UNIT 5 SOURCES OF LONG TERM AND SHORT TERM FINANCE

5.1 INTRODUCTION

Finance is the lifeblood of an enterprise, because it is interlinked with all activities performed by the business enterprises. In a human body, if blood circulation is not proper, body function will stop. Similarly, if the finance is not being properly arranged, no enterprises can definitely accomplish its objectives. Every business organisation whether big, medium and small needs finance to carry on its operations and also to meet its day to day expenses. Capital required for business can be classified under two main categories i.e.

1) Fixed Capital
2) Working Capital

Every business needs funds for two purposes- for its establishment and to carry out its day-to-day operations. Long-term funds are required to create production facilities through the purchase of plants, machinery, furniture, land, building etc. The investment required for these fixed assets is called fixed capital. Funds are also required for short term purposes such as for the purchase of raw material, payment of wages and other day to day expenses etc. these funds are known as working capital.

Financial Requirements

Short-Term	Medium-Term	Long -Term
Bank credit	Issue of debentures	Issue of shares
Trade credit	Issue of preference shares	Issue of debenture
Cash credit	Bank loans	Ploughing back of profit
Overdraft	Public deposits/ fixed deposits	Loans from specialized financial institutions
Factoring		
Accruals		
Deferred incomes		
Commercial paper		

Fig 5.1 Financial Requirements

The various sources of raising long term funds are equity share capital, preference share capital, debentures, long term loans from banks etc. The short term sources of funds are banks, trade credit, cash credit, overdraft, factoring or receivable credit, accruals, deferred incomes, commercial paper etc.

In present unit you will study about the various short term sources of finance and long term sources of finance.

5.2 LEARNING OBJECTIVES

After reading this unit, you should be able to

- Explain the meaning and purpose of long term finance and short-term finance.
- Identify the various sources of long term finance and short-term finance
- Define equity shares and preference shares.

5.3 LONG TERM FINANCE – ITS MEANING AND PURPOSE

Every business organisation requires funds to buy fixed assets like land, building, plant, machinery, furniture etc. These assets may be regarded as the foundation of a business. The capital required for fixed assets is called **fixed capital**. A part of the working capital is also of a permanent nature. Funds required for this part of the working capital and for fixed capital are called long term finance.

A financial requirement of every business concern is differ from other firm. The funds may be required for the long period or the short period. Long-term financial requirement means the finance needed to acquire land and building for business concern, purchase of plant and machinery and other fixed expenditure. Hence, it is also called a capital expenditure.

Purpose of long term finance:

Long term finance is required for the following purposes:

1. To Finance fixed assets:

Business requires fixed assets for its operations. Funds required to buy these assets is for a long term period, because such assets can be used for a long period and are not for resale.

2. To finance the permanent part of working capital:

Business is an ongoing activity. It must have a certain amount of working capital which would be needed again and again. This part of working capital is of a fixed or permanent nature. This requirement is also met from long term funds.

3. To finance growth and expansion of business:

Expansion of business requires investment of a huge amount of capital permanently or for a long period.

5.4 SOURCES OF LONG TERM FINANCE

The main sources of long term finance are as follows:

- **Equity Shares**
- **Preference Shares**
- **Debentures**
- **Retained Earnings or Ploughing back of Profits**

Let's study one by one in detail.

5.5 EQUITY SHARES

Issue of shares is the main source of long term finance. Shares are issued by joint stock companies to the public. A company divides its capital into units of a definite face value, say of Rs. 10 each or Rs. 100each. Each unit is called a share. A person holding shares is called a shareholder. **Equity Shares** also known as ordinary shares. The holders of these shares are the real owners of the company. They have a control over the working of the company. Equity shareholders are eligible to get dividend and dividend is paid to them after the payment to preference shareholders. The rate of dividend on equity shares is not fixed as its depend upon the profits of the company. The equity shareholders take more risk than preference shareholders. In case of bankruptcy equity capital is paid to equity shareholders after meeting all other claims including that of preference shareholders. They take risk of both dividend and share capital

Characteristics of Equity Shares

1. Maturity: Equity shares provide permanent nature of capital to the company, which has no maturity period. It cannot be redeemed during the life time of the company.

2. Claim on Income: Equity shareholders have a residual claim on the income of a company. They have a right to get income left after paying fixed rate of dividend to preference shareholders. The earnings or the income available to the shareholders is equal to the profit after tax minus preference dividend. In many cases, they may not get anything if profits are insufficient, or may get even a higher rate of dividend.

3. Claims on Assets: If the company wound up, the ordinary or equity shareholders have the right to get the claims on assets. These rights are only available to the equity shareholders.

4. Right to Control or Voting Rights: Equity shareholders are the real owners of the company. They have voting rights in the meeting of the company. With the help of voting right power; they can change or remove any decision of the business concern. Equity share holders only have voting rights in the company meeting and also they can nominate proxy to participate and vote in the meeting instead of the shareholder.

6. Pre -emptive Right: Equity shareholder pre-emptive rights. The pre-emptive right is the legal right of the existing shareholders. It is attested by the company in the first opportunity to purchase additional equity shares in proportion to their current holding capacity.

7. Limited liability: Equity shareholders are having only limited liability to the value of shares they have purchased. If the shareholders are having fully paid up shares, they have no liability.

Advantages of Equity Shares

1. Permanent sources of finance: Equity share capital is belonging to long term permanent nature of sources of finance; hence, it can be used for long-term or fixed capital requirement of the business concern.

2. Voting rights: Equity shareholders are the real owners of the company who have voting rights. This type of advantage is available only to the equity shareholders.

3. No fixed dividend: Equity shares do not create any obligation to pay a fixed rate of dividend.

4. Less cost of capital: Cost of capital is the major factor, which affects the value of the company. If the company wants to increase the value of the company, they have to use more share capital because, it consists of less cost of capital (Ke) while compared to other sources of finance.

5. Retained earnings: When the company have more share capital, it will be suitable for retained earnings which are the less cost sources of finance while compared to other sources of finance.

Disadvantages of Equity Shares

1. Irredeemable: Equity shares cannot be redeemed during the life time of the business concern. It is the most dangerous thing of over capitalization.

2. Obstacles in management: Equity shareholder can put obstacles in management by manipulation and organizing themselves. Because, they have power to contrast any decision which are against the wealth of the shareholders.

3. Leads to speculation: Equity shares dealings in share market lead to secularism during prosperous periods.

4. Limited income to investor: The Investors who desire to invest in safe securities with a fixed income have no attraction for equity shares.

5. No trading on equity: When the company raises capital only with the help of equity, the company cannot take the advantage of trading on equity.

5.6 PREFERENCE SHARES

Preference Shares are the shares which carry preferential rights over the equity shares. These rights are (a) receiving dividends at a fixed rate, (b) getting back the capital in case the company is wound-up. Investment in these shares is safe, and a preference shareholder also gets dividend regularly.

Preference shares may be classified into the following major types:

1. Cumulative preference shares

Cumulative preference shares have right to claim dividends for those years which have no profits. If the company is unable to earn profit in any one or more years, C.P. Shares are unable to get any dividend but they have right to get the comparative dividend for the previous years if the company earned profit.

2. Non-cumulative preference shares

Non-cumulative preference shares have no right to enjoy the above benefits. They are eligible to get only dividend if the company earns profit during the years. Otherwise, they cannot claim any dividend.

3. Redeemable preference shares

When, the preference shares have a fixed maturity period it becomes redeemable preference shares. It can be redeemable during the lifetime of the company. The Company Act has provided certain restrictions on the return of the redeemable preference shares.

4. Irredeemable Preference Shares

Irredeemable preference shares can be redeemed only when the company goes for liquidator.

There is no fixed maturity period for such kind of preference shares.

5. Participating Preference Shares

Participating preference shareholders have right to participate in extra profits after distributing the equity shareholders.

6. Non-Participating Preference Shares

Non-participating preference shareholders are not having any right to participate extra profits after distributing to the equity shareholders. Fixed rate of dividend is payable to the type of shareholders.

7. Convertible Preference Shares

Convertible preference shares holders have right to convert their holding into equity shares after a specific period. The articles of association must authorize the right of conversion.

8. Non-convertible Preference Shares

There shares, cannot be converted into equity shares from preference shares.

Features of Preference Shares

The common features of preference shares are given below:

1. Maturity: Generally, preference shares resemblance equity shares in respect of maturity. So they have no fixed maturity period except in the case of redeemable preference shares. At the time of liquidation of company preference shareholder are paid after paying the creditors but before paying the equity shareholders.

2. Claims on income: Preference shareholders have prior claims on income over the equity shareholders. A fixed rate of dividend is payable on preference shares.

3. Claims on assets: Preference shares have a preference in repayment of capital at the time of liquidation of a company. At the time of winding up of the company their claim settled first before making payment to the equity shareholders.

4. Control: Preference shareholders do not have any voting rights, so they do not have any say in the management of the company.

5. Hybrid form of security: Preference shares, in real sense are the hybrid form of security as it includes some features of equity and other of debt financing. It resembles the equity in the sense 1) payment of dividend is not compulsory 2) dividend is payable out of the profits only.3) it is not deductible as an expense while determining tax liability of the company. On the other hand it has some features of debt financing also 1) it carries fixed rate of dividend. 2) It entitles to a right to its holder prior to equity shareholders 3) it does not carry voting right.

Advantages or Merits of Preference Shares

Preference shares provide number of advantages which are given below.

1. Fixed Dividend: Preference shareholders earn fixed rate of dividend. It is also called as fixed income security because it provides a constant income to the investors.

2. Cumulative Dividends: Preference shares provide cumulative dividends which means that if in any year company does not have profits the company does not earn any profit in any previous years; it can be cumulative with future period dividend.

3. Redemption: Preference Shares can be redeemable after a specific period except in the case of irredeemable preference shares. There is a fixed maturity period for repayment of the initial investment.

4. Participation: Participative preference shares holders can participate in the surplus profit after distribution to the equity shareholders.

5. Convertibility: Convertible preference shares can be converted into equity shares when the articles of association provide such conversion.

Disadvantages of Preference Shares

1. Expensive sources of finance: Preference shares are expensive source of finance compared to equity shares.

2. No voting right: Generally preference shareholders do not carry voting rights. Hence they have no say in the management of the company.

3. Fixed dividend only: Preference shareholders get only fixed rate of dividend. They may not enjoy more profits of the company.

4. Permanent burden: Cumulative preference shares become a permanent burden so far as the payment of dividend is concerned. Because the companies have to pay dividend for the un profitable years also.

5. Taxation: In the taxation point of view, preference shares dividend is not a deductible expense while calculating tax. But, interest is a deductible expense. Hence, it has disadvantage on the tax deduction point of view.

5.7 DEBENTURES OR BONDS

Whenever a company wants to raise long term finance, it can borrow from the general public by issuing loan certificates called Debentures. Debentures are the acknowledgement of debt. According to Thomas Evelyn, "A debenture is a document under the company's seal which provides for the payment of a principal sum and interest thereon at regular intervals, which is usually secured by a fixed or floating charge on the company's property or a loan to the company”. A debenture holder is termed as the creditor of the company. A fixed rate of interest is paid on the debentures.

Characteristics of Debenture

Following are the characteristics of Debentures:

i) Debenture holders are the creditors of the company. They are entitled to periodic payment of interest at a fixed rate.

ii) Debentures are repayable after a fixed period of time, say five years or seven years as per agreed terms.

iii) Debenture holders do not carry voting rights.

iv) Ordinarily, debentures are secured. In case the company fails to pay interest on debentures or repay the principal amount, the debenture holders can recover it from the sale of the assets of the company.

Types of Debentures

Debentures may be divided into the following major types:

1. Unsecured debentures: Unsecured debentures are not given any security on assets of the company. It is also called simple or naked debentures. This type of debentures is treated as unsecured creditors at the time of winding up of the company.

2. Secured debentures: Secured debentures are given security on assets of the company. It is also called as mortgaged debentures because these debentures are given against any mortgage of the assets of the company.

3. Redeemable debentures: These debentures are to be redeemed on the expiry of a certain period. The interest is paid periodically and the initial investment is returned after the fixed maturity period.

4. Irredeemable debentures: These kinds of debentures cannot be redeemable during the life time of the business concern

5. Convertible debentures: Convertible debentures are the debentures whose holders have the option to get them converted wholly or partly into shares. These debentures are usually converted into equity shares.

Conversion of the debentures may be:

- Non-convertible Debentures
- Fully convertible debentures
- Partly convertible debentures

6. Other types: Debentures can also be classified into the following types.

Some of the common types of the debentures are as follows:

1. Collateral Debenture

2. Guaranteed Debenture

3. First Debenture

4. Zero Coupon Bond

5. Zero Interest Bond/Debenture

Advantages of Debenture

Debenture is one of the major parts of the long-term sources of finance which of consist the following important advantages:

1. Long-term sources: Debenture is one of the long-term sources of finance to the company. Normally the maturity period is longer than the other sources of finance.

2. Fixed rate of interest: Fixed rate of interest is payable to debenture holders, hence it is most suitable of the companies earn higher profit. Generally, the rate of interest is lower than the other sources of long term finance.

3. Trade on equity: A company can trade on equity by mixing debentures in its capital structure and thereby increase its earnings per share. When the company apply the trade on equity concept, cost of capital will reduce and value of the company will increase.

4. Income tax deduction: Interest payable to debentures can be deducted from the total profit of the company. So it helps to reduce the tax burden of the company.

5. Protection: Various provisions of the debenture trust deed and the guidelines issued by the SEB1 protect the interest of debenture holders.

Disadvantages of Debenture

In spite of many advantages, Debenture financing suffers from the following major disadvantages:

1. Fixed interest: The fixed interest payment every year and repayment of principal amount at the time of maturity is the legal obligations of the company. Hence, it is a permanent burden on the company and is not suitable to those companies whose earnings fluctuate considerably.

2. No Voting Rights: Debenture holders do not carry any voting rights. Hence, they cannot have any controlling power over the management of the company.

3. Creditors of the company: Debenture holders are merely creditors and not the owners of the company. They do not have any claim on the surplus assets and profits of the company beyond the fixed interest and their principal amount.

4. High risk: Every additional issues of debentures becomes more risky and costly on account of higher expectation of debenture holders. This enhanced financial risk increases the cost of equity capital and the cost of raising finance through debentures which is also high because of high stamp duty.

5. Restrictions of further issues: The Company cannot raise further finance through debentures as the debentures are under the part of security of the assets already mortgaged to debenture holders.

5.8 RETAINED EARNINGS OR PLOUGHING BACK OF PROFITS

The ploughing back of profits means that companies do not share all its profits among the shareholders as dividend rather some part of profit is kept aside. Such profit is retained or reinvested by the company for the its further development. Such a phenomenon is also called Self Financing, Internal Financing or Inter financing. Under this method, a part of total profits is transferred to various reserves such as General Reserve, Debenture Redemption Reserve and Dividend Equalisation Reserve etc. These reserves can be used to meet long term financial requirements. Sometimes secret reserve is also created without the knowledge of shareholders.

Merits of Ploughing Back of Profits

Following are the benefits of retained earnings:

1. Economical Source of Capital:

It acts as a very economical as there is no obligation on the part of the company either to pay interest or pay back the money. It can safely be used for expansion, growth and modernization of business.

2. 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.

3. Benefits to the shareholders:

Shareholders may get dividend out of reserves even if the company does not earn enough profit. Due to reserves, there is capital appreciation, i.e. the value of shares goes up in the share market.

Limitations of Ploughing Back of Profits:

The limitations of Ploughing Back of Profits are given below.

1. Huge Profit:

This method of financing is possible only when there are huge profits and that too for many years.

2. Dissatisfaction among shareholders:

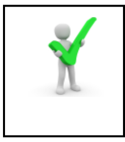
When funds accumulate in reserves, bonus shares are issued to the shareholders to capitalise such funds. Hence the company has to pay more dividends. By retained earnings the real capital does not increase while the liability increases. In case bonus shares are not issued, it may create a situation of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

3. Fear of monopoly:

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

4. Mis-management of funds:

Capital accumulated through retained earnings encourages management to spend carelessly.



Check Your Progress-A

Q1.What are the characteristics of equity shares?

Q2. What are the advantages of preference shares?

Q3. What is the need of ploughing back of profits?

Q4. What are debentures?

Q5. What are the convertible debentures?

5.9 OTHER POPULAR SOURCES OF LONG TERM FINANCE

1. Lease Financing

Lease financing is emerged as the popular and common methods of long term finance, in addition to debt and equity financing. Leasing is an arrangement which provides the firm with a use and control over assets without buying and owning the same. It is a form of renting asset. According to the equipment leasing association of UK definition, "leasing is a contract between the lessor and the lessee for hire of a specific asset selected from a manufacturers or vender of such assets by the lessee. The lessor retains the ownership of the asset. The lessee passes the possession and uses the asset on payment for the specified period".

Elements of Leasing

Parties: These are essentially two parties to a contract of lease financing, namely the owner and user of the assets.

Lesser: Lesser is the owner of the assets that are being leased. Lessers may be individual, partnership, joint stock companies, corporation or financial institutions.

Lessee: Lessee is the receiver of the service of the assets under a lease contract.

Lease broker: Lease broker is an agent in between the lesser (owner) and lessee. He acts as an intermediary in arranging the lease deals. Merchant banking divisions of foreign banks, subsidiaries Indian banking and private foreign banks are acting as lease brokers.

Lease assets: The lease assets may be plant, machinery, equipments, land, automobile, factory, building etc.

2. Hire purchase

Hire purchase is a mode of financing the price of the goods to be sold on a future date. In a hire purchase transaction, the goods are let on hire, the purchase price is to be paid in instalments and hirer is allowed an option to purchase the goods by paying all the instalments. Hire purchase is a method of selling goods. In a hire purchase transaction the goods are let out on hire by a finance company (creditor) to the hire purchase customer (hirer). The buyer is required to pay an agreed amount in periodical instalments during a given period. The ownership of the property remains with creditor and passes on to hirer on the payment of the last instalment.

Features

- Under hire purchase system, the buyer takes possession of goods immediately and agrees to pay the total hire purchase price in instalments.
- Each instalment is treated as hire charges.
- The ownership of the goods passes from the seller to the buyer on the payment of the last instalment.
- In case the buyer makes any default in the payment of any instalment the seller has right to repossess the goods from the buyer and forfeit the amount already received treating it as hire charges.
- The hirer has the right to terminate the agreement any time before the property passes. That is, he has the option to return the goods in which case he need not pay instalments falling due thereafter. However, he cannot recover the sums already paid as such sums legally represent hire charges on the goods in question.

Leasing Versus Hire Purchase

Both leasing and hire purchase are the source of financing. The two are not similar on many accounts. The following points of distinction are worth consideration from points of view of the lessee and the hirer:

Point of Difference	Leasing	Hire Purchase
1. Ownership	Ownership is not transferred to the lessee.	Ownership is transferred to the hirer on the payment of last instalment.
2. Tax Deductibility	Lease rents are tax-deductible expense.	Only the interest and not the entire instalment is deductible.
3. Salvage value	Lessee cannot realise the salvage value of the asset on the expiry of the lease of life of the asset.	Hirer can realise the salvage value of the asset after payment of last instalment and expiry of the life of the asset.

3. Venture Capital

The term "Venture Capital" represents financial investment in a highly risky project with the objective of earning a high rate of return. It is a long-term financial assistance provided to projects, which are established to introduce new products, inventions, idea and technology. Venture capital finance is more suitable to highly risky projects which consists of huge investment and provides results after 5 to 7 year.

The term Venture Capital fund is usually used to denote Mutual funds or Institutional investors. They provide equity finance or risk capital to little known, unregistered, highly risky, young and small private business, especially in technology oriented and knowledge intensive business. Venture Capital termed as long-term funds in equity or semi-equity form to finance hi- tech projects involving high risk and yet having strong potential of high profitability.

Features of Venture Capital

Venture Capital consists of the following important features:

(1) Venture Capital consists of high risk and high return based financing.

(2) Venture Capital financing is equity and quasi equity financing instruments.

(3) Venture Capital provides moderate interest bearing instruments.

(4) Venture Capital reduces the financial burden of the business concern at the initial stage.

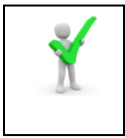
(5) Venture Capital is suitable for risky oriented and high technology based industry.

4. Private Equity

Private equity is a pooled investment vehicle used for making investments in various equity (and to a lesser extent debt) securities according to one of the investment strategies associated with private equity. Private equity is typically limited partnerships with a fixed term of 10 years (often with annual extensions).

Features of private equity

- Equity holders can enjoy the benefits of acquiring majority or minority stakes.
- Usual duration of stay of private equity holder in business enterprises varies from 3 to 6 years.
- It takes around 3 months to complete usual transactions.



Check Your Progress-B

Q1. Write a note on Lease Financing?

Q2. What is Venture Capital?

Q3. What are the features of Venture Capital?

Q4. Difference between lease and hire purchase financing.

5.10 SHORT TERM SOURCES OF FINANCE

Once the business is established, it required funds to meet its day to day expenses. For example raw materials are required at regular intervals, wages to workers, water and power charges etc. Thus there is a continuous necessity of liquid funds to be available for meeting these expenses. For financing such requirements short-term funds are needed. Inadequacy of short-term funds may even lead to closure of business.

In this section, you will study about the various sources of short-term finance. The sources of short- term finance are given below.

Sources of Short-term Finance:

There are a number of sources of short-term finance which are listed below:

1. Trade Credit

Trade credit refers to credit extended to manufactures and traders by the suppliers of goods in normal course of business. Usually business enterprises buy supplies on a 30 to 90 days credit. It means that the goods are delivered to the buyers but payments to be received in future as per terms of the sales invoice. This type of credit does not make the funds available in cash but it facilitates purchases without making immediate payment. This is quite a popular source of finance.

2. Commercial Banks

Commercial banks are the main source of short term finance to business firms. The major portion of short term finance is provided by the commercial banks. Banks provide various varieties of loans to meet the specific requirements of a concern. The different forms in which banks provide the loans and advances to the business concerns are given below.

(i) Loans

When a certain amount is advanced by a bank against some security it is called a loan. The loan is paid to the borrower either in cash or by credit to his account. The borrower is required to pay interest on the entire amount of loan from the date of its sanction. Commercial banks generally provides loan up to one year for meeting working capital requirements. Now- a -days, term loans exceeding one year is also provided by banks.

(ii) Cash Credit

It is an arrangement whereby banks allow the borrower to money up to a specified limit against some tangible securities or guarantees. This limit is known as cash credit limit and customer can withdraw from his cash credit limit according to his needs and he can also deposits amount when he has surplus of it. Initially this limit is granted for one year. This limit can be extended after review for another year. However, if the borrower still desires to continue the limit, it must be renewed after three years. Interest is charged only on the daily balance and not on the amount of entire limit.

(iii) Overdraft

When a bank allows its depositors or account holders to withdraw money more than the balance to his credit up to certain limit it is known as overdraft facility. This limit is granted purely on the basis of credit-worthiness of the borrower. Banks generally give the limit up to Rs.20, 000. In this system, the borrower has to show a positive balance in his account on the last Friday of every month. Interest is charged only on the overdrawn money. Rate of interest in case of overdraft is less than the rate charged under cash credit.

(iv) Discounting of Bill

Banks also advance money by discounting bills of exchange, promissory notes and hundies. When these documents are presented before the bank for discounting, banks credit the amount to cutomer’s account after deducting discount. The amount of discount is equal to the amount of interest for the period of bill.

3. Customers’ Advances

Sometimes businessmen asked their customers to make some advance payment. It is generally said when the order is quite large or things ordered are expensive. Customers’ advance represents a part of the payment towards price on the product (s)which will be delivered at a later date. Customers generally agree to make advances when such goods are not easily available in the market or there is an urgent need of goods. A firm can meet its short-term requirements with the help of customers' advances.

4. Instalment credit

Instalment credit is now-a-days a popular source of finance for consumer goods like television, refrigerators as well as for industrial goods. Under this system possession of goods are taken immediately but the payment is made in instalments over a pre-determined period of time. Interest is charged on the unpaid price or it may be adjusted in the price.

5. Loans from Co-operative Banks

Co-operative banks are a good source to procure short-term finance. Such banks have been established at local, district and state levels. District Cooperative Banks are the federation of primary credit societies. The State Cooperative Bank finances and controls the District Cooperative Banks in the state. They are also governed by Reserve Bank of India regulations. Some of these banks like the Vaish Co-operative Bank was initially established as a co-operative society and later converted into a bank. These banks grant loans for personal as well as business purposes. Membership is the primary condition for securing loan. The functions of these banks are largely comparable to the functions of commercial banks.

5.11 SUMMARY

Capital is the life blood of business. A business requires capital to purchase its fixed assets, which is called long term finance. The factors that determine the long term requirements of capital are: (i) Nature of business, (ii) Size of business, (iii) Kinds of goods produced, and (iv) Technology used.

The main sources of raising long term finance are: (i) Shares, (ii) Debentures (iii) Retained earnings, (iv) loans from financial institutions, and (v) term loans from banks. Share is an unit of capital of a company of a definite face value. Share indicates certain rights of its holder and the extent of his liability. Shares are mainly of two types: (i) Equity shares (ii) Preference shares.

Preference shares are the shares which carry preferential rights of receiving dividend and repayment of capital (in case the company is wound up) over other shares. Equity shares are shares which do not carry any preferential right. Holders of these shares are the real owners of the company. They get dividends only when dividend on preference shares has been paid. Issue of debenture is a source of borrowed capital. A debenture is a written acknowledgement of debt by a company. Debenture holders are the creditors of the company. They do not enjoy any voting rights. They are secured. Debentures may be (a) redeemable or irredeemable, and (b) convertible or non-convertible.

Retained earnings are a portion of profit, earned by an enterprise, set aside to finance its activities. It is also called ploughing back of profit or internal financing. Commercial banks traditionally give loans for a short period. But recently they have started giving term loans both by extending the short-term loans and also directly for a long period.

Short-term finance is required by business firms to meet day to day expenses. It facilitates the smooth running of business operations. It enables holding of stocks of raw materials and finished products, helps to increase the volume of production at short notice and bridges the time gap between commencement of production and realisation of sales. There are a number of sources of short-term finance: (i) Trade Credit,(2) Bank credit including loans and advances, cash credit, overdraft and discounting of bills, (3) Customers' advances, (4) instalment credit, and(5) Loans from co-operative banks.

Short-term finance is helpful to business in meeting temporary requirements of funds without a heavy burden of interest. It is a flexible source of finance. When necessary, it may also serve long-term purposes through renewal. However interest has to be paid on short-term borrowing, irrespective of profit or loss. It also needs security of assets to be provided by the borrower.

5.12 GLOSSARY

Financing: Financing is the provision of capital to corporations, households, and governments for the purposes of investment

Long-term finance: Long-term finance/long-term financing are used interchangeably in this report. They refer to the provision of long-dated funds to pay for capital-intensive undertakings that have multiyear payback periods

External financing: External financing is the provision of capital from outside investors to corporations, households, and governments (for example, via bank loans or capital markets).

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5.15 TERMINAL QUESTIONS

Q1. Why does business need long term finance? Explain in brief.

Q2. Give the advantages and disadvantages of equity shares.

Q3. Differentiate between:

(a) Equity shares and preference shares

(b) Shares and Debentures

Q4. State the meaning of Debenture. Give the merits and demerits of debentures as a source of long term finance.

Q5. Define Retained Earnings. What are limitations of Retained Earning as a source of finance?

Q6. List out the various advantages and disadvantages of long term loans from commercial banks.

Q7. Why short-term finance is a necessity for business enterprises?

Q8. List the various sources of short-term finance.