Advantages and limitations of each source of finance finance essay

This assignment covers all detail about sources of finance. The aim of the research is to identify different sources of finance like short-term finance, medium-term finance and long-term finance. The first part of the assignment gives you an introduction about sources of finance. The second part covers short-term sources of finance and their advantages and limitations. The third part covers medium-term sources of finance and their advantages and disadvantages. And the last part covers long-term sources of finance and its merits and demerits.

Sources of Finance

Introduction

As you know food is necessary for human life. Similarly finance is the heart of any business. It is most important for modern business, which requires huge capital. Finance could be needed for new businesses, when they recover a cash flow problem, new machinery, set up a new plant or takeover another business. Generally funds required for businesses are classified into short term, medium term and long term. In this section we look at the different source of finance and see the advantages and limitations of each.

Business

Leasing

Public Deposit

Mortgage

Shares

-Equity Share

-Preference Share

Debentures

Retained Earning

Commercial Bank Loan

Borrowing

Trade Credit

Overdraft

Bill Discounting

Customer’s Advances

Instalment Credits

Loan from Co-operative banks

Short Term Source

Long Term Source

Medium Term Source

Sources of Finance

Short Term Sources of Finance

Definition

When we want to establish a new business, it is essential to know the amount of finance required. Some sources are overdraft, customer advances, loan from co-operatives, cash and trade credit etc. that make money for short time. It is called short-term source of finance. Generally Short-term is only for 1 year. In this section we learn about above source of finance and their relative advantages and limitations.

Short-term sources of finance:

Trade Credit

Overdraft

Discounting of bills

Customer’s advances

Instalment Credit

Loan from co-operative bank

Trade Credit : Providing business customers with time to arrange for the payment of goods they have already received. This period is one of the interest free credit. It is a costly source of finance. Trade credit is used when the buyer is not able to pay the real cost of goods.

1Trade credit refers to credit granted to manufactures and traders by the suppliers of the raw materials, finished goods, components etc. Usually business enterprises by supplies on a 30 to 90 days credit.

Advantages of Trade Credit:

If new business start up has trade credit, they will not need more money in capital. It is a good idea to someone who want to start a new business with less money.

You can buy goods and make payment later when you sold all the goods and get some money or make a good profit. The time period may be after 25-30 days.

Business can look in good position without having any serious trouble in immediate payment, which may set them back.

Trade Credit improve the cash flow and provide easy platform for business.

With the trade credit, business can focus on other area like sales, marketing and other research.

Trade credit is available only with purchase of raw material or finished goods. The term and conditions of trade credit very according to the custom and usage of trade.

Disadvantages of Trade Credit:

If repayments are not made by in time, the business will receive a very bad credit history. They will not trusted in the future, if your business require any loan or trade credit.

If company has a good credit history, it will get trade credit but these can be hard to build up for new business.

Overdraft : It is a common source of short term finance because of its flexibility. When borrowed fund are not require longer time they can pay easily and quick. The risks to the lender are less then a long term loan because it is very cheap.

2When a bank allows its depositors or account holders to withdraw money in excess of the balance in his account upto a specified limit, it is known as overdraft facility. This limit is granted purely on the basis of credit-worthiness of the borrower.

Advantages of Overdraft:

Flexible 3 – An overdraft is there when you need it and cost is zero (in case of small fee) when you do not need. It allows you to make essential payments whilst chasing up your own payments, and helps to maintain cash flow.

Quick – It is very easy and quick to arrange, providing a good cash flow backup with the minimum of fuss.

It allow to make essential payment whilst chasing up your own payment and help to maintain cash flow. You only need to borrow what you need at that time.

Disadvantages of Overdraft:

Cost – Sometimes it carry very higher interest rates and fees then loan. This makes them very expensive.

Recall – The bank can take back the entire overdraft amount at any time if you have broken terms and conditions or it may happen if you fail to make other payment.

Security – Overdraft may need to be secured against your business assets, which put them at risk if you fail in repayment.

Bill Discounting : Some bank provide short-term loan by discounting bill of exchange. In such cases bank deduct discount while making payment. The amount of discount is generally equal to the amount of interest for the remaining period of payment. The advantages and disadvantages from this source are following.

4When these document is presented before the bank for discounting, banks credit the amount to customer's account after deducting discount. The amount of discount is equal to the amount of interest for the period of bill.

Advantages of Bill Discounting:

Availability of cash – The drawer gets cash immediately by the discounting bill. He does not have to wait for the payment until the expiry of credit period mansion on the bill.

Security – Bank normally do not ask for any other security while making payment against the bill discounted. However if customer is interested, banks also grant him limit for discounting of bill. This limit is identify as a ' limit against discounting bill.'

Nature of liability for repayment – Repayment of money advanced against discounted bill is the responsibility of the drawee of bill of exchange. In case drawee does not pay or refuse the pay, the drawer who got payment after discounting the bill is held responsible for payment.

Disadvantages of Bill Discounting:

Advance payment of interest – While discounting a bill, bank deduct the discount and balance is credited in customer's account. This discount is similar to the amount of interest for the remaining period of payment. Thus a person receiving money through discounting of bill has to offer advance interest on the amount of bill.

Facility is subject to the parties credit – Normally banks extend this facility after being satisfied with the credit of parties involved. Bank may be ask for some security. So, it is not a easy available facility.

Problem when non-payment – Bills not paid upon maturity are to be certified by Notary Public and a certain amount in the form of nothing is paid. Thus it became an additional burden.

Customers’ Advances : The advance make by the customer against the value of order placed. Thus the remaining amount of goods to be supplied later. Let see more details about the advantages and limitations.

Advantages of Customers’ Advances:

Interest Free – Amount offered as advance is interest free. Hence the funds are available without any involving problem.

No Security – The seller is not required to deposit any major security while demanding advance from the customer. Thus assets remain free of charge.

Repayment – Ones money received in advance will not be refunded. Hence there are no procedures for repayment.

Disadvantages of Customers’ Advances:

Limited amount – Amount received from a customer is subject to the value of order. Borrowers demand may be more then the advance amount.

Limited Period – The period of advance amount is only up to the delivery goods. It cannot be renewed.

Penalty – Normally advances are subject to the condition that if goods are not delivered on time then order would be cancelled and advance amount would be refunded with interest.

Instalment Credit : Instalment credit is a system under which a small payment is made at the time of taking the goods and remaining amount is paid in instalment. Generally instalment amount is including of interest. The advantages and limitations of this system are as under:

Advantages of Instalment Credit:

Ownership of asset – Delivery of good is assured immediately on payment of down payment.

Convenient payment of assets – Costly assets which can not purchase directly with full payment can be purchase by instalment payment.

Saving of one time investment – If the price of asset is high and lumpsum amount is made then the business fund are blocked. In this case instalment credit leads to saving of one time investment.

More facility for business – If the facility of payment in instalment is available then business firm can afford to by new furniture, machinery or other necessary things. Thus, your business reputation looked in good condition by instalment credit.

Disadvantages of Instalment Credit:

Commitment for payment – Payment in instalment is a commitment. So you have to pay your instalment in whatever condition of your business.

Necessary to pay interest – Payment of interest is necessary in this system. Generally sellers charge very high rate of interest.

More interest – If buyer fail to pay the instalment, seller sometimes impose penalty or additional interest.

Loan from Co-operative bank : Co-operatives banks are good source of short-term finance. Membership is the primary condition for securing loan in this bank. This bank grant loans for personal and business purposes too. The advantages and limitations of this bank are as under:

Advantages of Loan from Co-operative bank:

These loans create a sense of thrift among the low-income group.

Being a member of co-operative bank, the borrower can participate in the management.

Loan generally granted at a lower rate of interest.

Loan from this banks are easily available.

Loans are given for good purposes that help to develop the financial and social status of the people.

Sometimes these banks organise training program for member to familiars them with the various avenues of the business and regarding proper utilisation of loan money.

Disadvantages of Loan from Co-operative bank:

These loans are available only to members.

Loan from this bank is available only for limited purposes.

Co-operative banks depend on the supports of the government. So, government rules and regulations sometimes may be makes in trouble to the borrowers.

These bank find it difficult to ensure repayment of loan money due to inadequate information about the need and utilisation of fund by the borrower. There is little scrutiny of the repaying capacity of the loan seeker at the time of granting loan.

Medium Term Source of Finance

Definition

Medium term source of finance means fund does not require more then 3 years. Normally medium term funds are require by business for repairing and maintenance of machinery or other equipment. So firm get this finance from bank or other kind of source.

Medium term source of finance:

Leasing

Public Deposit

Mortgage

Leasing : Leasing is the method of capital funding requirement. Leasing based on the principal that income is earned from the use of an asset. The advantages and limitations of leasing are following:

Advantages of Leasing:

Reduced initial cash flow – The big advantage of leasing equipment is that the cost is spread over a number of years. You have not to pay the entire amount upfront. This can help to maintain cash flow. Poor cash flow is the main cause of small business and leasing can help you to keep it under better control.

Budgeting – Normally this is a fixed contract. So the amount can be worked into your business budget much more easily.

Tax Advantages – lease rentals are considered as an operating cost. So it is possible to deduct them from taxable profits. However, before the contract you should always check the equipment you are buying is eligible or not.

Security – When you lease the product, you are not owner of this product. It means the leasing company gives better security. You don't need any further security to be able to start a contract.

Disadvantages of Leasing:

No ownership – Main disadvantage is that you are not the owner of the product. It means the leasing company is the owner during and after the lease. As you do not own the product, you are unable to sell it in the event it is no longer needed, and you cannot upgrade to a newer or better product without either paying off the remaining contract, or paying a large fee to cancel the contract.

No sell – As you are not owner of the product, you can not sell it. If you do not longer needed, you have to pay large fee to cancel the contract.

Termination – Leases are very difficult to terminate early.

Long term expense – Although leasing allow you to avoid paying a large amount, but after a long time it works out considerably more expensive. Over the period of standard lease, you pay the actual cost of product and other charges.

Maintenance – You are responsible for maintenance of the product. If you have not trained employee to fix the equipment, this could be more costly in the serious fault. Some leasing company will allow you to cover maintenance cost but you have to pay some extra amount.

Commitment – Once you signed a lease contract, you are committed to making payment for the entire lease period even you stop using a property.

Public Deposit : It is very old and popular source of finance. When modern banks were not established, people used to deposit their saving with reputed business. The maturity period for public deposit is minimum 6 months and maximum 3 years. The advantages and disadvantages of public deposit are following:

Advantages of Public Deposit:

Easy to deposit – The method of borrowing money from public is very easy. It does not require many legal formalities. It has to be advertised to be newspaper.

Easily available – If companies have good reputation, they are able to obtain funds directly from public without any more financial difficulties.

Income tax purpose – Interest paid on this deposit is a deductible expenses for income tax.

Fix rate – The rate of interest on this deposit is fixed, it helps the company to play trading on equity, if the company is earning more then the rate of interest paid on public deposit.

Flexibility – Public deposit bring more flexibility in the structure of the capital of the company. These can be raised when needed and refunded when not needed.

Disadvantages of Public Deposit:

Insecurity – Public deposits have no charge on the assets of the company. So it may be not safe to deposit saving in those companies which are not very popular.

Uneconomical – The rate of interest paid on public deposit may be low but there are other expenses like commission, which make it uneconomical.

Short period – Public deposits are available mainly for short period. So company cannot depend on it for a long time.

Misuse – The management may misuse your deposit. So in this case it is not secure.

Bad effect on capital market – It is an easy and cheaper source of raising money. Thus, more money deposited with the companies, there will be less investment in securities. Hence the capital market will not grow.

Mortgage : A mortgage is a loan specially for the purchase of property. The borrower can use theirs own property as security for the loan. The advantages and limitations of mortgage are following:

Advantages of Mortgage:

Tax advantage – The interest payment on the mortgage are tax deductible.

Good cash flow – With the use of mortgage, you are able to access to capital that you would not normally have access with nominal up-front payment and the flexibility in management of repayment plan.

Cash flow management – Mortgage plan are pre-set, so you can make plan for future cash management.

Disadvantages of Mortgage:

Collateral – The nature of a mortgage require you to pledge the purchased property to the lender. When the mortgage is repaid, the owner is obligated to release the mortgage and is require to make available any government formalities.

Defaults – The lender may define a variety of events that will constitute a default on the mortgage, including failure to make any payment on time, bankruptcy, insolvency and breaches of any obligations in the mortgage agreement. Try to negotiate an advance written notice of any alleged default, with a reasonable amount of time to cure the default.

Long Term Source of Finance

Definition

Long-term source of finance are those that are need over a longer period of time. Generally time duration may be more then 5 years. Long-term finance are needed for fund expansion, set up new office, buying new business or fixed assets like furniture, building, machinery, land etc. Funds require for this business is called long-term finance. The amounts of long-term capital depend upon the scale of business and nature of business.

Following various sources of long-term finance and advantages and disadvantages of each source.

Long-term source of finance:

Shares

Equity Share

Preference Share

Debentures

Retained Earning

Commercial Bank Loan

Borrowing

Shares : Shares is the main source of long-term finance. The joint stock companies issue shares to the general public. These shareholders are the owners of the company. There are two types of shares (1) Equity Share (2)

Preference Share. Company divides its capital into units of particular value like £10 each or £200 each. Each unit is called share.

Equity Share – Dividend on these shares is paid after the fixed rate of dividend has been paid on the preference share. The rate of dividend is not fixed because it is depend upon the profit available. The equity shareholders control the affairs of the company and have an unlimited interest in the company's profit. The advantages and disadvantages of equity share are following:

Advantages of Equity Share: [For Shareholders]

Income Profit – The equity shareholders are the residual claimants of the profit. The company may add to the profit by trading on equity. Thus equity capital may get dividend at high in good period.

Rights – Equity shareholders have right for voting to right persons as directors who can control and manage the affairs of the company.

Transferable – These shares are transferable units.

The value of equity share goes up in the stock market with increase in profit of the concern.

Advantages of Equity Share: [[5]For Limited Company]

A company can raised fixed capital by issuing equity shares without creating any charge on its fixed assets.

The capital raised by issuing equity shares is not required to be paid back during the life time of the company. It will be paid back only if the company is wound up.

There is no liability on the company regarding payment of dividend on equity shares. The company may declare dividend only, if there are enough profits.

If a company raise more capital by issuing equity shares, it leads to greater confidence among the investors and creditors.

Disadvantages of Equity Share: [For Shareholders]

Irregular income – The dividend on equity share is subject to availability of profit. If there are preference shareholders, they get first dividend before equity shareholders. Equity shareholders may get no dividend if company has not enough profit.

Capital loss – During recession period, the profit of the company come down and the rate of dividend also come down. Due to low rate of dividend the market value of equity shares goes down resulting in a capital loss to the investors.

Dilution in control – Each sale of equity shares dilutes the voting power of the existing equity shareholders. Equity shares are transferable and may bring about centralisation power in few hands.

Impossible trading – If equity shares alone are issued, the company cannot trade on equity.

Over capitalisation – If company issue more equity shares may result in over capitalisation. In that condition dividend per share is low which make bad effect on investor.

High cost – It cost more to finance with equity shares then with other securities as the selling costs and underwriting commission are paid at a higher rate on the issue of these shares.

Speculation – Equity shares of good companies are subject to hectic speculation in the stock market. Their prices change frequently which are not in the interest of the company.

Disadvantages of Equity Share: [[6]For Limited Company]

No trading on equity – Trading on equity means ability of a company to raise fund through preference shares, debentures and bank loan etc. On such funds the company has to pay at a fixed rate. This enables equity shareholders to enjoy a higher rate of return when profits are large. The major part of the profit earned is paid to the equity shareholders because borrowed funds carry only a fixed rate of interest. But if a company has only equity shares and does not have their preference shares, debentures or loans, it can not have the advantage of trading on equity.

Conflict of interests – As the equity share holders carry voting rights, groups are formed to corner the votes and grab the control of the company. There develops conflict of interest which is harmful for the smooth functioning of a company.

Preference Share – Rising capital by issue of these shares is a most important method of rising long-term funds. Preference shares are the shares, which carry initial rights over the equity shares. These shares are receiving dividend at a fixed rate. All shareholders gets dividend regularly. The advantages and disadvantages of preference share are following:

Advantages of Preference Share:

Fixed income – The dividend payable on preference shares is on fixed rates even if there is no profit.

First right – Preference shareholders have first right to get dividend. Thus they enjoy the minimum risk.

Less capital losses – As the initial right of repayment of their capital in case of winding up he company, it saves them from capital losses.

Fair security – Preference share are fair security for the shareholders during depression period when profit of the company are down.

Disadvantages of Preference Share:

No Voting right – Preference shareholders have no any voting rights in the company.

Fixed income – The dividend payable on preference shares is on fixed rates even if the company earns higher profit.

No claim on surplus amount – The shareholders have no rights to claim on surplus amount. They can only ask for the capital investment in the company.

Not secure – They cannot be secure on the company’s assets.

Debentures : Whenever company want to borrow a large amount of money for long but fixed period, it can borrow from the general public by issuing loan certificate called debenture. The holders of the debentures are the creditors of the company. The total amount is divided into units of fixed amount. These are offered to the genera public to subscribe in the same manner as in done in the case of share. A debenture is issued under the common seal of the company. It is a written acknowledgment of money borrowed. For example, if company need £5, 000, 000 for 10 years, it will issued debentures. Each cost of debenture may be £100.

Advantages of Debentures:

Creditors – Debenture holders are the creditors of the company.

Allowing control over the company – Debenture holders have no right either to vote or take part in the management of the company.

Reliable Source – These are repayable after a fixed period of time, the company can make the best use of money. It helps long term planning.

Tax benefit – Interest paid on debenture is treated as a expense and is charged to the profit of the company. Thus the company saves income tax.

Safety – Debenture are more secure. When the company is winding up, they are repayable before any payment is made to the shareholders.

Disadvantages of Debentures:

More finance more difficulty – Debenture finance enables a company to trade on equity. But more finance leaves little for shareholders, as most of the profits may be require paying interest on debentures.

Burden in time of depression – During depression time the profit of the company decline. It may be difficult to pay interest on debenture. As interest goes on accumulating, it may lead to the closure of the company.

Can't borrow money – Usually debentures are secure. The company creates a charge on its assets in favour of debenture holders. So the company, which does not have own enough assets, they cannot borrow money by issuing debentures.

Burden – As the interest on debenture have to be paid every year whether there are profits or loss. It becomes burden in case of company incurs loses.

Retained Earning : The part of the profit which is not distributed among the shareholders but is retained and is used in business is called retained earning. As per Indian company Act. Companies are require to transfer a part of their profit in reserves. The amount so kept in reserve may be used to buy fixed assets. This is called internal financing.

Advantages of Retained Earning:

Cheap – There are no expenses behind earning capital from this source. There is no obligation on the part of the company either to pay interest or pay back the money. It can safely used for business.

Financial Stability – A company which has enough reserves can face ups and downs in business. Such companies can continue with their business even in depression, thus building up its goodwill.

Good for shareholders – Shareholders may get dividend out of reserves if the company does not earn enough profit. Due to reserve, there is capital appreciation, i. e. the value of shares go up in the share market.

Disadvantages of Retained Earning:

If Huge profit – This method of financing is possible only then there are huge profits and that too for many years.

Dissatisfaction – When funds accumulate in reserves, bonus shares are issued to the shareholders to capitalise such funds. Hence the company has to pay more dividend. By retained earning the real capital does not increase while the liability increases. In case bonus shares are not issued, it may create a situation of under-capitalisation because the rate of dividend will be much higher as compared to other companies.

Monopoly – Through ploughing back of profits, companies increase their financial strength. Companies may throw out their competitors from the market and monopolize their position.

Mis-management of funds – Capital accumulated through retained earnings encourages management to spend carelessly.

Commercial Bank Loan : Some commercial banks giving loans for a long period. i. e. for more than ten year. The period of repayment of long is extended at intervals long period. Commercial banks provide long term finance to small scale units in the priority sector.

Advantages of Commercial Banks Loan[7]:

It is a flexible source of finance as loans can be repaid when the need is met.

Finance is available for a definite period, hence it is not a permanent burden.

Banks keep the financial operations of their clients secret.

Less time and cost is involved as compared to issue of shares, debentures etc.

Banks do not interfere in the internal affairs of the borrowing concern, hence the management retains the control of the company.

Loans can be paid-back in easy installments.

In case of small-scale industries and industries in villages and backward areas, the interest charged is low.

Disadvantages of Commercial Banks Loan :

Banks require personal guarantee or pledge of assets and business cannot raise further loans on these assets.

In case the short-term loans are extended again and again, there is always uncertainty about this continuity.

Too many formalities are to be fulfilled for getting term loans from banks. These formalities make the borrowings from banks time consuming and inconvenient.

Borrowing 8 : Most business rely on borrowings as well as equity to finance operations. Lenders enter into a contract with the business in which the rate of interest, dates of interest payment, capital payments and security far the borrowing are clearly stated. In the event that the interest payment or capital payments are net made on the due dates, the lender will usually have the right, under the terms of the contract, to seize the asset on which the loan is secured and sell them in order to reply the amount outstanding, security for loan may take the form at a fixed charge on particular assets at the business or a floating charge on the whole at its assets. A floating charge will ' float' over the assets and will only fix on particular assets in the event that the business defaults on its borrowing obligations.

Advantages of Borrowing[9]:

Local savers may provide less costly funds; an important habit among clients and the public is rewarded.

Lower interest loans provide experience for the company in borrowed funds

Local bank become familiar with micro and small enterprise potentials.

Access to larger sums more quickly based on track record.

Allow longer term projections than grants

Provides a discipline similar to that of micro and small enterprise clients.

Disadvantages of Borrowing :

Too many subsidized loans can retard move to market rate.

Loans may be dollarized in inflationary situation.

Local banks may not be willing to be cooperative.