

Sources of finance for a public limited company finance essay



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Finance is the basic ingredient of a business. Insufficiency or absence of cash can pose a threat for a business. Without cash a business is unable to survive. Various sources of finance help to fulfill the needs of wages, advertising, expansion, payment of interests etc (Pride et. al, 2009). Different sources of finance are used depending upon their maturity period. Each source has its advantages and disadvantages.

Sources of finance

The sources of finance are broad classified into the following:

Long term Finance

Medium term finance

Short term finance

Long Term Sources of Finance

Long term sources of finance are those methods that are adopted to provide finance for a long period of time. This period of time must be of one year and above. Long term sources are generally complex and are usually adopted to fund activities like going for acquisitions, product extensions, or buying up of new premises etc. Example of long term financing includes a 40 year mortgage or a 10 year treasury note. The sources of long term finance are:

Debentures

Debentures are the long term loans raised from public by a Public limited company. These debentures are usually ranged from 0. 01\$ to 100\$ with varied interest rates. Debentures are floated with certain terms and

conditions and are generally secured against the assets of a company (Chakraborty, 2004).

Advantages of debentures

Debentures are a well suited mode of long term financing as the interest payable on debentures is made before taxation.

Another advantage of debenture is that they are payable even when the company does not produce profit.

Issue cost of debenture is low as compared to that of preference capital and equity.

Disadvantages of debentures

As mentioned above, certain terms and conditions are set out for debentures. Failure to meet those conditions, like interest and principal repayment requirement, can result in not only financial and social humiliation but can also lead to bankruptcy.

Debentures are influenced by the inflation rates. If, by chance the inflation rate significantly drops down, then the real cost of the debt will become higher than what was initially set (Chandra, 2008).

Convertible debentures

Convertible debentures offer the advantage of quick conversion of debt into equity. Convertible debentures are similar to the normal debentures in terms of interest rates specification and the principal payment, except that in

convertible debentures the buyer has the option of converting them into company's issuing share at a pre decided ratio.

Convertible debentures are used by the companies to attract investors. Like the Essar steel, India issued convertible debentures coupled with warranty and loyal coupons as well as optionally fully convertible debentures to attract investors (Nidheesh, 2009).

Advantages of convertible debentures

Convertible debentures are favorable for the issuing company as they offer low interest payments as compared to the traditional debt.

For investors they offer a secure means of investment through participation in the stock options and guaranteed coupon payments.

There will be no capital gains tax for the holders of convertible debenture.

Disadvantages of convertible debentures

In case of bankruptcy, the debenture holder has a low priority claim on the company's asset as compares to the straight debt holders.

The Valuation techniques for convertible debentures are a bit tricky and may require additional scrutiny (Hanif, 2001)

Common Stock

Common stock is a long term security that is issued to the owners of the company.

Advantages of common stock

Common stock offer several advantages.

Common stocks are liquid i. e. they can be easily and readily bought and sold.

The risk associated with common stock is very less as it is only limited to the initial cash investment made.

They are labeled to be high returners as compared to the other sources of investment.

Disadvantages of common stock

The owners of common stock are last to be paid in the business after payments to employees, suppliers, creditors etc.

The stock prices are usually unstable, that is they rise and fall quickly. So the investors are required to be vigilant in this regard.

Preference shares

Preference shares refer to those shares that offer a fixed percentage of dividends that is paid in preference to the common shares to the stock holders.

Advantages of preference shares

There advantages are:

In preference shares the company is not forced to pay the dividends in the period when the profits are poor.

Preferred shareholders receive their payments first as compared to the common stock holders in event of bankruptcy.

Disadvantages of preference shares

They are riskier, as unlike other instruments, they are not secured against the assets of the company.

The interest yield on preference stock is low as compared to the loan stock

In case of non-payment the preferred stock holders, unlike debenture holders cannot call for a receiver for the claims (Carter et. al, 1997).

Mortgage

A mortgage is a long term source of finance that is given by the borrower to the lender in exchange for the security of the real estate property. One can choose between a fixed rate and adjustable rate mortgage depending upon one's risk bearing capacity, financial health and other requirements.

Advantages of mortgage

The mortgage financing makes the borrowing flexible and affordable as it provides ownership of real estate along with the provision of financial aid.

The interest rate on mortgage is tax free.

The fixed schedule of mortgage payments allows you to plan up your cash flux and plan your needs and requirements accordingly.

Disadvantages of mortgage

The default risk is high in case of mortgage.

The mortgage terms and conditions requires for collateral to be pledged as security. The lender has a right to claim on the security in case of default payments.

Finance Strategy: Finance simplified for you

Government grants/loans

Government grants are of great assistance to the entrepreneurs in terms of providing the financial hold up. Many of the government organizations are able enough to finance the young entrepreneurs to help them develop the right strategy for their business. The government organizations' grant is not only limited to the strategic thinking phase, they also help the entrepreneurs in putting the plan to reality and also supporting the start up costs (Gruber, 2009).

Advantages of Government grants

The government grants are easily and readily available for a business idea. Although a lengthy application process is involved, yet the process is much quicker than the other lenders. Like SBA (Small Business Association) approves a loan in 3-5 business days.

The interest rate is lower for government grants especially in case of student loans.

Disadvantages of Government grants

The element of bureaucracy is usually involved to approach for the grants

The government organization giving the money, try to exert influence on the business management.

The grantee is subjected to tougher terms and conditions in order to be eligible for the grant.

Retained Profit

Retained profit involves allocation of profit from an existing business to be reinvested in to the same business for the purpose of financing. This money can be used to buy new equipment, machinery, raw material and other such type of investments.

Advantages of retained profit

This type of self financing helps the company to withstand any contingency requirements and uncertainties or even a calamity.

The cost of raising finance from outside source is saved through the retained profit move.

There are no lengthy legal formalities involved in this type of financing.

Disadvantages of retained profit

Some companies falsely use the retained profit as a means of manipulating the value of shares and dividends.

Improper use of retained profit in risky adventures may result in a loss.(Rajni and Hiro, 2008)

Medium term sources of finance:

Medium term financing or intermediate financing is done for a period intermediate between 1 to 10 years. Medium term financing is generally done for the purpose of maintenance or up gradation of the business like making improvements in the plant, buying up of raw material, assets and equipment. The sources of medium term finance are:

Loans

Loans are a means of providing long term financing for activities such as buying of fixed assets like plant and equipment, funding up of working capital and or covering losses.

Advantages of loans

Through loan, the financing is secured for the life of a loan. You can purchase a loan for almost everything now.

Loan helps you to make things affordable.

You can match the term of your loan to the life of an asset you want to purchase. For example you can take a loan of three years for a machine whose working life is three years.

Disadvantages of loans

If you miss a monthly payment, things might get difficult for you that may include penalties or even your property possession.

It is a long term commitment. Some banks offer repayment facility but they charge extra fees for repayments.

Venture Capital Trust

Venture capital trust refers to those companies that are listed on the London stock exchange, and are in search of investors to raise an equity capital of about 10 to 30 million pounds. The VCT managers are given three years to invest cash, gilts and bonds into different companies.

Advantages of venture capital trust

VCT's are particularly famous for providing tax efficient investment.

They provide tax free dividends

Offer Tax free capital growth

Disadvantages of venture capital trust

The VCT investment mode has higher risk associations as compared to life insurance fund, collectives and other modes. The major risks are:

The Unquoted companies (UK Smaller Companies)

Liquidity issues (ability to sell shares)

Market timing risk

Leasing

A lease in agreement of purpose signed for a specific time frame, conveying the use of a particular resource. Leasing is preferable when the cost of purchasing equipment is higher than the cost of leasing. The lessee gets the rights to use the equipment in exchange of rental payments to the lessor.

For example in the golf industry, the golf operators make use of leased golf cars, leased golf aeration equipment, mowing machines etc.

Advantages of leasing

In lease financing the interest rate is fixed throughout the course of payment

Leasing helps in the conservation of capital as it does not outline any requirements of deposition of cash at the beginning.

Leasing a property is much simpler as compared to mortgage financing.

(Schmidgall, 2004)

Disadvantages of leasing

In lease you have to bear the cost of equipment maintenance as specified, when you are not even the owner of the equipment.

Lease payments are to be paid till the termination of the original term period. So even if a lessor is facing a downturn he is still supposed to make the payments that can be troublesome.

Hire Purchase

Nowadays, machines transport vehicle, equipment etc are bought through hire purchase. Possession of the good is transferred to the hirer but the ownership is only given after the last installment has been paid. Hirer can also choose to pay off all the installments in one go.

Advantages of hire purchase

The hirer is not bound in case of hire purchase. How can either wait for the full payment term or can go for the purchase by paying the amount at once.

The cost of equipment under hire purchase is less as compared to leasing.

They have little statutory control

Disadvantages of hire purchase

The cost of maintenance is to be burnt by the hirer thus reducing his profit margin.

20 to 25 percent advance payment has to be paid to the vendor at the time of hire purchase contract.(Maheshwari, 2003)

Business Angels

Business angels refer to those people that have a lot of money that they are looking to invest somewhere. They are one step ahead of friends, family founders etc.

Venture Capitalists

Business Angels

Friends

Founders and family

High Risk Lower (But still somewhat high risk)

(Source: Sources of funding for Australia's Entrepreneurs by Howard Frederick, Siri Terjesen, pp. 30)

Advantages of business angels

As compared to the financial institutions, raising funds through business angels is beneficial as it does not involve high fees.

Business angels offer different investment criteria from other instruments, offer longer investment opportunities, convenient investment processes and lower targeted rate of returns.

Disadvantages of business angels

Business angels try to make their say in operations of the business, and can also affect the business expertise, their value and their contribution.

There is a history of a small proportion of business angels turning out to be devils, fulfilling their own motives rather than contributing into the good of the business

Business angels, unlike the venture capitalist are less likely to re-invest in the same business (Frederick and Terjesen, 2007).

Short term sources of finance:

The money needs for less than a year are fulfilled through short term financing. They provide a cash influx or the fulfillment of short term inventory needs and repairs as well as short term investments. For example retailers like Wal-mart make use of short term financing to build up their inventories before peak selling periods. The sources of short term finance are:

Bank Over drafts

Bank overdrafts are a short term medium of financing that fulfills the contingency needs of the business especially for the adjustments in the fluctuations of cash flow and sudden demands.

Advantages of bank overdrafts

Over draft is a simple and supple means of financing

The interest is chargeable on the everyday overdrawn amount.

Disadvantages of bank overdraft

The bank can call for repayment at any time.

Cannot be borrowed for larger amounts

The rate of interest for bank draft is higher than that for loans.

Trade credit

Trade credit is the easiest source of financing, where the suppliers of a business enable you to take up the material with the flexibility of making the payment later on. So whenever material equipments etc are taken without on-spot cash payment, trade crediting is involved.

There are certain terms and conditions involved in trade crediting and depending on those terms the crediting can be costly. For example the terms involved in purchasing supplies from a supplier on trade credit is 3 percent cash discount within 12 days and a net date of 30 days. By this the supplier is lending you two percent discount on purchase price within those 12 days. However, by using the trade credit benefit you are conserving your money

for 18 more days. If we calculate on an annual basis the 3 percent discount missed may cost you more.

Advantages of trade credit

Trade credit is readily and conveniently available, since the suppliers are up for a business easily

If the company is facing any financial flops, Trade credit sourcing may be beneficial as the suppliers are lenient in giving finances.

Usually no or minimal security or guarantees are required in case of trade credit

Disadvantages of trade credit

The giving up of the cash discount offered by the suppliers, in case of early payment, can be the biggest drawback for taking up trade credit,

The firms credit rating may get affected through trade crediting (Shim and seigel, 2007)

Factoring

Factoring is a source of financing that is based upon the business outstanding invoices. It works in the way that the business sends a copy of the invoice received from the customer to the factor. The factor pays a set amount of the invoice value that usually makes 80 to 85 percent of the total amount to be paid. This payment is readily done usually within twenty four hours. However, a small number of invoices make the factoring

uneconomical. Companies that have a turnover rate of 200, 000 pounds and above can make use of the factoring.

For example in India, several measures have been taken for factor development. Like the State bank of India formed SBI Factors and commercial services limited in various states of India to help the small scale businesses who were suffering the shortage of capital.(Page 81)

Advantages of factoring

Factoring helps in the improvement of the firms' credit management

Factoring enables a continuous inflow of funds

Factoring can be of great benefit particularly in case of need.

Disadvantages of factoring

Among the different forms of short term financing, the cost of factoring is higher than others

Factoring may damage the good will of the firm from clients point of view, as he may see it as a sign of financial weakness (Banjerjee, 2005)

Invoice Discounting

Invoice discounting is very similar to factoring except for a minor difference. In factoring the third party approaches the customer for the settlement of invoices and manages the other business details. But in invoice discounting the customers are totally unaware of your financing relationships. The company itself maintains responsibility for the ledgers and invoice processing.

Advantages of invoice discounting

As the customers are unaware, so the company's goodwill is not much affected

As the cash is readily available it can be used for future investments and fund other orders

The management no longer need to spend time on unpaid accounts and can utilize their time in planning elsewhere

Disadvantages of invoice discounting

Terminating the agreement can be difficult in case of invoice discounting

Disputed invoices can sometimes pose a problem and should be carefully dealt with.

Conclusion

So whether you are thinking of setting up a new business or extending the existing one, money will always be the first and the foremost requirement.

One should always properly assess the business resources for financing, as some sources may be suitable for business finance and other might not be.

For example setting up a road side coffee stall requires different type of financing than setting up a garment industry business.

But for many business the issue is not only to identify the right source of finance but also to find where to get the funds for setting up, expansion purpose and likewise. Therefore it is imperative to analyze the various source of financing available to a business and to assess thoroughly the

appropriation of the resources in relation to the business. Investment readiness is always needed. A wealthy and beneficial financial package should, therefore, be selected as it is not only the question of money, but also the question of the whole of the life cycle of the business.