity holders do not receive dividend at fixed rate and there is no obligation of payment of dividend; only after payment to creditors the dividend must be paid.
3. *No charge in assets*: no need to mortgage the assets of the company for issuing the shares, assets are free from any charge.
4. *Source of prestige*: the higher the equity part greater is the reputation and creditworthiness of the business.
5. *Low denomination*: generally the face value of equity is low so as to make sure more and more people would subscribe.
6. *Suitable for risk takers*: these share are suitable for the investors who want to take the risk and want to get maximum returns over the period of time and thus enjoying voting rights and also participating in the management.

Disadvantages: {to be read by the student}

**Preference shares:**

These shares are named as they carry preferential rights or priority in payment of the dividend over the equity holders.

They are paid fixed rate of dividend and carry no voting rights.

These shares have features both of equity and debentures, therefore they are hybrid form of securities to raise finance for the company.

They get voting rights only in certain extreme and emergency situation like amendment in MOA etc.

***Types of preference shares***:

1. Cumulative preference shares:

In this type of shares dividend gets accumulated if due to some reason dividend is not paid in one year, such unpaid dividend get accumulated in next year and can be paid in lump sum in next year. Preference shares are always cumulative by default.

1. Non-cumulative shares:

In this type dividend if unpaid is not carried in next and not accumulated, if the dividend remain unpaid in the year, then it won’t be ever paid back, is lost for ever.

1. Participating shares:

These shares carry the rights to participate in sharing surplus profits after the fixed dividend is paid in both equity and preference. These holders get some amount of residual profits.

1. Non-participating Shares:

Shares do-not carry any right to participate in residual profits sharing, they only get their part of dividend.

1. Redeemable shares:

These shares can be refunded either on the expiry of specified date or at the option of the company. As per companies Act these shares must be redeemed within 20 years of date of issue.

1. Irredeemable shares:

These shares are redeemed or repaid only at the time of winding up of the company, they can’t be repaid during the life of a company.

1. Convertible shares:

These shares can be converted into equity shares after the expiry of a certain time period, it’s the option given by the company but generally this option is not present.

1. Non-convertible shares:

These shares cannot be converted into equity shares at any cost or expiry of any time period.

**Advantages:**

1. *Attractive to cautious investors*: these shares attract those investors who want secure returns and don’t want to take much risk with the investment.
2. *Fixed payment of dividend*: the company has to pay the dividend irrespective of whether profits are insufficient thus creating regular payment of dividend.
3. *No interference*: They do not carry voting rights thus there is no dilution of control and no interference by anyone besides equity holders.
4. *Trading on equity*: due to fixed rate of dividend the extra amount of profit can be used to create more equity and use for raising more credit.
5. *No charge on assets*: no need to mortgage the assets of the company for issuing the shares, assets are free from any charge for raising any loans.
6. *Variety*: different types of shares are at disposal of a company and can be issued based on the requirement of the company thus providing variety of options for the company.

Disadvantages: {to be read by the student}

**Retained earnings/ Plough back profits**:

It is a part of profit which are not distributed among shareholders or not reinvested in the business for the expansion or growth purpose, rather this portion is kept with the company for the future uncertainties.

Part of profits is transferred to reserves and thus after many years of accumulation creates a sufficient amount to face any uncertainty in future. Retained earnings are also called plough back profits or internal financing. And acts as a cushion which can minimize the jerks and damage to the business thus it is referred as “cushion finance”

**Advantages:**

1. *Convenience:* R.E are most economical and easily available fund to the company no cost involved and no expenses or legal formalities.
2. *No charge on assets*: no need to mortgage the assets of the company for issuing the shares, assets are free from any charge for raising any loans.
3. *No obligation*: There is no obligation to pay dividend or any payment as it is owners’ money and involving no explicit cost.
4. *No interference*: there is no voting rights allotted to it, thus not diluting the powers of equity holders and no interference in management of the company.
5. *Goodwill*: higher R.E means higher goodwill, strength, credibility and earning capacity of the company. With increase in R.E the credit worthiness increases.
6. *Growth and expansion*: this part of finance can be used in expanding and diversifying the business as it has no obligation attached to it, it belongs to the owners and it can be reinvested in any business activity of introducing new product or importing latest technology or geographical expansion of business.

Disadvantages: {to be read by the student}

**Debentures:**

Debentures forms the part of borrowed fund of the company, it is defined as debt capital or simply acknowledgement of debt, and the creditors having debentures are called debenture holders.

Debenture is a certificate issued by the company under its common seal as an acknowledgement of the debt, and also undertaking to repay the specified amount after certain period of time.

Features:

1. Represents the borrowed fund
2. Repayment is in the form of interest.
3. Interest payable after every year irrespective of whether profits earned or not.
4. Carry no voting rights.
5. Involve fixed charge on assets from the creditors.
6. If interest not paid, they can take legal action against the company.
7. Redeemable after certain time period.

**Types of debentures:**

1. Secured debentures: these debentures carry fixed floatation charge on assets, a mortgage deed is created by the company and in case of default the assets is to be sold off.
2. Unsecured debentures: these debentures do not carry any fixed charge on assets, they are promised to pay the interest without the security, and no property is mortgaged or pledged.
3. Redeemable debentures: these are repayable after predetermined time period during the lifetime of the company. And are paid after the expiry of the date on demand of the holder.
4. Irredeemable debentures: these are not repayable during the lifetime of the company, they are only repaid after the winding up of the company.
5. Convertible debentures: they can be converted into equity shares after the maturity time period specified by the company. These holders can become shareholders after some time.
6. Non convertible debentures: they cannot be converted into equity shares after the maturity time period, they always remain creditors of the company.
7. Registered debentures: the name of the holder of the debenture is registered with the company and the repayment is made to the registered person and they can be transferred only after creating transfer deed.
8. Bearer debentures: these are not registered on any name, simply has bearer name and is easily transferred from one person to another. The holder at the time is the owner of the debenture.

**Merits:**

1. Appeal for the cautious investors wanting to tale less risk.
2. Regular annual returns.
3. Safety of investment due to assets security.
4. Economical source due to low floatation cost.
5. No management interference.
6. Tax relief due to interest paid is deducted from taxable income.
7. Flexibility due to issuance and cancellation at the disposal of the company management**.**