4. TYPES OF FINANCING

❖ SHORT TERM SOURCE OF FINANCE

1) Trade Credit-

a) It represents credit granted by suppliers of goods etc, as an incident of sale.

b) It generate automatically in the course of business is common to almost all business organisation.

c) It can be in the form of creditors of bills payable. It also take the form of acquired expenses such as outstanding wages, electricity, and other overhead.

d) One very important Characteristic of trade is that it increases automatically with the increase in the volume of business.

2) Advance from Customers / Dealers:

a) Manufacturing and contractors engaged in producing or constructing costly goods involving considerable length of manufacturing or construction usually demand advance money from their customers at the time of accepting their orders for executing their contacts or supply the goods.

b) This is a cost free source of finance & really useful.

3) Bank Credit- It is primary institutional source of working capital finance in India.In fact , it represents most important source of financing of current assets.

❖ ***Forms of Credit.***

A) Cash credit:

a) Cash Credit is an arrangement under which a customer is allowed an advance up to certain limit against credit granted by bank.

b) Under this arrangement, a customer need not borrow the entire amount of advance at one time ; he can only draw to the extent of his requirements and deposit his surplus funds in his account. Interest is not actually charged on the full amount of the advance but on the amount actually utilized by him.

B) Overdraft:

a) It is a loan from a bank made on current account.

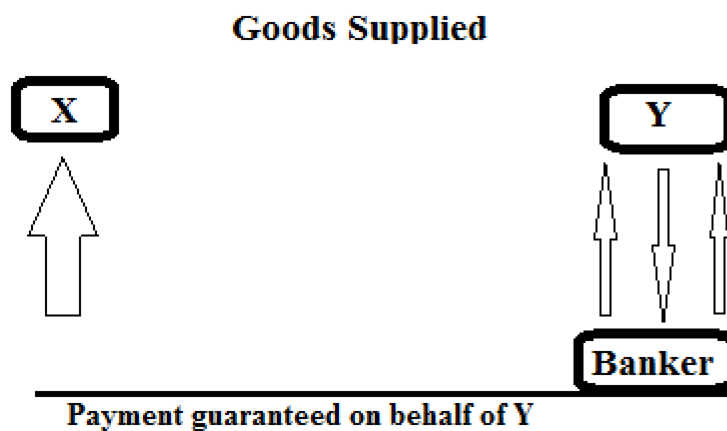
b) Often means of financing trading requirements on a short term basis, an overdraft is of no define duration & repayable on demand. The interest charged on a bank overdraft is usually higher than the bank rate , it is levied on a day-to-day basis i.e on the current amount borrowed & not on the agreed maximum.

C) Letter of Credit:

a) While the other forms of bank credit are direct form of financing on which banks provide funds as well as bear risk, letter of credit is an indirect form of working capital financing & banks assume only the risk , the credit being provided by the supplier himself.

b)The purchaser of goods on credit obtains a letter of credit from bank. The bank undertakes the responsibility to make payments to the supplier **in case the buyer fails to meet his obligations.**

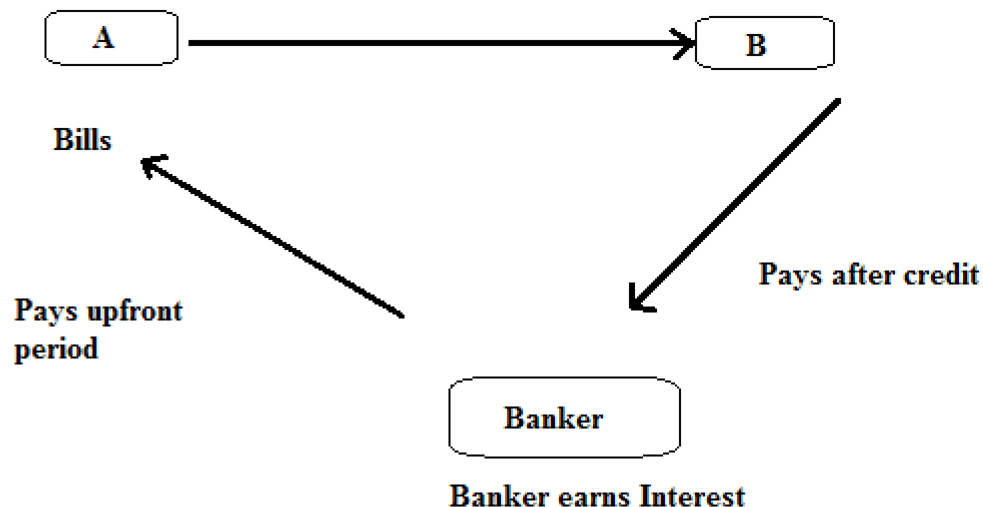
Thus, the module operandi of letter of credit is that the supplier sells good on credit / extent credit (finance)to the purchaser, the bank gives a guarantee & bears risk only in case of default by the purchaser.



4) Bill Discounting:

a) A bill may be discounted with the bank & when it matures on a future date the bank collects the amount from the part who has accepted the bill.

b) When a bank is short of funds it can sell on rediscount rate at 10-11% for 90 days , bill discounting is an extensive source of short.



5) Commercial Papers (CP):

a) CP is a unsecured promissory note.

b) It is promise to pay amount indicate by face value on a specific day.

c) It is an unsecured promise i.e lender does not have any assets backed or other such security.

d) CP is sold at discount according to expected interest rate.

e) On maturity , it is honoured at face value.

f) It can directly place with the investors or through dealers.

g) Presently features of CP regulation are as follows:-

- Minimum size Rs. 25 Lakhs with minimum unit of subscription Rs 5 Lakhs.
- Maximum limit is 100% of working capital limit.
- CP's can be issued for the period ranging from 15 days to 1 year. Renewal is treated as fresh issue.
- A company can issue CP only if it satisfies all of the following conditions.
    i. It has minimum tangible net worth of Rs.4 crores.
    ii. Funds based working capital limit is Rs 4 crores or more.
    iii. Credit rating is at least P2 (CRISIL) A2 (ICRA) PR-2 (CARE)
    iv. Its loan / advance account is rated as standard asset.

6) Inter-Corporate Deposits- A deposit made by one company with another company, normally for such period up to 5 months is referred to as inter-corporate deposit. Such deposit are usually of 3 types:

a) Call Deposits-In theory , a call deposit is withdrawable by the lender on giving a days notice. In practice however the lender has to wait for atleast 3 days.

b) Three Month Deposits- More popular in practice , these deposits are taken by borrowers to overcome a short term cash requirement that may caused due to one or more of the following factors: Disruption in production , excessive of raw material , tax payments , delay in collection , dividend payments , and unplanned capital expenditure.

c) Six Month Deposits- Normally lending companies do not extend deposits beyond this time frame. Such deposits are usually made with first class borrowers.

As inter-corporate deposits represent unsecured borrowing, the lending company must satisfy itself about credit worthiness of the borrowing firm.

7) Public Deposits (fixed deposits)

a) Public deposits are very important source of short term & medium term finances.

b) A company an accept public deposit subject to the stipulations of RBI from time to time maximum upto 35% of its paid up capital & reserves from the public & shareholders.

c) These deposits may be accepted for a period of 6 months to 3 years.

d) Public deposits are unsecured loans ; they should not be used for acquiring fixed assets since they are to be repaid within a period of 3 years.

e) These are mainly used to finance working capital requirements.

MERITS

- The method of financing through public deposits is simple & easy as it does not require much formality.
- It is cheaper method of raising short & medium term finance.
- It does not require any security.

DEMERITS

- Only companies enjoying good reputation in the market is able to raise finance through public deposits. This method of raising finance is unsuitable during the period of depression & financial stringency.
- This method of financing puts the company into serious financial difficulties. Even if there is a rumour that the company is not doing well ,the public depositors may put pressure on the company to refund the deposits.

8) Short Term Loan from Financial Institution- The LIC of India. The General Insurance Corporation of India & The Unit Trust of India provide short term loans to manufacturing companies with an excellent track record.

Features :-

- They are totally unsecured
- The loan is given for the period of 1 year & can be renewed for 2 consecutive years, provided the original eligibility criteria are satisfied.
- After a loan is repaid the company has to wait for atleast 6 months before availing of fresh loan.
- The loans carry a higher interest rate. However there is rebate of 1% for prompt payment.

9) Factoring - It is a financial transaction whereby a business sells its accounts receivables at discount to a factor. The three parties directly are : the seller , the debtor , the factor. The seller is owned money (usually for worked performed or goods sold) by the second party , the debtor. The seller than sells the debtors accounts at a discount to the third party, the factor. The debtor than directly pays the factor the full value of invoice.

Features of Factoring Arrangement :

- The factor selects the account of the seller that would be bought by it.
- The factor assumes responsibility for collecting the debt of accounts handled by it.
- The factor advance money to the seller against not yet collected & not yet due debts. Typically the amount advanced is 70-80% of the face value of the debts & carriers & interest banks.
- Factoring may be on a recourse basis (Presently in India it is done only on a resource basis) or non resource basis(full credit risk0

Domestic Factoring- With recourse factoring is the service presently offered by most of the factors in India. Under this category, besides finance against the receivable at the agreed percentage, collection of receivables & maintenance of sales ledger are undertaken. The clients customers are notified of factors interest in the factored debt to the customers given an undertaking to pay the value of the debt to the factor directly on the due date. Factor does not assume the credit risk of debts. In case the customer does not pay the debts on maturity ,factor will have recourse against the client to recover the amount paid. This is diagrammatically represented as follows :

Undisclosed Factoring- It is another variant of factoring, where the customers of factor's client are not notified of the factoring arrangement. This category of facility is considered depending on the merits of the proposal, at factor's discretion .In this type of factoring ,maintenance of sales ledger & collection of debt are undertaken by the client himself. The client undertakes to pay the value of the debts factored on the due dates irrespective of the fact whether the customer has paid the debts or not, this facility is considered on selective basis only.

Benefits of Factoring

A) Seller have instant access to their earnings, they can promptly settle their creditors, avail cash discount and improve their profits.

B) Sale ledger of the client is maintained by factors on computer and rendered every month.

C) Factors attend to the task of collecting the debt, seller can concentrate on building their business by attending to other important management functions such as planning, production, & marketing.

D) Formalities with factor are relatively simple and hassle free.

❖ LONG TERM SOURCE OF FINANCE

1) Equity Shares-

a) Right to vote in general meeting of the shareholder to pass out resolution. It is always one vote per share held by the person.
b) Right to control the operations of the company. Shareholders have a right to cast one vote per share in the election for directors of the company. Directors in turn select the

management of the company that actually controls everyday operations. Directors have right to pass any resolution for the company. Thus shareholder exercise their right to control through directors & management.

c) Pre-emptive right is the right to maintain proportionate ownership by purchasing additional equity shares. The existing shareholders have first right of refusal on subscription of fresh equity, in proportion to the shares held by them.
d) Right to income : Equity investors have full right over all the residual income. This is the income remaining after satisfying all the claims of other investors. This income may be distributed in the form of dividend pr may be retained by the company. Incomes retained and ploughed back in the business tend to increase the market value of shares , if invested properly.

MERITS

i. Does not involve obligatory dividend payment.
ii. Perpetual in nature as it is not repayable during the lifetime of company
iii. Forms the basis of further long term financing in the forms of borrowing related to the creditworthiness of the firm.
iv. For a shareholders the merit is that it has limited liability and they are the owners of the company

DEMERITS

i. Dilution of control of existing shareholders on sale of new shares to outsiders / public.
ii. For shareholders the demerit is that they are last claimant i.e residual claim over the income and assets. Further they are scattered and unorganised and are unable to exercise effective and real control

2) Preference Shares-

Features of Preference Shares :

i. Preference Shares is a hybrid security because it has features of both equity shares and debentures.
ii. Preference shareholder have preferential rights before the ordinary shareholders in respects of capital at the time of winding up of the company.
iii. Preference shareholders have preferential rights in respect of dividend before equity shareholders.
iv. In case of cumulative preference shares it gives a right to demand all the arrears of unpaid dividend during the subsequent years when the profits are ample.
v. The dividend on preference shares is fixed and they must be declared before declaring equity dividend
vi. The obligation to pay fix rate of dividend is not binding.
vii. Preference shareholders have no voting shares.

3) Debentures-

Features :

i. Debenture holders are the creditors of the company.
ii. Interest on debentures has to be paid irrespective of the fact whether the company has made profit or loss.
iii. Money received by the company by the issue of a debenture is a loan.
iv. Debenture holders have no voting rights.
v. Debenture holder have a prior claim over the shareholders in the event of liquidation regarding the payment of money.
vi. There is no dilution of control due to the raising of debentures.
vii. Trading on equity is possible by raising debenture in case of profitable companies.
viii. Interest on debenture is deductible for taxation purpose.
ix. Debenture are generally secured on the assets of the companies and therefore there is less risk

4) Term Loans

Features :

i. Maturity-Term loans are generally for a period of 6 to 10 years. In some cases grace period of 1 to 2 years is also granted.
ii. Direct Negotiation- Term loan is a private placement. It avoids underwriting commission and other flotation costs.
iii. Security- Term loans are always secured .They are secured specifically by the assets acquired using term loan funds. This is called PRIMARY SECURITY.
iv. Term loans are generally secured by the company's current assets and future assets. This is called SECONDARY OR COLLATERAL SECURITY.

Also the lender may create either fixed or floating charge against the firm's assets. Fixed charge means legal mortgage of specific assets.

v. Other Restriction-Lenders also impose other restrictions to reduce their risk. These measures may be some or all the following or even beyond these :
   a. Shares of the promoters are pledged with the lenders , till loan is repaid.
   b. Receivable may be compulsorily deposited in a specific account called as escrow account. Withdrawals from this account are subject to the permission of the lenders.
   c. Total borrowing from all the lender may be capped with a specific limit.
   d. Lenders demand first charge on all contingent receivables including insurance claims.
   e. For substantial amount of loans, lenders may appoint their nominee on the board of directors.

5) INTERNAL FUNDS – AS A SOURCE OF FINANCE.

Also known as "Ploughing Back of Profits" or "Self financing" or "Accumulation of earning over a period of time" or "Internal financing"

Instead of distributing the entire profits to the shareholders in the form of dividend, the company retains a part of its earnings for the purpose of; accumulation of earnings, investing in fixed assets and / or to meet working capital needs, if the need so arise.

Merits of Ploughing Back of Profits

i. Economical- Cost of raising such funds is nil, as the company need not advertise or pay underwriting commission or brokerage.
ii. Reduces the reliance of the firm on external borrowings.
iii. Helps in expansion and diversification.

Demerits of Ploughing Back of Profits

i. Danger of manipulation by the management by using it for their personal extravaganza or to manipulate the share prices on the stock exchange.
ii. Chances of over-capitalization. Over capitalization is a situation when a firm's earning are comparatively less as compared to similar companies in the industry. Such a situation also arises when a company employs more funds than is actually needed.

6) Venture Capital-

Venture capital institutions, which emerged the world over to fill gaps in the conventional financial mechanism, focused on new entrepreneurs ,commercialization of new entrepreneurs, commercialization of new technologies & support to small & medium enterprises in the manufacturing & service sector. It injects long term capital into the small & medium sectors. Venture capital is a way in which investors support entrepreneurial talent with finance & business skills to exploit market opportunities & obtain long term capital gains. It is a provision of risk bearing capital usually in the form of participation in the equity to companies with high growth potential. It involves risk return spectrum.

7) Hire Purchase-

Hire purchase is a type of installation credit under which the hire purchaser, called hirer, agrees to take the goods on the hire at a stated rental, which is inclusive of the repayment of principal as well as interest, with an option to purchase. Under this transaction, the hire purchaser acquires the property (goods)immediately on signing the hire purchase agreement but the ownership or title of the same is transferred only when the last installment is paid.

8) Leasing-

A lease may be defined as a contractual arrangement or transaction in which a party owning an asset or equipment (lessor) provides the asset for the use to another or transfer the right to use the equipment to the user (lessee), for an agreed period of time for consideration in the form of periodic payments called rentals which may be further accompanied with the premium.

At the end of the contract the assets reverts back to the lessor unless there is a provision for renewal of contract. Thus in a lease transaction the owner & the user if assets are different. Further it resembles a device of financing / money lending.

9) Innovative Capital Market-

i. Zero Interest Bond /Debentures (ZIS / D) - Also known as zero coupon bonds / debentures, ZIB's do not carry any explicit/ coupon rate of interest. T hey are sold at discount from their maturity value. The difference between the face value of the bond & the acquisition cost is that gain / return to the investors.
ii. Deep Discount Bonds (DDB) – A DDB is a form of ZIB. It is issued at a deep / steep discount over its face value. The DDB appreciates to its face value over the maturity period. The DDB's are being issued by public financial institutions in India, namely IDBI, SIDBI and so on. The demerit of DDB's is that they are exposed to high repayment risk as they entail a balloon payment on maturity.
iii. Security Premium Notes (SPN's) – The SPN is a secured debenture redeemable at a premium over the face value / purchase price. It resembles a ZIB. There is a lock in period for SPN during which no interest is paid. The holder has the option to sell back the SPN to the issuing company at par after the lock in period. The redemption is made in instalments. The SPN is tradable instrument. E.g TISCO SPN.
iv. Floating Rate Bonds - Interest on such bonds is not fixed. It is floating & in linked to benchmark rate such as bank rate, interest on treasury bills.
v. Warrants – Warrant is an instrument that gives its holder the right to purchase a certain no. of shares at a specified price over a certain period of time. Warrants are of two types-Detachable or Non Detachable.

10) GDR & ADR-

GDR is a foreign currency denominated negotiable certificate which trades in at least two countries outside the issuer's home market.

ADR's created by U.S.A wherein a U.S depository bank would hold a predetermined number of foreign securities & issue against them ADR's which are freely tradable only in U.S stock exchanges. For issue of ADR's requires the clearance of the SEC in USA for which the issuing company has to furnish the required details.