PAPER NO. AD24

ACCOUNTING TECHNICIAN DIPLOMA (ATD)

LEVEL II

FUNDAMENTALS OF FINANCE

STUDY NOTES

KASNEB SYLLABUS

GENERAL OBJECTIVES

This paper is intended to equip the candidate with knowledge. skills and attitudes that will enable him/her to apply the principles of finance in business decision making

8.0 LEARNING OUTCOMES

A candidate who passes this paper should be able to:

- Identify various sources of finance for organisations
- Calculate non-complex risk and return measures
- Determine the cost of capital for an organisation
- Evaluate the viability of capital investments using appropriate appraisal techniques
- Advise on various forms of dividends payable by an organisation
- Apply basic concepts of Islamic Finance.

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CHAPTER 1

NATURE AND PURPOSE OF FINANCE

Meaning of Finance

The term finance should be understood in two perspectives - finance as a resource and finance as a discipline. Finance, as a resource, refers to monetary means of financing assets of an entity. Finance as a discipline or subject of study, describes how individuals , governments and corporate organizations manage the flows of money through an organization. In other words, finance tells how people make decisions about the collection and allocation of resources in organizations like corporation, school, bank or government agency. Therefore, it is important for all individuals, businesses, governments and non-government organizations to appreciate the significance of finance in their day-to-day businesses.

Finance was a branch of economics till the closure of nineteenth century. Finance as a separate academic discipline is still evolving. Practicing managers and academicians have been contributing in its expansion and enrichment.

SCOPE OF FINANCE

At the present state, the academic discipline of finance includes the following specialized areas in its scope.

1. Public Finance

Like business organizations, governments (local, state or federal) raise and spend large sum of money, but unlike business organizations, they pursue non-profit goals. To deal with governmental financial matters, a separate and specialized field of finance has emerged as public finance.

2. Securities and Investment Analysis

This area is of interest to individuals and institutional investors. It covers mainly measurement of risk and return on investment in securities.

3. Institutional Finance

Institutional finance deals with issues of capital formation and the organizations that perform the financing function of the economy. Therefore, it mainly studies saving and capital formation and institutions involved in this process such as banks, insurance companies, provident and pension funds, etc.

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4. International Finance
International finance studies economic transactions among nations, corporations and individually internationally. It is concerned with flows of money across international boundaries.

5. Financial Management
Business firms face problems dealing with acquisition of funds and optimum methods of employing the funds. Thus, financial management studies financial problems in individual firms, seeks low-cost funds and seeks profitable business activities.

RELATIONSHIP BETWEEN FINANCE AND ACCOUNTING

Finance and accounting are two closely related activities in a company.

Finance includes activities that help a company fund its activities and operations.

Accounting is the process of recording and reporting financial figures from business transactions.

The relationship between finance and accounting exists because the former activity often uses figures from the latter. In other cases, finance analysts review accounting information to determine the efficiency and effectiveness of operations.

A company often separates its finance and accounting functions among several workers. This ensures the company has the proper segregation of duties to prevent employees from manipulating information. The company also needs to create specific job responsibilities to further define roles. Large companies may also need to have two separate departments in order to process their financial data. In many cases, the finance department will have fewer employees than the accounting department.

Financial statements are typically the final output from a company's accounting department. These statements present a record for a specific period in a company's life. Finance and accounting personnel work together to present the financial statements to upper management. For example, finance personnel may review and make suggestions on correcting the financial statements. Finance personnel may also create ratios in addition to statements to provide additional insight into the data.

Another relationship between finance and accounting is the creation of a company's budget or working capital analysis. Finance personnel often create budgets to present the expected financial outlays in the future. Accountants prepare information at the end of each month that affects current budgets. Finance personnel ensure the company maintains its budget and all figures are in proper accounts. Creating new budgets also requires the use of current accounting information.

Working capital analysis and other uses of accounting information also extend the relationship between finance and accounting. Finance personnel must ensure the company has enough cash to operate. A mix of debt or equity financing is often necessary to overcome any cash shortfalls as computed by a working capital or cash budget. Without accounting information, these budgets and the related shortfalls are nearly impossible to determine. Finance personnel can also make other recommendations for working capital adjustments.

Other possible decisions that result from corporate finance include business valuation, investment decisions, and dividend planning. These decisions are all a working part of the relationship between finance and accounting. Companies can also create other relationships based on their need for financial data.

FINANCE FUNCTIONS

The following explanation will help in understanding each finance function in detail

1. Investment Decision

One of the most important finance functions is to intelligently allocate capital to long term assets. This activity is also known as capital budgeting. It is important to allocate capital in those long term assets so as to get maximum yield in future. Following are the two aspects of investment decision

a. Evaluation of new investment in terms of profitability
b. Comparison of cut off rate against new investment and prevailing investment.

Since the future is uncertain therefore there are difficulties in calculation of expected return. Along with uncertainty comes the risk factor which has to be taken into consideration. This risk factor plays a very significant role in calculating the expected return of the prospective investment. Therefore while considering investment proposal it is important to take into consideration both expected return and the risk involved.

Investment decision not only involves allocating capital to long term assets but also involves decisions of using funds which are obtained by selling those assets which become less profitable and less productive. It wise decisions to decompose depreciated assets which are not adding

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value and utilize those funds in securing other beneficial assets. An opportunity cost of capital needs to be calculating while dissolving such assets. The correct cut off rate is calculated by using this opportunity cost of the required rate of return (RRR)

2. Financial Decision

Financial decision is yet another important function which a financial manger must perform. It is important to make wise decisions about when, where and how should a business acquire funds. Funds can be acquired through many ways and channels. Broadly speaking a correct ratio of an equity and debt has to be maintained. This mix of equity capital and debt is known as a firm's capital structure.

A firm tends to benefit most when the market value of a company's share maximizes this not only is a sign of growth for the firm but also maximizes shareholders wealth. On the other hand the use of debt affects the risk and return of a shareholder. It is more risky though it may increase the return on equity funds.

A sound financial structure is said to be one which aims at maximizing shareholders return with minimum risk. In such a scenario the market value of the firm will maximize and hence an optimum capital structure would be achieved. Other than equity and debt there are several other tools which are used in deciding a firm capital structure.

4. Dividend Decision

Earning profit or a positive return is a common aim of all the businesses. But the key function a financial manger performs in case of profitability is to decide whether to distribute all the profits to the shareholder or retain all the profits or distribute part of the profits to the shareholder and retain the other half in the business.

It's the financial manager's responsibility to decide a optimum dividend policy which maximizes the market value of the firm. Hence an optimum dividend payout ratio is calculated. It is a common practice to pay regular dividends in case of profitability Another way is to issue bonus shares to existing shareholders.

5. Liquidity Decision

It is very important to maintain a liquidity position of a firm to avoid insolvency. Firm's profitability, liquidity and risk all are associated with the investment in current assets. In order to maintain a tradeoff between profitability and liquidity it is important to invest sufficient funds in current assets. But since current assets do not earn anything for business therefore a proper calculation must be done before investing in current assets.

Current assets should properly be valued and disposed of from time to time once they become non profitable. Currents assets must be used in times of liquidity problems and times of insolvency.

ROLE OF A FINANCE MANAGER

Some of the major functions of a financial manager are as follows:

1. Estimating the Amount of Capital Required
2. Determining Capital Structure
3. Choice of Sources of Funds
4. Procurement of Funds
5. Utilisation of Funds
6. Disposal of Profits or Surplus
7. Management of Cash
8. Financial Control.

Financial Manager is the executive who manages the financial matters of a business.

The functions of Financial Manager are discussed below:

1. Estimating the Amount of Capital Required:

This is the foremost function of the financial manager. Business firms require capital for:

i. purchase of fixed assets,
ii. meeting working capital requirements, and
iii. modernisation and expansion of business.

The financial manager makes estimates of funds required for both short-term and long-term.

2. Determining Capital Structure:

Once the requirement of capital funds has been determined, a decision regarding the kind and proportion of various sources of funds has to be taken. For this, financial manager has to determine the proper mix of equity and debt and short-term and long-term debt ratio. This is done to achieve minimum cost of capital and maximise shareholders wealth.

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3. Choice of Sources of Funds:

Before the actual procurement of funds, the finance manager has to decide the sources from which the funds are to be raised. The management can raise finance from various sources like equity shareholders, preference shareholders, debenture- holders, banks and other financial institutions, public deposits, etc.

4. Procurement of Funds:

The financial manager takes steps to procure the funds required for the business. It might require negotiation with creditors and financial institutions, issue of prospectus, etc. The procurement of funds is dependent not only upon cost of raising funds but also on other factors like general market conditions, choice of investors, government policy, etc.

5. Utilisation of Funds:

The funds procured by the financial manager are to be prudently invested in various assets so as to maximise the return on investment: While taking investment decisions, management should be guided by three important principles, viz., safety, profitability, and liquidity.

6. Disposal of Profits or Surplus:

The financial manager has to decide how much to retain for ploughing back and how much to distribute as dividend to shareholders out of the profits of the company. The factors which influence these decisions include the trend of earnings of the company, the trend of the market price of its shares, the requirements of funds for self- financing the future programmes and so on.

7. Management of Cash:

Management of cash and other current assets is an important task of financial manager. It involves forecasting the cash inflows and outflows to ensure that there is neither shortage nor surplus of cash with the firm. Sufficient funds must be available for purchase of materials, payment of wages and meeting day-to-day expenses.

8. Financial Control:

Evaluation of financial performance is also an important function of financial manager. The overall measure of evaluation is Return on Investment (ROI). The other techniques of financial control and evaluation include budgetary control, cost control, internal audit, break-even analysis and ratio analysis. The financial manager must lay emphasis on financial planning as well.

GOALS OF A FIRM

Goals of a firm are divided into financial and non-financial goals

Financial goals of the firm

Profit Maximization

Main aim of any kind of economic activity is earning profit. A business concern is also functioning mainly for the purpose of earning profit. Profit is the measuring techniques to understand the business efficiency of the concern. Profit maximization is also the traditional and narrow approach, which aims at, maximizes the profit of the concern. Profit maximization consists of the following important features.

1. Profit maximization is also called as cashing per share maximization. It leads to maximize the business operation for profit maximization.
2. Ultimate aim of the business concern is earning profit, hence, it considers all the possible ways to increase the profitability of the concern.
3. Profit is the parameter of measuring the efficiency of the business concern. So it shows the entire position of the business concern.
4. Profit maximization objectives help to reduce the risk of the business.

Favourable Arguments for Profit Maximization

The following important points are in support of the profit maximization objectives of the business concern:

i. Main aim is earning profit.
ii. Profit is the parameter of the business operation.
iii. Profit reduces risk of the business concern.
iv. Profit is the main source of finance.
v. Profitability meets the social needs also.

Unfavourable Arguments for Profit Maximization

The following important points are against the objectives of profit maximization:

i. Profit maximization leads to exploiting workers and consumers.
ii. Profit maximization creates immoral practices such as corrupt practice, unfair trade practice, etc.
iii. Profit maximization objectives leads to inequalities among the stake holders such as customers, suppliers, public shareholders, etc.

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Drawbacks of Profit Maximization

Profit maximization objective consists of certain drawback also:

i. **It is vague:** In this objective, profit is not defined precisely or correctly. It creates some unnecessary opinion regarding earning habits of the business concern.

ii. **It ignores the time value of money:** Profit maximization does not consider the time value of money or the net present value of the cash inflow. It leads certain differences between the actual cash inflow and net present cash flow during a particular period.

iii. **It ignores risk:** Profit maximization does not consider risk of the business concern. Risks may be internal or external which will affect the overall operation of the business concern.

Wealth Maximization

Wealth maximization is one of the modern approaches, which involves latest innovations and improvements in the field of the business concern. The term wealth means shareholder wealth or the wealth of the persons those who are involved in the business concern.

Wealth maximization is also known as value maximization or net present worth maximization. This objective is an universally accepted concept in the field of business.

Favourable Arguments for Wealth Maximization

i. Wealth maximization is superior to the profit maximization because the main aim of the business concern under this concept is to improve the value or wealth of the shareholders.
ii. Wealth maximization considers the comparison of the value to cost associated with the business concern. Total value detected from the total cost incurred for the business operation. It provides extract value of the business concern.
iii. Wealth maximization considers both time and risk of the business concern.
iv. Wealth maximization provides efficient allocation of resources.
v. It ensures the economic interest of the society.

Unfavourable Arguments for Wealth Maximization

i. Wealth maximization leads to prescriptive idea of the business concern but it may not be suitable to present day business activities.
ii. Wealth maximization is nothing, it is also profit maximization, it is the indirect name of the profit maximization.
iii. Wealth maximization creates ownership-management controversy.
iv. Management alone enjoy certain benefits.
v. The ultimate aim of the wealth maximization objectives is to maximize the profit.
vi. Wealth maximization can be activated only with the help of the profitable position of the business concern.

Non-financial goals

- **Social Responsibility and Ethics**

It has been argued that the unbridled pursuit of shareholders wealth maximization makes companies unscrupulous, anti social, enhances wealth inequalities and harms the environment. The proponents of this position argue that maximizing shareholders wealth should not be pursued without regard to a firm's corporate social responsibility. The argument goes that the interest of stakeholders other than just shareholders should be taken care of. The other stakeholders include creditors, employees, consumers, communities in which the firm operates and others. The firm will protect the consumer; pay fair wages to employees while maintaining safe working conditions, support education and be sensitive to the environment concerns such as clean air and water. A firm must also conduct itself ethically (high moral standards) in its commercial transactions.

Being socially responsible and ethical cost money and may detract from the pursuit of shareholders wealth maximization. So the question frequently posed is: is ethical behavior and corporate social responsibility inconsistent with shareholder wealth maximization?

In the long run, the firm has no choice but to act in socially responsible ways. It is argued that the corporation's very survival depend on it being socially responsible. The implementation of a pro-active ethics ad corporate social responsibility (CSR) program is believed to enhance corporate value. Such a program can reduce potential litigation costs, maintain a positive corporate image, build shareholder confidence, and gain the loyalty, commitment and respect of firm's stakeholders. Such actions conserve firm's cash flows and reduce perceived risk, thus positively effecting firm share price. It becomes evident that behavior that is ethical and socially responsible helps achieve firm's goal of owner wealth maximization.

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- **Growth and expansion.**

This is a major objective for small companies which seek to expand operations so as to enjoy economies of scale.

Difficulty of Achieving Shareholders Wealth Maximization

Two difficulties complicate the achievement of the goal of shareholder wealth maximization in modern corporations. These are caused by the agency relationships in a firm and the requirements of corporate social responsibility (As discussed above).

AGENCY THEORY

An agency relationship is created when one party (principal) appoints another party (agent) to act on their (principals) behalf. The principal delegates decision making authority to the agent. In a firm agency relationship exists between;

1 Shareholders and management
2 Shareholders and creditors
3 Shareholders and the government
4 Shareholders and auditors

Shareholders and management

The separation of ownership and control in most modern corporations' causes a conflict of interest between the personal interest of appointed managers (agent) and the interests of the owners of the firms (principals).this conflict is known as the **agency conflict.**

The following are some decisions by managers which would result in a conflict with shareholders:

1. Managers may use corporate resources for personal use.
2. Managers may award themselves hefty pay rises
3. Managers may organize mergers which are intended for their benefit only and not for the benefit of shareholders.
4. Managers may take holidays and spend huge sums of company money.
5. Managers may use confidential information for their benefit(insider trading)

Resolution of conflict

1. Performance based remuneration

This will involve remunerating managers for actions they take that maximize shareholders wealth. The remuneration scheme should be restructured in order to enhance the harmonization of the interest of shareholders with those of management. Managers could be given bonuses, commissions for superior performance in certain periods.

2. Incurring agency costs

Agency costs refer to costs incurred by shareholders in trying to control management behavior and actions and therefore minimize agency conflicts.

These costs include:

i. **Monitoring costs.** They arise as a result of mechanisms put in place to ensure interests of shareholders are met. They include cost of hiring external auditors, bonding assurance which is insurance taken out where the firm is compensated if manager commits an infringement, internal control system implementation.
ii. **Opportunity costs** which are incurred either because of the benefit foregone from not investing in a riskier but more profitable investment or in the due to the delay in decision making as procedures have to be followed(hence, a timely decision will not be made)
iii. **Restructuring costs** are those costs incurred in changing or altering an organizations structure so as to prevent undesirable management activities.
iv. **Board of directors**- a properly constituted board plays the oversight role on management for the shareholders.

3. Threat of corporate takeover

When management of a firm under performs this result in the shares of that firm being undervalued there is the threat of a hostile takeover. This threat acts to force managers to perform since should the firm be taken over they will be replaced.

4. Shareholders intervention

The shareholders as owners of the company have a right to vote. Hence, during the company's AGM the shareholders can unite to form a bloc that will vote as one for or against decisions by managers that hurt the company. This voting power can be exercised even when voting for directors. Shareholders could demand for an independent board of directors.

5. Legal protection

The companies act and bodies such as the capital markets authority have played their role in ensuring trying to minimize the agency conflict. Under the companies act, management and board of directors owe a duty of care to shareholders and as such can face legal liability for their acts of omission or commission that are in conflict with shareholders interests. The capital market authority also has corporate governance guidelines.

6. Use of corporate governance principles which specify the manner in which organizations are controlled and managed. The duties and rights of all stakeholders are outlined.

7. Stock option schemes for managers could be introduced. These entitle a manager to purchase from the company a specified number of common shares at a price below market price over duration. The incentive for managers to look at shareholders interests and not their own is that,

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if they deliver and the company's share price appreciates in the stock market then they will make a profit from the sale.

8. Labour market actions such as hiring tried and tested professional managers and firing poor performers could be used. The concept of 'head hunting' is fast catching on in Kenya as a way of getting the best professional managers and executives in the market but at a fee of course.

Shareholders vs. creditors

In this relationship the shareholders (agent) are expected to manage the credit funds provided by the creditors (principal). The shareholders manage these funds through management.
Debt providers/creditors are those who provide loan and credit facilities to the firm. They do this after gauging the riskiness of the firm.
The following actions by shareholders through management could lead to a conflict between them and creditors

1. Shareholders could invest in very risky projects-The management under the directive of the shareholders may undertake highly risky investments than those anticipated by the providers of long term debt finance. The creditors would not be interested in highly risky projects because they stand to lose their funds when the investments collapse. Even if the risky projects succeed they would not benefit because they only get a fixed rate of return.
2. The dividend payments to shareholders could be very high-An increase in the dividend rate in most cases is financed by a decrease in investments. This in turn reduces the value of bonds. If the firm is liquidating and it pays a liquidating dividend to its shareholders, the providers of capital could be left with worthless claims.
3. Default on interest payments to bondholders
4. Shareholders could organize mergers which are not beneficial to creditors
5. Shareholders could acquire additional debt that increases the financial risk of the firm
6. Manipulation of financial statements so as to mislead creditors
7. Shareholders could dispose of assets which are security for the credit given
8. Under investments -The shareholders may invest in projects with a negative net present value.
9. The shareholders may adopt an aggressive management of working capital. This may bring conflicts in liquidity position of the firm and would not be in the interest of the debt holders

Resolution of this conflict

1. ***Restrictive covenants***- these are agreements entered into between the firm and the creditors to protect the creditor's interests.

These covenants may provide restrictions/control over:

i. Asset based covenants- These states that the minimum asset base to be maintained by the firm.
ii. Liability based covenant- This limits the firm's ability to incur more debt.
iii. Cashflow based covenant- States minimum working capital to be held by the firm. This may restrict the amount of dividends to be paid in future.
iv. Control based covenant – Limits management ability to make various decisions e.g. providers of debt fund may require to be represented in the BOD meetings.

2. Creditors could also offer loans but at above normal interest rates so as to encourage prompt payment

3. Having a callability clause to the effect that a loan could be re-called if the conflict of interest is severe

4. Legal action could also be taken against a company

5. Incurring agency costs such as hiring external auditors

6. Use of corporate governance principles so as to minimize the conflict.

Shareholders and the government

The shareholders operate in an environment using the license given by the government. The government expects the shareholders to conduct their business in a manner which is beneficial to the government and the society at large.
The government in this agency relationship is the principal and the company is the agent. The company has to collect and remit the taxes to the government. The government on the other hand creates a conducive investment environment for the company and then shares in the profits of the company in form of taxes. The shareholders may take some actions which may conflict the interest of the government as the principal.

These may include;

(a) The company may involve itself in illegal business activities
(b) The shareholders may not create a clear picture of the earnings or the profits it generates in order to minimize its tax liability.(tax evasion)

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(c) The business may not response to social responsibility activities initiated by the government
(d) The company fails to ensure the safety of its employees. It may also produce sub standard products and services that may cause health concerns to their consumers.
(e) The shareholders may avoid certain types of investment that the government covets.

Solutions to this agency problem

(i) The government may incur costs associated with statutory audit, it may also order investigations under the company's act, the government may also issue VAT refund audits and back duty investigation costs to recover taxes evaded in the past.
(ii) The government may insure incentives in the form of capital allowances in some given areas and locations.
(iii) Legislations: the government issues a regulatory framework that governs the operations of the company and provides protection to employees and customers and the society at large.ie laws regarding environmental protection, employee safety and minimum wages and salaries for workers.
(iv) The government encourages the spirit of social responsibility on the activities of the company.
(v) The government may also lobby for the directorship in the companies that it may have interest in. i.e. directorship in companies such as KPLC, Kenya Re. etc

Shareholders and auditors

Auditors are appointed by shareholders to monitor the performance of management.
They are expected to give an opinion as to the true and fair view of the company's financial position as reflected in the financial statements that managers prepare. The agency conflict arises if auditors collude with management to give an unqualified opinion (claim that the financial statements show a true and fair view of the financial position of the firm) when in fact they should have given a qualified opinion (that the financial statements do not show a true and fair view). The resolution of this conflict could be through legal action, removal from office, use of disciplinary actions provided for by regulatory bodies such as ICPAK.

CHAPTER 2

SOURCES OF FINANCE

Sources of finance mean the ways for mobilizing various terms of finance to the industrial concern. Sources of finance state that, how the companies are mobilizing finance for their requirements. The companies belong to the existing or the new which need sum amount of finance to meet the long-term and short-term requirements such as purchasing of fixed assets, construction of office building, purchase of raw materials and day-to-day expenses.

Sources of finance may be classified under various categories according to the following important heads:

1. Based on the Period
2. Based on Sources of Generation

1. Based on the Period

Sources of Finance may be classified under various categories based on the period.

SHORT-TERM SOURCES

Apart from the long-term source of finance, firms can generate finance with the help of short-term sources like loans and advances from commercial banks, moneylenders, etc. Short-term source of finance needs to meet the operational expenditure of the business concern.

Short-term source of finance include:

- Bank overdraft
- Trade Credit
- Leasing
- Bank loans
- Credit cards
- Factoring

Bank Overdraft

Almost all businesses have an account with a bank. All the deposits and withdrawals are dealt by the bank. All banking institutions are aware that businesses do not always get money from sales

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straight away. Due to the differences in its proceeds and its costs the organization can often face problems. This problem can be solved by arranging an overdraft.

However, this source of short term business finance has a few disadvantages as well. For small firms the interest rate on an overdraft can be quite high. Also, the business is not permitted to exceed their overdraft limit beyond a point.

Trade Credit

This is a source of short term business finance lent for a specific period of time to a business to pay for goods that they have received. Trade Credit cycle usually runs for a period of 28 days. But sometimes businesses may not pay back the loan for much longer durations. This grants the business the time to be able to deal with their finances, and balance their cash flows more efficiently.

Trade Credit is also an excellent way to finance inventories, which refers to the number of days the vendor will allow before the payment is due. Trade credit usually does not cost anything since the vendors offer it as an inducement to continue doing business.

Credit Card

This is the short term source of business finance that is very similar to trade credit. If something is bought using a credit card, the businessman is entitled to a certain period of time to either pay the full amount or a partial amount.

Most of the businesses have a corporate credit card. This can be a very helpful, practical and low cost way of expense management if the payment is made in full.

Lease

This source of short term business finance implies that the business is paying for the use of a product but it does not own it. Lease is often referred to as hiring. A lease arrangement on a product might mean that the company pays out a certain amount of money per month for a specific number of years. At the end of the time period the product is returned to the owner.

The Lease agreements have the following benefits:

It is cheaper to coordinate a lease rather than having to purchase the product.

Leases have a flexibility factor. Product might be needed for a short time or for a particular project and so there is no need for outright purchase.

The owner of the product is accountable for the upkeep and this reduces the business costs.

The payments are usually fixed and do not change with the change of interest rates. This makes the business operate more efficiently.

Bank Loans

Bank loans are a highly flexible option for short term business finance. The length of time that the loan has to be repaid in can vary. Loans that are given by the bank for less than one year are considered as short term finance. However, this can be expensive since there are interest payments to be made which can sometime vary.

Disadvantages of Short Term Business Finance

Short term business finance is usually very helpful, but sometimes there could be a few downsides of this facility:

1. ***Perception of Poor Financial Health***

Investors that the company may be wooing will look at the economic statements before they make a large contribution. They want to ensure that the organization has available cash flow and the credit rating to get itself out of a fix.

If the company needs more money in a hurry, the presence of a short-term loan can inflate the numbers and make it appear that your business is in financial trouble. Open loans reduce your ability to get approved for long-term loans and increase your current overhead. Investors see your business as a risky investment that could falter under the pressure of a short-term loan.

2. ***Negative Credit Risk Assessments***

Late payment on the short term business finance can have a negative effect your credit rating.

3. ***Insufficient for Long-Term Goals***

This source of financing is best if the business has a pressing need for more cash. They are not at all recommended for financing complete new business ventures

4. ***Strain on the Day-to-Day Operations***

Lenders who give money to small business owners usually have strict penalties for delayed payments. This can hugely increase the interest rate on the loan.

5. ***Short Term Business Finance – A Summary***

Short term business finance permits the organizations to take advantage of sudden opportunities to make extra revenues or capture business ahead of the competition. Good short term funding sources provide the company with the edge of flexibility and versatility. The better and more dependable the short term sources of financing, the more competitive the organization will end

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up being. A short-term business loan can help even out cash flow when your accounts payable schedule.

So if you have a business proposal, Venture Giant can help you find that short term business finance. Simply log on, submit your business proposal on this platform and make it available to the huge list of active angel investors that Venture Giant has access to.

Besides short term business finance, Venture Giant can also get you the early stage, seed investment capital or finance to start your business, launch new products or business service.

LONG-TERM SOURCES

Finance may be mobilized by long-term or short-term. When the finance mobilized with large amount and the repayable over the period will be more than five years, it may be considered as long-term sources. Share capital, issue of debenture, long-term loans from financial institutions and commercial banks come under this kind of source of finance. Long-term source of finance needs to meet the capital expenditure of the firms such as purchase of fixed assets, land and buildings, etc.

Purpose of Long Term Finance:

- To finance fixed assets.
- To finance the permanent part of working capital
- Expansion of companies.
- Increasing facilities.
- Construction projects on a big scale.
- Provide capital for funding the operations. This helps in adjusting the cash flow.

Factors determining Long-term Financial Requirements:

- Nature of Business
- Nature of Goods produced
- Technology used

Uses of Long Term Financing:

Long term financing is used in separate ways by different types of business entities. The business entities that are not corporations are only supposed to use long term financing for the purpose of debt. However, the corporations can use long term financing for both debt and equity purpose

Long-term sources of finance include:

- Equity/ordinary Shares
- Preference Shares
- Debenture
- Long-term Loans
- Fixed Deposits

2. Based on Sources of Generation

Sources of Finance may be classified into various categories based on the period.

INTERNAL SOURCES

Internal Sources of Finance are the sources of finance or capital for business firms which are generated by the business itself in its normal course of operations.

Internal source of finance includes

- Retained earnings
- Depreciation funds
- Surplus

EXTERNAL SOURCES

This is the money raised from outside the business

External sources of finance may be include

- Share capital
- Debenture
- Public deposits
- Loans from Banks and Financial institutions

Ordinary shares

Equity Shares also known as **equity shares,** which means, other than **preference shares**. Equity shareholders are the real owners of the company. They have a control over the management of the company. Equity shareholders are eligible to get dividend if the company earns profit. Equity share capital cannot be redeemed during the lifetime of the company. The liability of the equity shareholders is the value of unpaid value of shares.

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Features of Equity/ordinary Shares

Equity shares consist of the following important features:

1. **Maturity of the shares:** Equity shares have permanent nature of capital, which has no maturity period. It cannot be redeemed during the lifetime of the company.
2. **Residual claim on income:** Equity shareholders have the right to get income left after paying fixed rate of dividend to preference shareholder. The earnings or the income available to the shareholders is equal to the profit after tax minus preference dividend.
3. **Residual 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:** Equity shareholders are the real owners of the company. Hence, they have power to control the management of the company and they have power to take any decision regarding the business operation.
5. **Voting rights:** Equity shareholders 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 shareholders 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. For example: If the shareholder purchased 100 shares with the face value of Rs. 10 each. He paid only Sh. 900. His liability is only Sh. 100.

Total number of shares 100 Face value of shares Sh. 10

Total value of shares	$100 \times 10 = 1,000$
Paid up value of shares	900
Unpaid value/liability	100

Liability of the shareholders is only unpaid value of the share (that is Sh. 100).

Advantages of Equity Shares

Equity shares are the most common and universally used shares to mobilize finance for the company. It consists of the following advantages.

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. If the company earns profit, equity shareholders are eligible for profit, they are eligible to get dividend otherwise, and they cannot claim any dividend from the company.
4. **Less cost of capital:** Cost of capital is the major factor, which affects the valueof 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 (K_e) 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 is 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 lifetime 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.

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PREFERENCE SHARES

The parts of corporate securities are called as preference shares. It is the shares, which have preferential right to get dividend and get back the initial investment at the time of winding up of the company. Preference shareholders are eligible to get fixed rate of dividend and they do not have voting rights.

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.

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.

Participating Preference Shares

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

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.

Convertible Preference Shares

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

Non-convertible Preference Shares

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

Features of Preference Shares

The following are the important features of the preference shares:

1. **Maturity period:** Normally preference shares have no fixed maturity period except in the case of redeemable preference shares. Preference shares can be redeemable only at the time of the company liquidation.
2. **Residual claims on income:** Preferential shareholders have a residual claim on income. Fixed rate of dividend is payable to the preference shareholders.
3. **Residual claims on assets:** The first preference is given to the preference shareholders at the time of liquidation. If any extra Assets are available that should be distributed to equity shareholder.
4. **Control of Management:** Preference shareholder does not have any voting rights. Hence, they cannot have control over the management of the company.

Advantages of Preference Shares

Preference shares have the following important advantages.

1. **Fixed dividend:** The dividend rate is fixed in the case of preference shares. It is called as fixed income security because it provides a constant rate of income to the investors.
2. **Cumulative dividends:** Preference shares have another advantage which is called cumulative dividends. If 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 shareholders can participate in the surplus profit after distribution to the equity shareholders.
5. **Convertibility:** Convertibility preference shares can be converted into equity shares when the articles of association provide such conversion.

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Disadvantages of Preference Shares

1. **Expensive sources of finance:** Preference shares have high expensive source of finance while compared to equity shares.
2. **No voting right:** Generally preference shareholders do not have any voting rights. Hence they cannot have the control over the management of the company.
3. **Fixed dividend only:** Preference shares can 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 company must pay the dividend for the unprofitable periods 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.

DEFERRED SHARES

Deferred shares also called as founder shares because these shares were normally issued to founders. The shareholders have a preferential right to get dividend before the preference shares and equity shares. According to Companies Act 1956 no public limited company or which is a subsidiary of a public company can issue deferred shares.

These shares were issued to the founder at small denomination to control over the management by the virtue of their voting rights.

NO PAR SHARES

When the shares are having no face value, it is said to be no par shares. The company issues this kind of shares which is divided into a number of specific shares without any specific denomination. The value of shares can be measured by dividing the real net worth of the company with the total number of shares.

$$The\ real\ net\ worth = \frac{\text{Value of no. per share}}{\text{Total no. of shares}}$$

Debentures

A Debenture is a document issued by the company. It is a certificate issued by the company under its seal acknowledging a debt.

According to the Companies Act 1956, "debenture includes debenture stock, bonds and any other securities of a company whether constituting a charge of the assets of the company or not."

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. These types of debentures are 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 kind 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

Features of Debentures

1. **Maturity period:** Debentures consist of long-term fixed maturity period. Normally, debentures consist of 10–20 years maturity period and are repayable with the principle investment at the end of the maturity period.
2. **Residual claims in income:** Debenture holders are eligible to get fixed rate of interest at every end of the accounting period. Debenture holders have priority of claim in income of the company over equity and preference shareholders.
3. **Residual claims on asset:** Debenture holders have priority of claims on Assets of the company over equity and preference shareholders. The Debenture holders may have either specific change on the Assets or floating change of the assets of the company. Specific change of Debenture holders are treated as secured creditors and floating change

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of Debenture holders are treated as unsecured creditors.

4. **No voting rights:** Debenture holders are considered as creditors of the company. Hence they have no voting rights. Debenture holders cannot have the control over the performance of the business concern.
5. **Fixed rate of interest:** Debentures yield fixed rate of interest till the maturity period. Hence the business will not affect the yield of the 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 applies 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

Debenture finance consists of the following major disadvantages:

1. **Fixed rate of interest:** Debenture consists of fixed rate of interest payable to securities. Even though the company is unable to earn profit, they have to pay the fixed rate of interest to debenture holders; hence, it is not suitable to those company earnings which fluctuate considerably.
2. **No voting rights:** Debenture holders do not have any voting rights. Hence, they cannot have the control 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 in the surplus profits of the company.
4. **High risk:** Every additional issue 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.

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