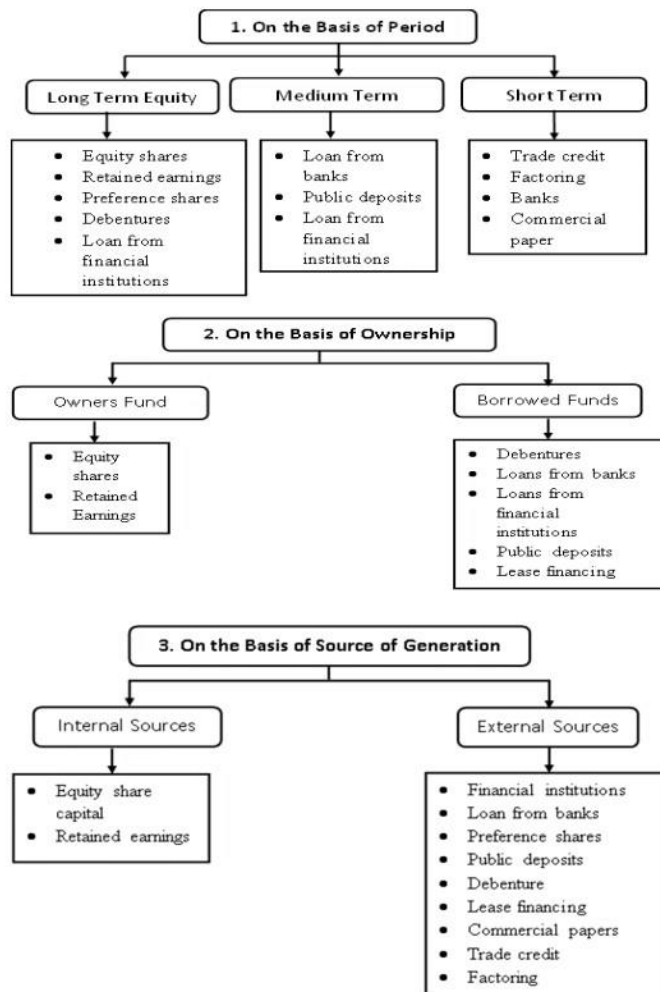


Sources of Finance

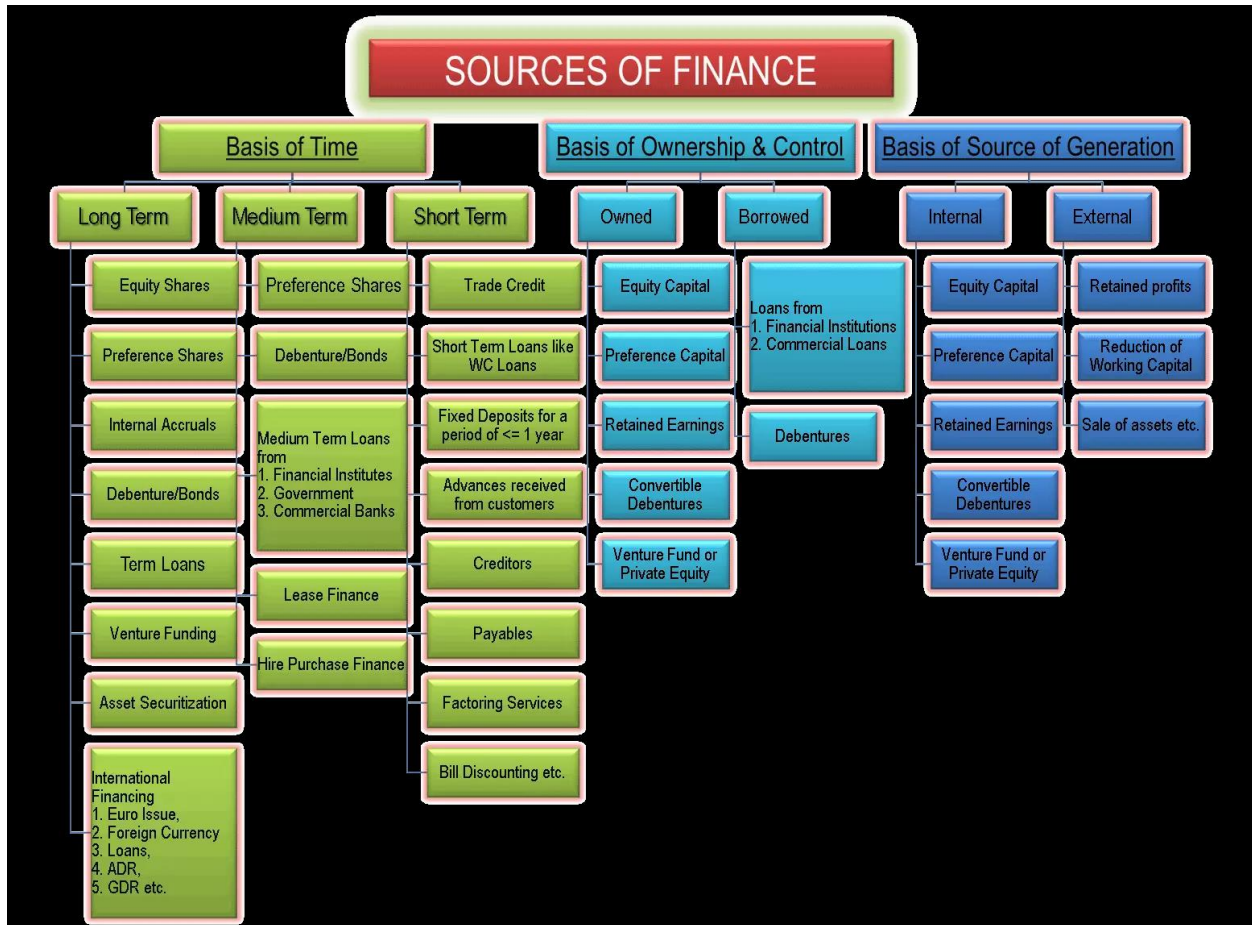
Sources of finance for business are equity, debt, debentures, retained earnings, term loans, working capital loans, letter of credit, euro issue, venture funding etc. These sources of funds are used in different situations. They are classified based on time period, ownership and control, and their source of generation. It is ideal to evaluate each source of capital before opting for it.

Sources of capital are the most explorable area especially for the entrepreneurs who are about to start a new business. It is perhaps the toughest part of all the efforts. There are various capital sources, we can classify based on different parameters. Having known that there are many alternatives to finance or capital, a company can choose from. Choosing the right source and the right mix of finance is a key challenge for every finance manager. The process of selecting the right source of finance involves in-depth analysis of every source of fund. For analyzing and comparing the sources, it needs the understanding of all the characteristics of the financing sources. There are many characteristics based on which sources of finance are classified.



Based on a time period, sources are classified as long-term, medium term, and short term. Ownership and control classify sources of finance into owned and borrowed capital. Internal

sources and external sources are the two sources of generation of capital. All the sources have different characteristics to suit different types of requirements. Let's understand them in a little depth.



According to Time Period

Sources of financing a business are classified based on the time period for which the money is required. The time period is commonly classified into the following three:

LONG TERM SOURCES OF FINANCE / FUNDS	MEDIUM TERM SOURCES OF FINANCE / FUNDS	SHORT TERM SOURCES OF FINANCE / FUNDS
Share Capital or Equity Shares	Preference Capital or Preference Shares	Trade Credit
Preference Capital or Preference Shares	Debenture / Bonds	Factoring Services
Retained Earnings or Internal Accruals	Lease Finance	Bill Discounting etc.
Debenture / Bonds	Hire Purchase Finance	Advances received from customers
Term Loans from Financial Institutes, Government, and Commercial Banks	Medium Term Loans from Financial Institutes, Government, and Commercial Banks	Short Term Loans like Working Capital Loans from Commercial Banks

Venture Funding		Fixed Deposits (<1 Year)
Asset Securitization		Receivables and Payables
International Financing by way of Euro Issue, Foreign Currency Loans, ADR, GDR etc.		

Long-Term Sources of Finance

Long-term financing means capital requirements for a period of more than 5 years to 10, 15, 20 years or maybe more depending on other factors. Capital expenditures in fixed assets like plant and machinery, land and building, etc of business are funded using long-term sources of finance. Part of working capital which permanently stays with the business is also financed with long-term sources of funds. Long-term financing sources can be in the form of any of them:

- Share Capital or Equity Shares
- Preference Capital or Preference Shares
- Retained Earnings or Internal Accruals
- Debenture / Bonds
- Term Loans from Financial Institutes, Government, and Commercial Banks
- Venture Funding
- Asset Securitization
- International Financing by way of Euro Issue, Foreign Currency Loans, ADR, GDR, etc.

Medium Term Sources of Finance

Medium term financing means financing for a period of 3 to 5 years and is used generally for two reasons. One, when long-term capital is not available for the time being and second when deferred revenue expenditures like advertisements are made which are to be written off over a period of 3 to 5 years. Medium term financing sources can in the form of one of them:

- Preference Capital or Preference Shares
- Debenture / Bonds
- Medium Term Loans from
- Financial Institutes
- Government, and
- Commercial Banks
- Lease Finance
- Hire Purchase Finance

Short Term Sources of Finance

Short term financing means financing for a period of less than 1 year. The need for short-term finance arises to finance the current assets of a business like an inventory of raw material and finished goods, debtors, minimum cash and bank balance etc. Short-term financing is also named as working capital financing. Short term finances are available in the form of:

- Trade Credit
- Short Term Loans like Working Capital Loans from Commercial Banks
- Fixed Deposits for a period of 1 year or less
- Advances received from customers
- Creditors
- Payables
- Factoring Services
- Bill Discounting etc.

According to Ownership and Control:

Sources of finances are classified based on ownership and control over the business. These two parameters are an important consideration while selecting a source of funds for the business. Whenever we bring in capital, there are two types of costs – one is the interest, and another is sharing ownership and control. Some entrepreneurs may not like to dilute their ownership rights in the business and others may believe in sharing the risk.

OWNED CAPITAL	BORROWED CAPITAL
Equity	Financial institutions,
Preference	Commercial banks or
Retained Earnings	The general public in case of debentures.
Convertible Debentures	
Venture Fund or Private Equity	

Owned Capital

Owned capital also refers to equity. It is sourced from promoters of the company or from the general public by issuing new equity shares. Promoters start the business by bringing in the required money for a startup. Following are the sources of Owned Capital:

- Equity
- Preference
- Retained Earnings
- Convertible Debentures
- Venture Fund or Private Equity

Further, when the business grows and internal accruals like profits of the company are not enough to satisfy financing requirements, the promoters have a choice of selecting ownership capital or non-ownership capital. This decision is up to the promoters. Still, to discuss, certain advantages of equity capital are as follows:

- It is a long-term capital which means it stays permanently with the business.
- There is no burden of paying interest or installments like borrowed capital. So, the risk of bankruptcy also reduces. Businesses in infancy stages prefer equity for this reason.

Borrowed Capital

Borrowed or debt capital is the finance arranged from outside sources. These sources of debt financing include the following:

- Financial institutions,
- Commercial banks or
- The general public in case of debentures

In this type of capital, the borrower has a charge on the assets of the business which means the company will pay the borrower by selling the assets in case of liquidation. Another feature of the borrowed fund is a regular payment of fixed interest and repayment of capital. Certain advantages of borrowing are as follows:

- There is no dilution in ownership and control of the business.
- The cost of borrowed funds is low since it is a deductible expense for taxation purpose which ends up saving on taxes for the company.
- It gives the business the benefit of leverage.

ACCORDING TO SOURCE OF GENERATION:

Based on the source of generation, the following are the **internal and external sources of finance:**

INTERNAL SOURCES	EXTERNAL SOURCES
Retained profits	Equity
Reduction or controlling of working capital	Debt or Debt from Banks
Sale of assets etc.	All others except mentioned in Internal Sources

Internal Sources

The internal source of capital is the one which is generated internally by the business. These are as follows:

- Retained profits
- Reduction or controlling of working capital
- Sale of assets etc.

The internal source of funds has the same characteristics of owned capital. The best part of the internal sourcing of capital is that the business grows by itself and does not depend on outside parties. Disadvantages of both equity and debt are not present in this form of financing. Neither ownership dilutes nor fixed obligation/bankruptcy risk arises.

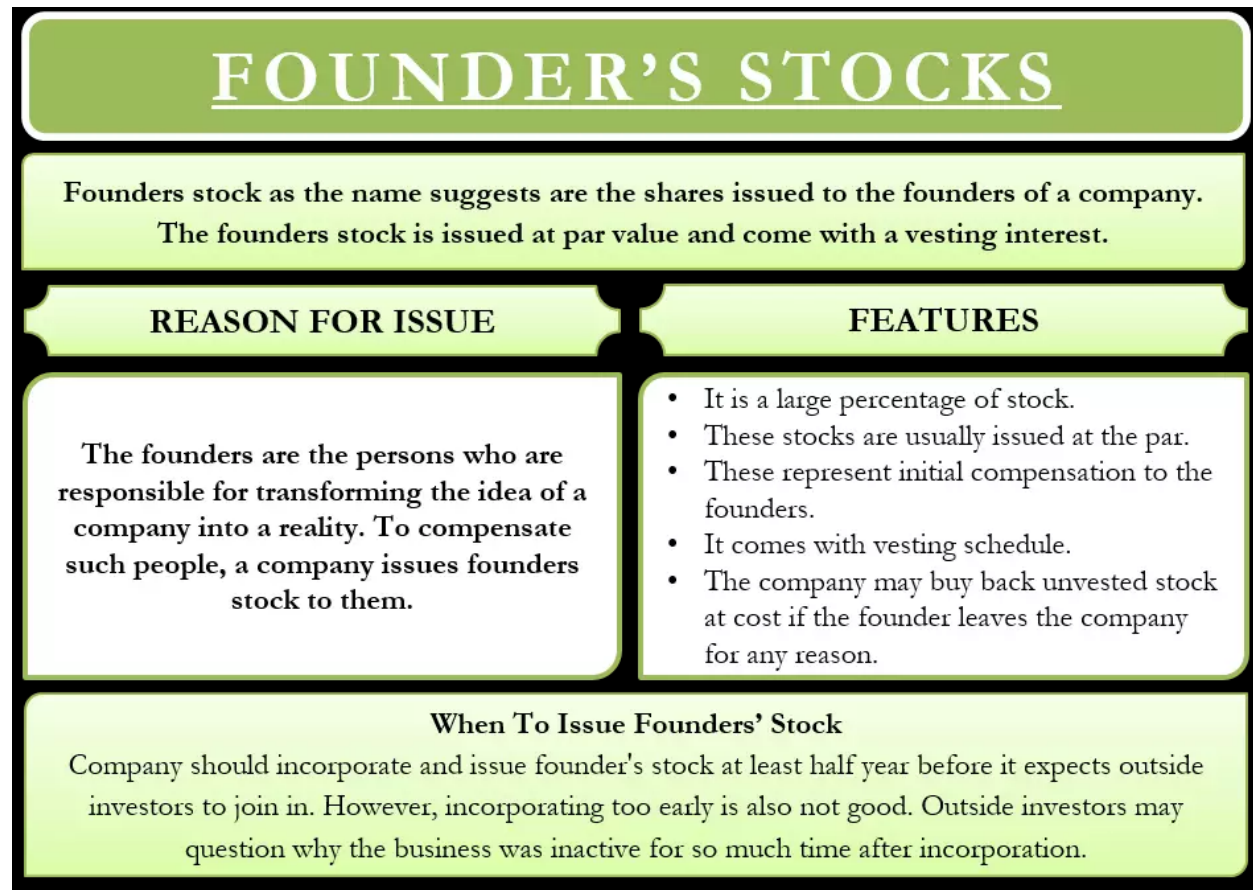
External Sources

An external source of finance is the capital generated from outside the business. Apart from the internal sources of funds, all the sources are external sources.

Deciding the right source of funds is a crucial business decision taken by top-level finance managers. The usage of the wrong source increases the cost of funds which in turn would have a direct impact on the feasibility of the project under concern. Improper match of the type of capital with business requirements may go against the smooth functioning of the business. For instance, if fixed assets, which derive benefits after 2 years, are financed through short-term finances will

create cash flow mismatch after one year and the manager will again have to look for finances and pay the fee for raising capital again.

Founders Stock – Meaning, Features And Importance



Founders Stock – Meaning, Features And Importance

Founders stock as the name suggests are the shares issued to the founders of a company. Apart from founders, it can also refer to the shares given to the early investors in the company. Such shares are not much different from the common stock that trade in the secondary market. The only difference being the founder's stock is issued at par value and come with a vesting interest.

WHY IS FOUNDER'S STOCK ISSUED?

A point to note is that founder's stock is not a legal term. Therefore, one won't find any such things in the corporate code or any other legal document. Rather, the term has come in use to describe the shares given to the early participants in the formation of a company.

Thus, the company's founders could include initial founders, early directors, partners, and first investors. Basically, these are the persons responsible for transforming the idea of a company into a reality. To compensate such people, a company issues founders' stock to them.

As said before, the company issues such shares at a very low value, and each founder gets a significant percentage of shares. A company can do so because when it issues such shares, it hasn't yet started the business.

After the start of the business, a company may give new team members stock with the same characteristics. Such stocks are also often called "founders." However, it gets difficult for a company issues these shares at par. Therefore, after incorporation, companies normally close "founder" class of stock.

FEATURES

- It is generally a large percentage of stock that each individual founder gets.
- A company issues such stocks at a nominal price, usually at the par value.
- These represent the initial compensation to the founders.
- Such stocks come with a vesting schedule.
- A company may buy back unvested stock at cost if the founder leaves the company for any reason.

VESTING

A company usually allocates and commits to founders' stock initially, but the founder doesn't get to own (vest) these shares until a later date. Vesting means the time until founders get to own the stock fully. For instance, if a founder gets shares with a vesting period of five years, it means he or she don't fully own the stock until then.

Companies, mostly startups, place some stock restriction agreements to ensure that individuals don't misuse it or they remain loyal to the company. Restrictions include the time limit after a founder can sell these shares in the market.

Usually, a company sets a vesting schedule for the founder's stock. This allows a company to buy back the shares if the founder leaves the business before his or her shares are fully vested.

Vesting also helps in addressing the free rider problem. This means that if one of the founders plans to leave when the company is still young, he or she does not get any more benefit at the expense of those who are staying with the company. Usually, venture capital or angel investors also ask for vesting restrictions.

DIFFERENT FROM COMMON STOCK

Apart from the fact that a company issues such shares at a very low price, there are more differences between the common stock and founders' stock. These differences are mostly in terms of dividend and other rights.

Such shares receive dividend after paying the common stockholders. However, such shares usually have right to all the profits after paying the dividends to the ordinary shareholders. But this is not always the case.

Whether or not the founder's stock gets the same rights as other common stockholders depends on the agreement between the founder and the company. Some of the exclusive rights that such shares may get are super-voting rights, right of first refusal, lock-up agreement, accelerated vesting upon the sale of the business, and co-sale provision.

Under 'right of first refusal,' a founder must offer his or her shares to the company first before selling it to a third-party. In 'co-sale provision,' the founder gets the right to add their shares if the company is issuing additional common shares. Under super-voting rights, founders get more than one vote per share. This is important if early founders plan to retain control over the company. A "lock-up agreement" limits the sale of the stock for some time after the IPO. The lock-up is usually for 180 days.

A company may include other special clauses as well after the discussion with the founder.

TAX CONCERNS OR WHEN TO ISSUE FOUNDERS' STOCK

Usually, founders don't incorporate a company until an investor or investors start showing real interest in the company. This can result in a significant tax liability if a business is close to getting capital.

For instance, if a company issues founders' stock at \$0.01, and shortly, outside investors get a stake at \$1 per share. An audit may reveal that the founder got the stock well below the fair market value. Thus, the difference in the price may represent an income for the founders' and hence, is taxable.

To avoid such issues, a company should incorporate and issue founder's stock at least half a year before it expects outside investors to join in. However, incorporating too early is also not good. Outside investors may question why the business was inactive for so much time after incorporation.

Leased Asset – Types, Accounting Treatment And More

CAPITAL AND OPERATING LEASE

CAPITAL/FINANCE LEASE

- Lease Term > 75% of useful life of asset.
- Option for lessee to acquire asset at end of lease term at price lower than market value.
- Ownership transfers to the lessee after the end of the lease period.
- Present value of the lease payments > 90% of the FMV of asset at start of lease.

ADVANTAGES OF LEASE

- Operating Lease : Lease Payment is an expense and cleans the balance sheet
- Lessee faces no risk of obsolescence under operating lease.
- Interest expense and depreciation lowers taxable income for lessee.
- If a business leases an asset rather purchasing it, this frees the capital for other investments.

DISADV.

- It may result in the agency cost problem.
- As lessee is not the owner, and thus, may not take enough care of the asset.
- Since the capital lease is a type of debt, it may limit a company's borrowing ability.
- Lease payments lower the net income for the equity holders.

Accounting Treatment

Capital lease affects the lessee's financial statements, including interest expense, depreciation expense, assets, and liabilities.

Operating lease does not have any effect on the balance sheet of a company.

Leased Asset – Types, Accounting Treatment and More

A Leased Asset is an asset that is leased by the owner to another party in return of money or any other favor. While leasing an asset, the owner enters into a contract allowing the other party the temporary use of an asset.

CAPITAL LEASE AND OPERATING LEASE

In terms of accounting, one can lease an asset in two ways – Capital Lease and Operating Lease. The difference between the two is on the basis of whether or not the risk and reward with the asset are transferred to the lessor or not.

If lessor gets the risks and rewards as well, it is a Capital lease or Financing lease under IFRS Standard. A lease qualifies as a capital lease if it meets any of the following conditions:

- Lease term must be greater than 75% of the useful life of the asset.
- There is an option for a lessee to acquire the asset at the end of the lease term at a price lower than the market value.

- Ownership transfers to the lessee after the end of the lease period.
- The present value of the lease payments is greater than 90% of the fair market value of the asset at the start of the lease.

All other types of the lease come under operating lease and are the same as a rent contract between a landlord and renter.

ACCOUNTING TREATMENT OF LEASED ASSET

CAPITAL LEASE

Though capital lease is a type of rental agreement, GAAP treats it as a purchase of assets if it meets certain conditions. Moreover, capital lease affects the lessee's financial statements, including interest expense, depreciation expense, assets, and liabilities.

A capital lease is a type of loan, and thus, the lease payment comes in the income statement. The lease payments also include interest, and the lessee needs to record it separately. For instance, if in a lease payment of \$1000, \$200 is for the interest expense, then \$800 would be a debit to the capital lease liability account and \$200 to the interest account. The accounts payable account gets a full credit of \$1000.

Lessee also needs to calculate the present value of all lease payments. This value is the recorded cost of the asset, and must be debited to the appropriate fixed asset account, and credited to the capital lease liability account. In the balance sheet, the present market value of the leased asset comes under the asset side.

Under a capital lease, the lessee must record the depreciation in a usual way. For instance, if an asset costs \$100000, no salvage value and useful life of ten years, then the annual depreciation on Straight-line basis will be \$10000.

If the leased asset is disposed of, the fixed asset account is credited, and the depreciation account is debited. This helps in eliminating the balances in these accounts. And, if there is a difference between the sale price and the net carrying amount of the asset, it is the profit or loss. This profit or loss from the disposal of the leased asset is recorded in the same period when the asset was disposed of.

OPERATING LEASE

Operating lease does not have any effect on the balance sheet of a company. They are short-term leasing of an asset and are similar to any renting contract. The regular lease payments are operating expenses, and thus, come under the income statement. Since the lessee does not get any ownership rights, the asset does not appear in the balance sheet. Thus, the lessee does not charge any depreciation.

CAPITAL AND OPERATING LEASE

CAPITAL/FINANCE LEASE

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- If a business leases an asset rather purchasing it, this frees the capital for other investments.

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Accounting Treatment

Capital lease affects the lessee's financial statements, including interest expense, depreciation expense, assets, and liabilities.

Operating lease does not have any effect on the balance sheet of a company.

ADVANTAGES

- In case of an operating lease, the company creates an expense and not a liability. This helps it to keep its balance sheet clean. That is why an operating lease is "off-balance sheet financing".
- Lessee faces no risk of obsolescence under operating lease as there is no transfer of ownership.
- Interest expense and depreciation lower taxable income for the lessee.
- Since cash outflow or lease payments are spread over several years, this lowers the burden of making one-time significant cash payment.
- If a business leases an asset rather purchasing it, this frees the capital for other investments.
- Lease expenses remain constant over the lease tenor or grow in line with the inflation. This helps a business to accurately plan cash outflows.
- Leasing is a good option for startups as it means lower capital requirements.

DISADVANTAGES

- A big disadvantage of leasing is that it may result in the agency cost problem. Since lessor transfers all rights to a lessee for a specific time, the lessee is free to use the asset the way

he or she likes, and this result in a moral hazard issue. As lessee is not the owner, and thus, may not take enough care of the asset. This separation between the ownership and the control of the asset is known as the agency cost of leasing.

- Since the capital lease is a type of debt, it may limit a company's borrowing ability.
- Lease payments lower the net income for the equity holders.

Bullet Loan

A bullet loan is a short-term financing option, with a single lump sum payment at the end of the loan's maturity term. Therefore, it is also called as "balloon loan". All types of customers – especially the ones dealing with land contracts or real estate developments can avail a bullet loan. Bullet loans are classified as mortgage, note, bonds or other types of credit instruments. Further, a bullet loan has a fixed or floating rate of interest. Typically, it will charge a higher rate of interest when compared to the standard loans

HOW DOES A BULLET LOAN WORK?

A borrower of the bullet loan is approved a maximum principal amount determined on the basis of repayment capability. The structure of the loan can be designed in different ways, depending upon the customer's repayment attitude or payment conditions. The borrower can repay the loan in a single or regular interest payment mode. The regular payment mode is like monthly, annually or yearly reducing the lump sum money at the maturity.

A lump-sum bullet loan includes accrual of interest as per the loan's term like monthly, annually and so on. It enables the borrower to make an entire payment on maturity. However, the borrower has the option to make regular interest payments, and eventually reduce payoffs at the time of maturity.

The latter is quite beneficial for the individual wherein the borrower expects a huge cash inflow, such as bonus or fixed returns. Apart from this, a periodic payment also lowers the financial burden at the time of repayment.

EXAMPLE:

Suppose you take a loan of amount \$1,900 and repay it back in a year at an interest of 10% annual compounding. In the case of bullet loan, the person will pay \$2,090 (\$1,900 as principal plus \$190 as interest) in a single payment mode.

BULLET LOANS

A bullet loan is a short-term financing option, with a single lump sum payment at the end of the loan's maturity term. Therefore, also called as "balloon loan".

ADVANTAGES

- Provides flexibility to the Borrower
- This loan is advantageous to the company which has a short-term cash flow problem.
- Availed by those who are short of money.
- There is an option wherein paying the interest monthly or yearly
- It is quite good for new business entities

DIS ADVANTAGES

- It involves a risk factor as it involves heavy payment at the end.
- This loan may incur a huge lump-sum interest payment at the end of maturity.
- It comes with a high rate of interest
- The loan may require refinancing

PAYMENT TYPES OF BULLET LOANS

In the US, the contract provisions that apply to the loan must state the payment of bullet loan to have "Truth-in-Lending". The consumer should be informed of all charges, terms, and costs on a loan. This is the stipulation under this law.

This is done so to make the borrower aware of his obligation as he may fall short of funds to make the repayment of the loan at the maturity. A two-step payment plan is used here under which the borrower can avail a reset option to reset the loan using current market rates and use amortizing payment mode. This option can be availed only if the borrower is still the owner with not less than 30 days late payment in the preceding 12 months and has no loans against the property.

On the other side, in the plan without the reset option, there might be an expectation that either the borrower has sold the property or refinanced it by the end of the maturity. This clearly involves the existence of refinancing risk in this kind of bullet loan repayment.

Further, in the US, the Federal National Mortgage Association features such loan or mortgage payments based on a 30-year amortization.

ADVANTAGES OF BULLET LOAN

- Bullet loan provides flexibility to the borrower especially, the real-estate developers
- The loan is advantageous for a company that has a short-term cash flow problem
- People who are short of money and expecting to receive money in the near term can avail it

- Bullet loans come with an option wherein paying the interest monthly or yearly reduces the financial burden on the borrower at the time of repayment of the loan.
- The bullet loan is quite good for new business entities as it provides flexibility to borrow cash as and when needed.

DISADVANTAGES OF BULLET LOAN

- The bullet loan involves a risk factor as it involves heavy payment at the end, the borrower may not have done preparations to repay the loan in one go
- The loan may incur a huge lump-sum interest payment at the end of maturity
- Bullet loan comes with a high rate of interest
- The loan may require refinancing and the borrower may end up incurring more closing tasks

REFINANCE BY SELLING

Further, people use bullet loan for buying a residential property and avoid high installments payment. However, it only works if the price of the property rises. At the maturity, they can sell off the property that would worth more or may refinance it.

On the contrary, if the property prices drop, this results in making borrowers suffer during the financial global crisis term. During this time the borrowers could not sell the property due to lower prices but would have used the profit to meet the bullet loan payment.

CONCLUSION

Bullet loans are a useful tool for businesses on short-term liquidity crunch, but banks require a high Loan-to-Value ratio. Value of the asset should cover the loan amount by a good margin. Loan-to-Value is defined this. Usually, in a bullet loan, banks require 75% of the loan to be covered by the asset value. This is so they can sell it and get repaid in case of delays in payment.¹⁻⁵

Angel Investors

Angel Investors are one of the easiest sources of financing for new entrepreneurs. These can be known or unknown people to the entrepreneur, but they are driven by the lure of returns later which makes them invest in the early stages of the business.

WHO IS AN ANGEL INVESTOR?

An angel investor is typically an individual or a high worth individual investor who provides funding or financial support for start-ups in lieu of a stake in ownership in the company. They are usually among the family or relatives of the entrepreneur. Angel investor also designated as a business angel, informal investor, angel funder or a private investor who invests between \$25,000-\$500,000 in the start-ups. At the initial startup stage, most investors and banks are hesitant to invest due to the high unforeseen failure risk.

ANGEL INVESTOR INVOLVEMENT

Apart from investing money, angel investors share their knowledge at the critical stages. They help the startups take their initial steps. Most of the angel investors are executives or they have well-versed industry experience.

Contrary to the popular belief that an angel investor is a high net worth individual, most of them are not even millionaires. Typically, they earn \$50,000 to \$100,000 a per annum.

In recent times, there has been a huge spike in the number of angel investors and one of the reasons being angel investors are not solely motivated by the pure monetary returns. Angels look forward to a founder who has a drive and passion for his business to tap the huge market opportunity that they have identified. They aim to mentor and financially support another generation of entrepreneurs and make use of their experience and network that can increase the likelihood of start-up enterprises to survive.

ANGEL INVESTORS

- ❖ An angel investor is typically an individual or a high worth individual investor who provides funding or financial support for start-ups in lieu of a stake in ownership in the company.
- ❖ They are usually among the family or relatives of the entrepreneur.
- ❖ Apart from investing money, angel investors share their knowledge at the critical stages.

ADVANTAGES	IMPORTANCE
<ul style="list-style-type: none"> • Financing from angel investment is much less risky than taking loans. • Capital needs are met by angels • Generate large number of jobs • Reinvests the return • Angels bring portfolio expertise such as business acumen, vertical expertise, director service etc. • Angel-funded firms are likely to survive at least four years • Angels do not demand high monthly fees 	<ul style="list-style-type: none"> ✓ Plays vital role in development of economy. ✓ More focused on commitment and passion of the founders ✓ They provide loans on relatively easier interest rates, unlike venture capital. ✓ They make a prominent difference with a startup's success and failure. ✓ They also look for defined exit strategy or acquisitions or initial public offerings (IPOs).

CONS	Typical Sources of Angel Investment includes :
<ul style="list-style-type: none"> ▪ There is a loss of complete control as an owner. ▪ It is quite hard to find a suitable angel investor ▪ They provides less structural support than an investing company. ▪ Angels rarely make follow on the investments ▪ There is a possibility of malpractices in angel investing. 	<ul style="list-style-type: none"> • Family and Friends, • Wealth of Individuals, • Groups and • Crowd funding.

IMPORTANCE OF ANGEL FINANCING

- An Angel investor plays a vital role in the development of the economy by providing the risk capital which contributes to the economic growth and technological advances.
- They are more focused on the commitment and passion of the founders and the larger market opportunities that they have identified.
- Early financing of the start-ups to some extent has become more dependent on angel investors, as they provide loans on relatively easier interest rates, unlike venture capital. The venture capital funds demand aggressive revenue growth quickly and are not able to accommodate many small deals. The traditional source of start-up and early-stage financing-bank lending is limited due to its risk level and handling costs.
- Angel investors make a prominent difference with a startup's success as well as its failure. Most of the times, they are the first and foremost investors.
- Further, professional angel investors look for defined exit strategy or acquisitions or initial public offerings (IPOs). Due to the least interest in giving their money back or generate any return
- The effective internal rate of return for a successful portfolio investor ranges from 20% to 30%. This is beneficial for the investors and for entrepreneurs, who are the primary sources of financing. Hence makes angel investment perfect for entrepreneurs who are financially struggling during the initial phase of their business.

ADVANTAGES OF ANGEL INVESTING

- One of the biggest advantages of the angel investor is that financing from angel investment is much less risky than taking loans. Unlike loans, investment capital does not have to be paid back even if the business fails.
- Capital needs of startups can be met by angels
- Angel-funded companies generate a large number of jobs.
- Often angels reinvest the returns from the portfolio.
- The wealth created out of angel investing is spawning in a greater number of companies.
- Angels bring portfolio expertise such as business acumen, vertical expertise, director service, and financial experience
- They differentiate between job creation and wealth creation
- Angel-funded firms are likely to survive at least four years and raise additional financing outside the angel group.
- These firms are to showcase improved venture performance and growth in web site traffic and web site rankings. This improved gain ranges from 30 to 50%.
- Angels do not demand high monthly fees and are located practically in all industries
- Further, angels can bring vast knowledge and experience to a new company.

DISADVANTAGES OF ANGEL INVESTING

- The primary disadvantage of using angel investors is the loss of complete control as an owner.
- If compared to venture capital, it is quite hard to find a suitable angel investor

- Business Angel provides less structural support than an investing company.
- Angels rarely make follow on the investments
- Further, there is a possibility of malpractices in angel investing as well.

TYPICAL SOURCES OF ANGEL INVESTORS

FAMILY AND FRIENDS

One of the most common sources of funding to generate instant capital is family and friends. New business ventures might have the risk of failure, leaving an impact on those who have invested in the business. The risk associated with the business is quite necessary to be upfront.

WEALTHY INDIVIDUALS

It includes individuals like doctors, lawyers, and others that have a net worth and are willing to invest around \$500,000 in return for equity. This process can be done verbally through local chambers of commerce and the likes.

GROUPS

Angels operate as part of an angel syndicate (a group of angel investors) that accordingly raises its potential investment level. The investment option where funds are to be invested is chosen by professional syndicate team.

CROWDFUNDING

It is a form of an online investing group., Crowdfunding involves raising funds from large groups of individuals, who invest amounts as small as \$1,000.

It is very important for entrepreneurs to think before accepting an angel investment. Qualities and benefits that it is bringing to the table besides money, such as expertise in business, contacts, managerial skills. It's also important to have a comprehensive business plan in place. As a small business, you'll need it in order to secure financing from lenders or investors.

Also, an angel can be a wise addition to your business decisions. They can help increase your market and become a sounding board for your ideas. Finding the appropriate angel at the right stage of the business can make a world of difference to your business.

Debenture Example

Debenture Example

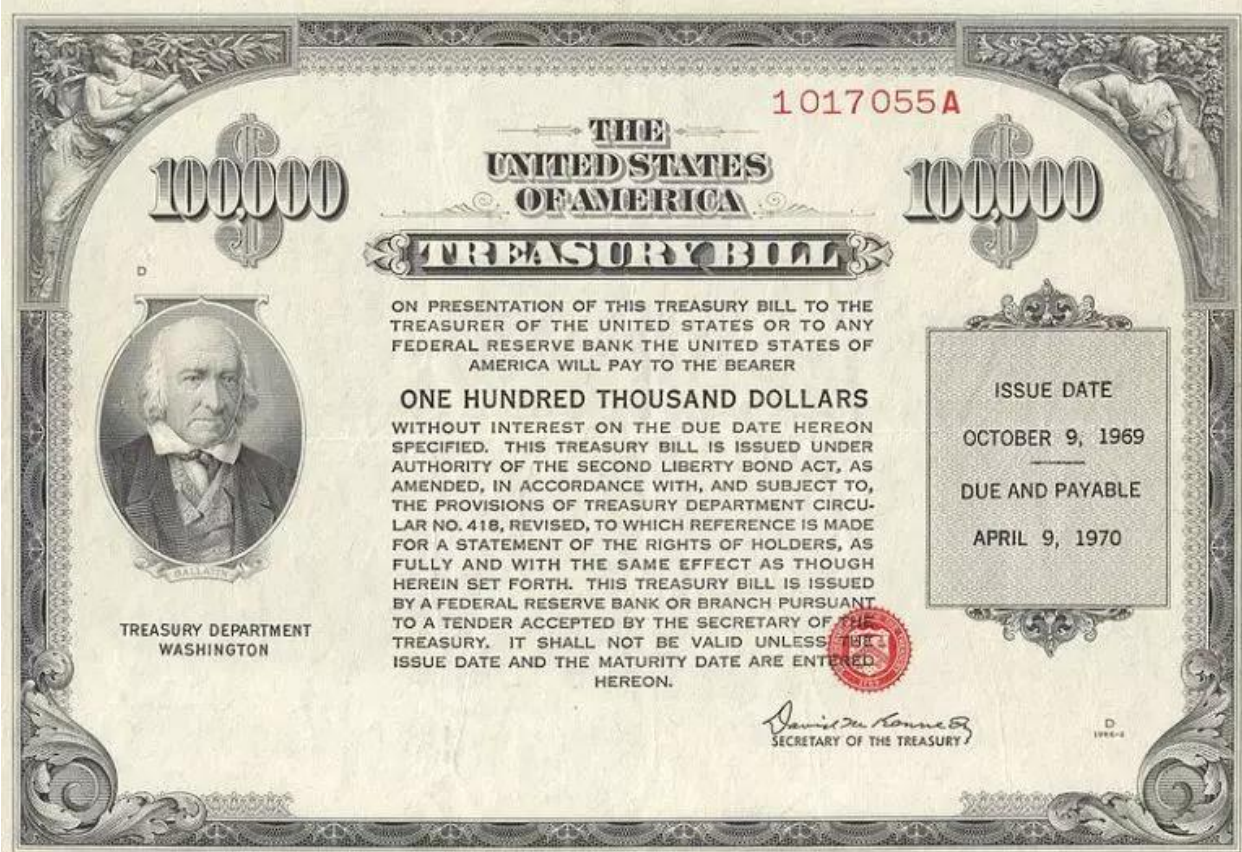
GOVERNMENT-ISSUED DEBENTURE EXAMPLE

Treasury bond or T-bond issued by the government would be a debenture example. These bonds help the government to finance its projects and to fund the day to day working operations. The Treasury Department of a Country issues these bonds throughout the year by the way of auctions.

The few Treasury bonds are traded in the secondary market. The financial institutions and the broker play a role in buying and selling of the debentures in the secondary market. The investor buys and sells the formerly issued debenture through these brokers and financial institutions. The

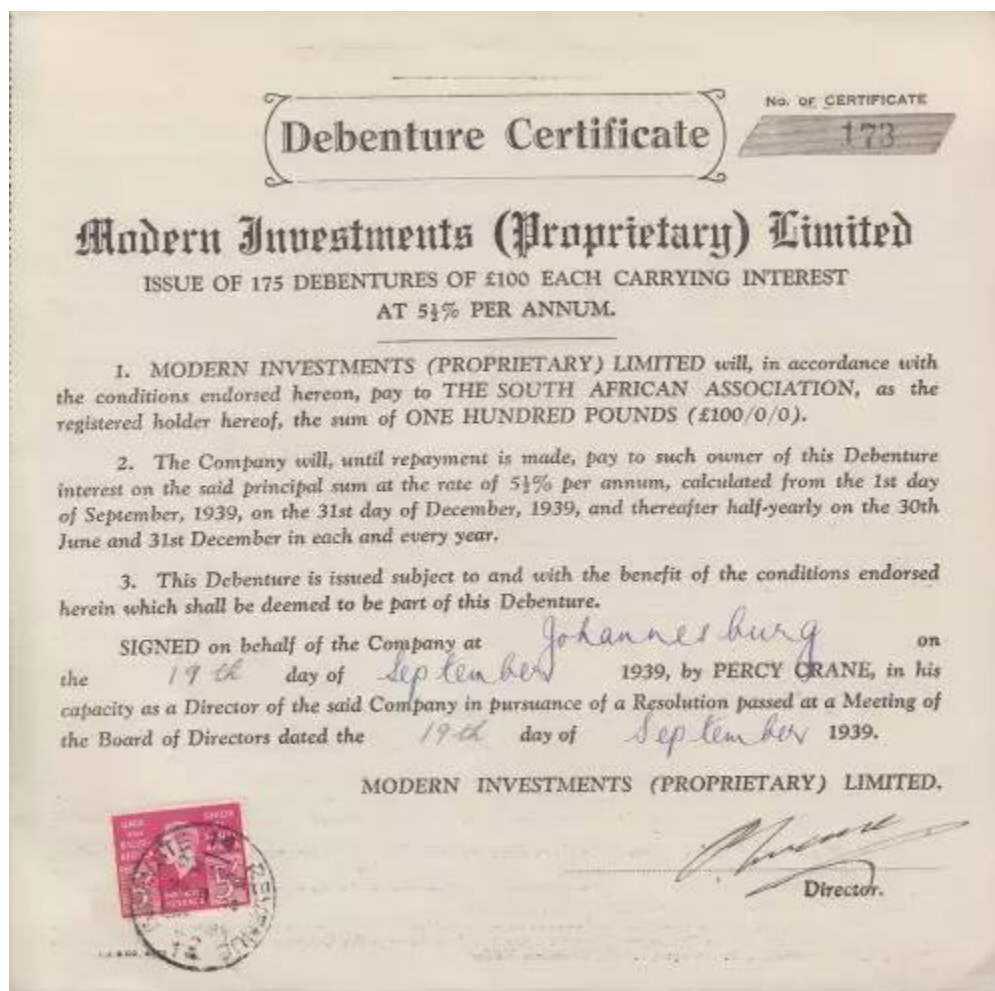
T-Bills that are issued by the Government are nearly risk-free as they are backed by the faith and credit of the Government of the Country. But, these debentures face the risks of inflation and rise in interest rate.

The picture below shows the Treasury bill the Government has issued



The above picture shows the principal amount i.e. One Hundred Thousand Dollars. The date of issue is October 9, 1969, and the due date or we call maturity date when the principal amount will be paid to the holder is April 9, 1970. This makes the maturity period of this bill is of 6 months. There is no interest to be paid on these bills at the time of maturity. These bills are only valid when the date of issue and maturity are specified.

COMPANY ISSUED DEBENTURE EXAMPLE



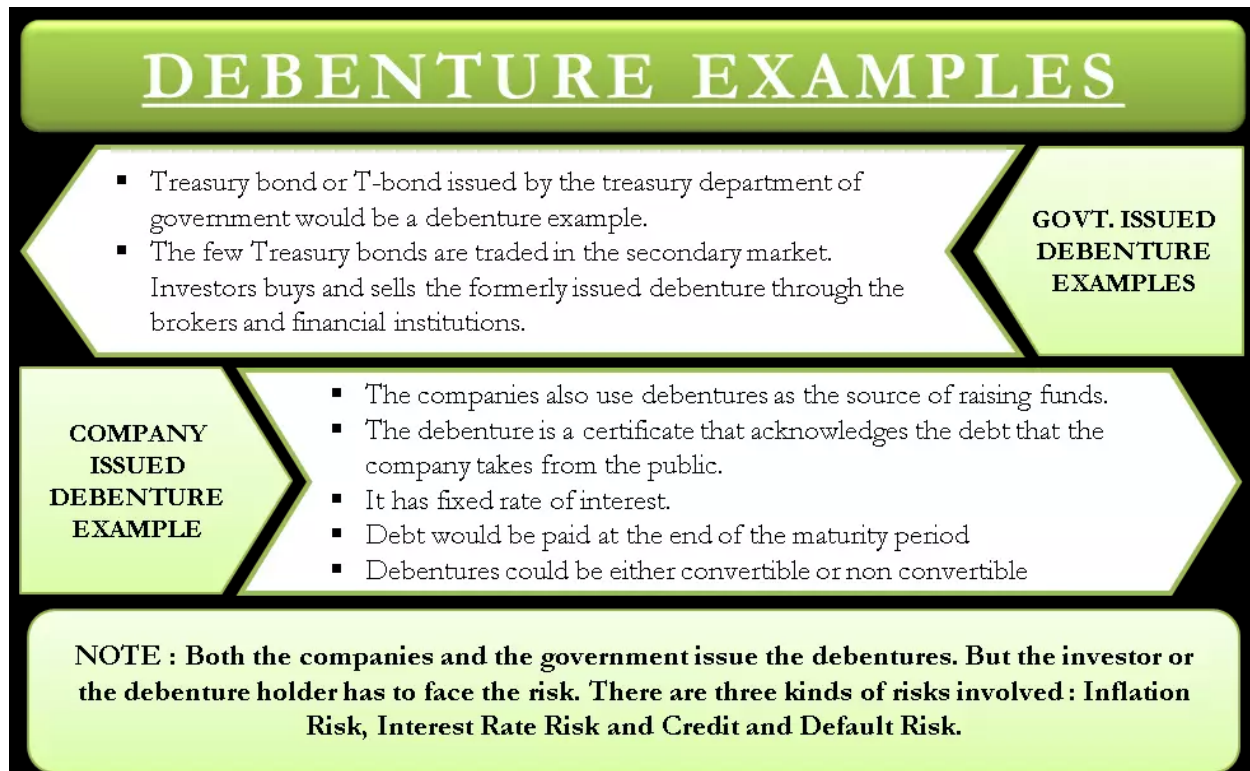
The companies also use debentures as the source of raising funds. The debenture is a certificate that acknowledges the debt that the company takes from the public. The funds that the company raises through debentures have a fixed rate of interest. The company has to repay the debt at the end of the specific time period. The debenture that the company issue can be the Non-Convertible Debentures (NCD) and Convertible Debentures.

The picture below Show Company issued a debenture example.

The picture shows the certificate of debenture issued by the Modern Investment (Proprietary) Ltd. This debenture example shows us how a debenture certificate that the company issues to its debenture holders. This certificate shows the Number of debentures (175), the rate per debenture (\$100), and rate of interest (5.5% per annum).

Along with it gives information about all the necessary information regarding issued debentures. The certificate has the seal of the company. The date of issue is also specified. The rate and period when the debentures holders will receive the interest are also specified (i.e. half-yearly).

There are various other debenture examples like NCDs (non-convertible debentures). The name of the debenture depends upon the company which has issued it. But the features of all the debentures are somewhat the same.



DEBENTURE RISKS TO INVESTORS

Both the companies and the government issue the debentures as and when they require. But the investor or the debenture holder must face the risk.

INFLATION RISK

The risk can be of inflation. Here, the inflation risk is when the interest rate that is paid to the investor does not keep with the rise in the rate of inflation. Say, the inflation rises by 4% and the interest rate on a debenture is 3%. The investor is very well going to be in loss.

INTEREST RATE RISK

There is another risk of the interest rate. Here, the investor holds the debts during the time of rising interest rates in the market. The investor finds himself getting less return on his investment as compared to the other investments that are paying high return in current market situations. Therefore, the investor will earn a lower yield in comparison to other investors (playing in current market situations).

CREDIT AND DEFAULT RISK

Further, the debentures also carry credit and default risk. As we know that the debentures are as secure as the financial strength of the issuer. If a company is struggling financially, whether due to internal reasons or because of macroeconomic factors, the investors are at the risk of default.

The only consolation, in this case, is that the debenture holders have a right to be paid before the common stock holders in case of bankruptcy.

Long Term Debt – Types, Benefits, Disadvantages And More

Long Term Debt – Types, Benefits, Disadvantages and More

Long Term Debt or LTD is a loan that is held beyond 12 months or more. In the Balance Sheet, companies classify long term debt as a non-current liability. Such type of loans can have a maturity date of anywhere between 12 months to 30+ years.

Usually, the capital-intensive industries who want to maintain a balance between their equity and debt go for a long-term debt for raising money. Assessing the long-term debt helps in understanding the financial health of a company.

DIFFERENT TYPES OF LONG-TERM DEBT

BONDS

These instruments are publicly tradable securities and carry a maturity of over twelve months. Bonds come with fixed maturity time such as a 10-year bond, 20-year bond, 30-year bond and more. There are so many categories of bonds such as puttable, callable, convertible, non-convertible, high yield bonds and investment grade bonds.

BANK DEBT

Any loan that comes from a bank or any other financial institutions comes under bank debt. Unlike bonds, these loans are not tradable or transferable.

MORTGAGES

To draw such loans, the company needs to put something as collateral such as real estate, buildings or land.

DEBENTURES

It is a type of debt that is not backed by any specific assets. Therefore, it comes below other types of debt in terms of priority of repayment.

LONG TERM DEBT : TYPE, BENEFIT AND DISADVANTAGES

Long Term Debt (LTD) is a loan that is held beyond 12 months or more. These are classified in the Balance Sheet as Non Current Liabilities.

IMPACT !!

- LTD comes under the Non Current Liabilities head (it may be clubbed or shown as a single line item).
- Interest on LTD is an expenses and therefore shall be debited to P&L A/c.
- Current Portion of LTD comes under Current Liabilities.

BENEFITS

- Long term debts give the organization immediate access to funds without worrying for paying it in the short term.
- The Companies have the option to structure the debt that way.
- Interest expense helps to bring down the taxable income and hence the company to pay less tax.
- The real reason behind companies preferring such debt is to take advantage of financial leveraging.

TYPES OF LTD

- ❖ **Bond** : These instruments are publically tradable securities and carry a maturity of over twelve months.
- ❖ **Bank Debt** : Any loan that comes from a bank or any other financial institutions
- ❖ **Mortgage** : To draw such loans, the company needs to put something as collateral such as real estate, buildings or land.
- ❖ **Debentures** : It is a type of debt that is not backed by any specific assets. It has priority over payment (like other debts)

DISADVANTAGES

- A company should not be overly dependent on debts because one has to pay it eventually. (Principal and interest)
- Equity is a safer option for the reason that it is not mandatory for a company to pay dividends.

ACCOUNTING TREATMENT

As we said before LTD comes in the balance sheet and is a non-current liability. A company can club all its long-term debts into a one line-item, and then list different types of debt under it. Or, the company can list each LTD as separate item. Both the treatments are correct, and a company may go for either of the two depending on its accounting policies.

Interest that a company pays on loan is an expense, and thus, comes in the profit and loss account. In the books of the companies, there is an item called “current portion of long-term debt.” While raising the money through debt, a company must pay some portion of the debt every year until the principal amount is paid in full.

The entire debt might be long term in nature, but the portion that the company pays in the current year does not fall under the long-term debt. This amount comes under the current liabilities as “current portion of the long-term debt.”

BENEFITS OF LONG-TERM DEBT

Every company needs funds to run its day-to-day business, buy fixed assets and for other business activities. Long term debts give the organization immediate access to funds without worrying for paying it in the short term. The borrower only has to make the payment of the current portion. In case, a company wants only a portion of total debt currently, they have the option to structure the debt that way. This way the company receives the debt as and when they need.

Interest that the borrower pays on the debt is taken as expense in the income statement. Therefore, it helps to bring down the taxable income. Such an arrangement helps the company to pay less tax. Reducing taxable income is never a primary aim of the company while taking the long-term debt. A company can also do so by increasing any other expense. The real reason behind companies preferring such debt is to take advantage of financial leveraging.

FINANCIAL LEVERAGE AND LTD

Financial Leverage helps a company in increasing its earnings because such LTD carries a fixed cost. Also, the interest payment is usually lower than the earnings that a company expects from the asset. Thus, companies prefer to have some portion of their total capital in the form of debt.

Use of financial leverage to buy assets or fund growth amplifies the earnings potential of a company. For instance, if a company buys an asset using LTD, and it generates more return than the interest on the LTD. In such a case, the value of asset and company would increase.

Let's understand this with the help of an example. Suppose Company A buys land for \$50000 using its own capital. Company B buys the same land using \$30000 (@10%) LTD and \$20000 own cash.

After one year, Company A sells the land at \$60000, i.e., at a profit of \$10000 or 20% on an investment of \$50000.

Company B also sells it for \$60000. Its total profit will be \$7000 (\$10000 – \$3000 interest). Return on investment, in this case, is 35% (\$7000/\$20000 own cash).

This proves that the use of financial leverage boosts the earnings.

DISADVANTAGES OF LTD

Too much of anything is bad and the same goes for the LTD. A company should not be overly dependent on the debts because one must pay it eventually. Not just the principal amount, but the company must pay the periodic interest as well.

Equity is a safer option for the reason that it is not mandatory for a company to pay dividends. However, if a company is issuing debt then interest payment is mandatory.

LTD – WHAT IT MEANS FOR INVESTORS?

While investing in a company, an investor should always keep a check on the debt to equity ratio of the company. Further, investors should keep track of the changing debt structure of a company.

Every time, a company issues new debt, investors should know the exact purpose. For instance, investors should examine if the new debt is for paying another, buy new assets, buy back shares or just to fund the operating expenses. Taking a loan for funding growth or buy back shares is in the interest of the investors.

On the other hand, going for a loan just to fund operating expenses or pay another loan should ring warning bells for the investors. It could mean that the company is having issues with the cash flows.

Moreover, investors must be aware of the industry standards when it comes to capital structure. For instance, manufacturing companies raise more capital in the form of debt to buy plant and equipment. Similarly, asset-heavy industries, such as steel and the telecommunication have relatively more debt on their balance sheet.

FINAL WORDS

A company must always aim for the optimal debt structure. An organization should know their capacity, the growth target of the business every year and consider other aspects before bulking up the debt. Also, the company should be extra careful and ensure that the principal and interest amount do not impact the cash flow considerably.

IPO Process

An IPO Process brings a private company on the platter to potential investors. There are various differences between private and public companies and the owners and management of the company have to look into various aspects such as the scale of business and potential to grow. Equity Financing is an intricate and essential part of a company to grow. To achieve a scale from a startup / mid-tier level to come to the level of an IPO is a milestone.

WHAT IS IPO?

IPO is a short term for “*Initial public offerings*”. It is a process by which a company goes public from private. The company sells its shares to the general mass under this process. IPO is a sign of financial stability and prosperity of a company. Going through this process gains the prestige of listing in NASDAQ OR NYSE. A company generally go for this step to raise funds for various needs of the company, like infrastructural investments, buying of new assets et cetera.

This process ranges from 4 to 6 months. All you need is make your company financially strong and stable enough and then make your way through the process it includes. Below mentioned is the process of Initial Public Offerings.

IPO PROCEDURE

IPO is a short term for “Initial public offerings”. It is a process by which a company goes public from private. The company sells its shares to the general mass under this process.

The first step in any IPO Process is selection of an investment banker. It assist you as well as provide you with underwriting.

Investment Bank

Documentation

The next step is of due diligence and regulatory filings. Underwritings include : Engagement Letter, Letter of Intent, Underwriting agreement.

Prior to the final registration of IPO, the company is required to provide all the needed information to the underwriter.

Registration Process

Pricing

In this part, the company along with the underwriter decides the price at which the share of the company would be sold. They decide the selling of total shares.

The underwriter creates a profitable market for the company and also aid it in case of any imbalances by purchasing the shares

Stabilization

Evaluation

In this process, the underwriter estimates and provides the company with the valuation of the IPO done

IPO PROCESS

Following are the mandatory process for a company to go public:

SELECTION OF AN INVESTMENT BANK

This is the primary step in the IPO process. Although a company can sell its shares on its own rarely it will result effectively. Hiring an investment bank in this regard is highly recommended. You need it for basically 2 purposes, i.e. assisting you and providing you with an underwriting (essential for IPO). You can seek the help of corporate finance in this matter.

It's well and good if you have a tie-up with an investment bank. But if you want to go for a fresh tie-up with an investment bank then generally the criteria looked upon to choose a bank are- Bank's ratings and reviews, the capability of bank to fulfill your needs, the expert's bank has in this regard, to mention a few.

DOCUMENTATION

After hiring an investment bank, the next step is of the due diligence and regulatory filings. There are 3 ways in which an underwriter can provide you with the underwritings. These are-

Firm's commitment

In this, the bank purchases all the required shares of a company and now sells it on its own to the public. This method assures the company a fixed amount of fund.

Best Effort's Agreement

In this, the bank acts only as a mediator/broker. Selling of shares determines the procedure for the company's fundraising.

Syndicate

In case of high risk or other such factors, not one but many banks do the work of share selling of a company. One bank acts as a lead bank and then the process is done.

VARIOUS UNDERWRITINGS PROVIDED BY THE BANK

ENGAGEMENT LETTER

One part of it states that all the expenses of the process will be incurred by the issuing company doesn't matter even if the company withdraw IPO process at any time. It is also termed as the reimbursement clause. Another is the gross underwriting discount (GUD). Its calculation is as followed:

GUD= sale price of the share by underwriter – purchasing price of a share by the underwriter.

LETTER OF INTENT

This letter includes an agreement between the underwriter and the issuing company. It states- the company agrees to submit all the required information to the underwriter and the later shall positively make an agreement with the company. Also, the underwriter gets the overallotment options of 15%.

UNDERWRITING AGREEMENT

This is the stage where the underwriter finally purchases all the agreed shares of the company. In other words, this part initiates the selling process of the company's shares.

REGISTRATION PROCESS

Prior to the final registration of IPO, the company is required to provide all the needed information to the underwriter. It also includes the negativities faces by the company. It has 2 sets:

The prospectus

Prospectus of IPO is given to every Institute or individual who buys the shares sold in the IPO.

Private Fillings

This is generally a confidential process done which includes the submission of the information to SEC for inspection.

PRICING

In this part, the company along with the underwriter decides the price at which the share of the company would be sold. They decide the selling of total shares. This step begins after the approval

of the SEC (Security and Exchange Commission). Then the date is finalized and a day before it, this step is concluded. Pricing entails both underpriced or overpriced. The later increase the chances of earning more profit.

Note: In the meantime, the company and underwriter prepare a prospectus and go for a roadshow. It is nothing but a way to pitch and bid for the upcoming IPO for better success. And it lasts for 3 to 4 weeks, generally. It greatly influences the pricing of the IPO.

STABILIZATION

This is the part where underwriter has a great role. The underwriter creates a profitable market for the company and also aid it in case of any imbalances by purchasing the shares of the company at a price which does not hit the company financially.

EVALUATION

This is the final stage of IPO and starts post 25 days of the enforcement of the process. In this process, the underwriter estimates and provides the company with the valuation of the IPO done, i.e. the funds raised by the company or any adversity faced. Financial analysis is what tells you the actual performance of your work

Different Types of Student Loans – Which One Suits You

Student loans are usually taken by parents to fund higher studies of their kids. Generally, these loans come with easy repayment option. The financial institutions usually allow the borrower to start paying the loan a couple of years after finishing the degree. This grace period is usually given to the students to ensure that they complete the course and get into a job, and therefore, are able to pay easily. The interest rates and other conditions on a student loan differ depending on the type of loan and agency from which the loan is availed. Let's understand the different types of student loans in detail.

DIFFERENT TYPES OF STUDENT LOANS

Broadly there are two different types of student loans on the basis of the agency from which the loan is taken – Federal Loans and Private Loans. Under Federal loan, it is the government who extends the loan to the student, while the private banks or credit Unions give private loans.

FEDERAL LOANS

There are several types of federal loan.

NEED-BASED LOANS OR SUBSIDIZED FEDERAL LOANS

Students who cannot afford higher studies but have shown promise in the academics are eligible for the need-based loans. These loans are interest-free (while students are in school) and students get a limit within which they can borrow the amount. This limit may increase each year, meaning a student would be able to withdraw more money every year of their college than the previous one. Also known as Subsidized Federal Loans, these are the most generous type of loans for a student to complete their higher education as they carry a low interest and are long term.

TYPES OF STUDENT LOANS

These loans are interest free (upto school) and students get a limit within which they can borrow the amount. Also known as Subsidized Federal Loan.

Need Based Loans

Unsubsidized Federal Loans

The interest is responsibility of borrower from the start of the loan. However, sometimes, one can postpone interest payments.

Students attending college in half or full time undergraduate situations qualify for such loans. Loan on the basis of attendance cost and their credit history.

Federal Plus Loan

Consolidation Loans

This is not actually a loan, but a facility. it allows graduates to pool several loans into a single loan. It means just one monthly payment to be made.

Such type is loan is for biological, adoptive, and stepparents to support an undergraduate dependent on them.

Parent PLUS loans

Federal Perkins Loans

These were the best loans for undergraduate, graduate, and professional students. Not available now.

Students or parents with decent credit history can avail this kind of loan. Interest rates are comparatively higher on these loans.

Private Loans

Refinanced Loans

Similar to the consolidation loans, private lenders also offer an option to combine different types of student loans into one loan.

UNSUBSIDIZED FEDERAL LOANS

It is a long-term loan but is not on the basis of need. Under this, the interest is the responsibility of the borrower from the start of the loan. However, in some cases, one can postpone interest payments.

Such loans also carry a low interest and are best for a student, who doesn't qualify for other financial aids. Moreover, these loans are also helpful for those who need more funds to cover their financial expense.

FEDERAL PLUS LOANS

Students attending the college in half or full-time undergraduate situations qualify for such loans. Parents get loans for the education of the student on the basis of attendance cost and their credit history. Just like the need-based loans, the Federal plus loans also carry low interest and repayment is scheduled within 60 to 90 days after the full loan disbursement or after the completion of the

course. Such a loan comes handy in bearing other college expenses after the use of other financial aids.

DIRECT CONSOLIDATION LOANS

This is not actually a loan, but a facility. As the name suggests, it allows graduates to pool several loans into a single loan. It means the borrower has to make just one monthly payment. Moreover, it can help in lowering the monthly liability as well by extending the loan to more years.

PARENT PLUS LOANS

Such type of loan is for biological, adoptive, and stepparents to support an undergraduate dependent on them. It is different from other loans in a way that the government expects parents to make the payment until the child is in school. However, one may request a deferment while applying for the loan.

FEDERAL PERKINS LOANS

Such loans are not available anymore. These were the best loans for undergraduate, graduate, and professional students. They were given on the basis of extreme financial need and the interest rate was also very low.

OTHER TYPE OF STUDENT LOANS

PRIVATE LOANS

Students or parents with decent credit history can avail this kind of loan. The credit unions or the financial institutions that give such loans are authorized but not banked by the government. In case, the student does not have a credit history, the guardian can apply for the loan and the student has to be a co-signer.

Interest rates are comparatively higher on these loans. Therefore, such a loan is suitable for those confident of repaying even with the high-interest rate. However, there are some private institutions that offer a lower interest loan for certain colleges.

One should opt for student loans from private institutions only when they do not get one from any Federal bank. Make sure that you understand all terms before availing a loan from a private organization.

REFINANCED LOANS

Like the consolidation loans, private lenders also offer an option to combine different types of student loans – Federal loans and private loans – into one loan. Such an option may not be a very good idea as it does not result in a saving. Such type of consolidation would expand the repayment term and can increase the cost.

One advantage of refinancing is the lower interest rate that would convert into saving. But, a borrower will need a robust credit score and steady income to qualify for a lower interest rate. You would see a lot of private lenders talk about the saving by an average customer through refinancing of the loan.

Mezzanine Fund – Importance, Advantages And More

Mezzanine Fund or Mezzanine loan does not fall into the category of a pure debt or pure equity. In other words, it is very high risk and high reward instrument that fills the gap between senior debt and equity. A company uses such type of funding to raise money for specific purposes rather than the traditional use-cases.

Just like any other fund, mezzanine fund pools the capital of the investors, and use it for various purposes such as acquisitions, recapitalizations or management/leverages buyouts. Companies usually treat this fund as equity in their Balance Sheet.

CHARACTERISTICS

- For a better understanding of the concept, let us look at the characteristic's mezzanine fund:
- These are subordinate to senior debt but are senior to common equity when it comes to the priority of payments.
- Mezzanine loans earn a higher yield than senior debt but are usually not secured.
- No option for principal amortization.
- Return is in the form of current interest coupon, payment in kind and warrants.

HOW THEY ARE DIFFERENT FROM PRIVATE EQUITY AND DIRECT LOANS

One must not confuse Mezzanine fund with private equity. Private equity aims to get a stake in the company they invest in. Mezzanine investors, on the other hand, get regular interest payment. However, such a loan may come with an option to convert into equity at a later date.

Mezzanine funds are different from direct lenders in a way that the latter invest in first-lien and senior-secured loans. On the other hand, mezzanine investors play a junior role.

MEZZANINE FUND

Mezzanine Fund or Mezzanine loan does not fall into the category of a pure debt or pure equity. In other words, it is very high risk and high reward instrument that fills the gap between senior debt and equity

CHARACTERISTICS

- Subordinate to the senior debt but are senior to common equity
- Earn a higher yield than senior debt
- No option of principal amortization
- Returns : Current interest coupon, payment in kind and warrants.

RATE OF RETURN

- Charges high rate of interest (higher risk, higher return).
- There are five way in which return becomes available : Ownership, Payable in kind interest, Participation Payout, Cash interest, Arrangement Fees

A private equity aims to get a stake in the company they invest in. Mezzanine investors, on the other hand, get regular interest payment.

BENEFITS

To Borrowers : Cheaper, No dilution of stake, Lower equity requirement, Lower tax liability, Enhances credibility, Boost capital structure.

To Lender : Regular revenue, Enhance the return, Investor gets regular returns

Mezzanine Funding should be preferred when it is used for Acquisition, Shareholder's Buyouts, Refinancing, Expansion

EXAMPLE

One goes for mezzanine funds only in certain situations such as when the private equity sponsor is willing only to invest 70% of the total required. In this case, the owner will have to invest the remaining 30%. However, if the owner brings a mezzanine investor who can bring 10%-15%, then his or her burden reduces.

For example, a food company is looking to acquire another restaurant in the town. Assume that the restaurant has an operating income of \$200,000 per year and owners have agreed to sell it for \$1 million. Now, the food company has is in negotiation with a senior lender, who can invest up to 60%.

Let's assume that the senior investor has put \$600,000 at the rate of 8% per year. The food company now will have to take care of the remaining \$400,000. The return on the investment for the senior lender would be \$48000 (8% interest). Now, the remaining operating profit after

subtracting the interest amount to the senior lender is \$152,000. After applying a tax rate of 35%, the profit after tax would be around \$98,800. The return on equity at a profit of \$98,800 is 24.7% per year.

Now, if the mezzanine fund investor comes in who agrees to invest \$200,000 at 15%. This would convert into \$48,000 to the senior investor and \$30,000 to the mezzanine investor. Post-tax profit now comes down to \$79,300. Although the return fell, the Food company will only have to invest half the total capital.

BENEFIT TO THE BORROWER

- Cheaper than equity.
- No dilution of stake.
- It also lowers the equity requirement.
- Lower tax liability as interest on mezzanine fund is tax deductible.
- Such funds enhance the credibility of a borrower. Mezzanine funds are risky, and the lender is very selective in giving such funds. Thus, the lender loans only to those who are financially sound.
- Boost the capital structure of the company.

BENEFITS TO LENDER

- Turns into a regular revenue stream for the lender.
- An option to convert the debt into equity could enhance the return if the company performs well.
- Mezzanine investors take a risk that is at par with the equity investors. However, unlike equity investors, who have no guarantee for dividends, mezzanine investors get regular interest payments

RATE OF RETURN ON MEZZANINE FINANCING

The mezzanine investors usually charge high interest on their investment in comparison to the traditional form of debt financing. The rate of return is usually higher because all other forms of debts come above mezzanine debt. This implies that those investing in the company through the mezzanine fund are taking higher risk, and therefore, deserve a higher return. There are five ways in which the return on the mezzanine fund becomes available.

OWNERSHIP

The mezzanine fund acts similar to convertible bonds in a way that in case of default, the lender has the right to a stake in equity or ownership conversion.

PAYABLE IN KIND INTEREST

Some companies opt for this where rather than getting the periodic interest, the principal amount increases to the amount of the interest.

PARTICIPATION PAYOUT

The lender of the mezzanine fund can also avail an arrangement where they can claim a certain percentage in the company's earning such as EBITDA, profit and so on.

CASH INTEREST

These are interest payments that are given as a percentage on the outstanding balance. Rate of interest can be either fixed or floating rate or linked to the base rate such as LIBOR.

ARRANGEMENT FEE

Mezzanine lenders can also charge an arrangement fee to cover the administrative costs. One has to pay such fee upfront in order to close the transaction.

WHEN TO GO FOR MEZZANINE FUND? FOR ACQUISITION

Companies usually go for mezzanine funds if they are acquiring another company. If a company knows that acquiring another firm would increase their revenue stream, they would want to acquire it. However, not every time, the firm would have liquid cash available, and therefore, would need quick funds.

SHAREHOLDER BUYOUTS

Usually, the family businesses are interested in the keeping majority shares with themselves. At times, such investors would want to repurchase the company's shares to strengthen their ownership in the company. The mezzanine fund comes very handily for such activities.

REFINANCING

Organizations at times also go for a mezzanine fund to make their debt capital structure more flexible. Such ready funds ensure that companies have enough funds for opportunities such as shareholder buyouts and acquisitions.

EXPANSION

Apart from the above three activities, companies can deploy it for expanding into new territory. Rapid growth is important for companies to increase their revenue stream. These funds can help them achieve the same in a short span of time.

The mezzanine fund is a popular source of funding used by the companies looking for rapid growth. Therefore, such companies do not mind paying a little higher rate of interest for accessing quick money.

Characteristics of Debenture

Debentures are the popular method the companies use to procure the long term finance for their financial needs. The funds raised through debentures represent the debts, and the holder's of the debenture are the creditors of the company. Due to this, the characteristics of debentures are very important. There are various types of debentures that the company can issue. The different types of debentures can be differentiated by their characteristics.

The debenture is a written instrument that the company sign under its common seal, acknowledging the debt due by it to the debenture holder. The company promises to pay the periodic payment of interest to the holder for the use of his funds. The company pays the fixed rate interest to the holder.

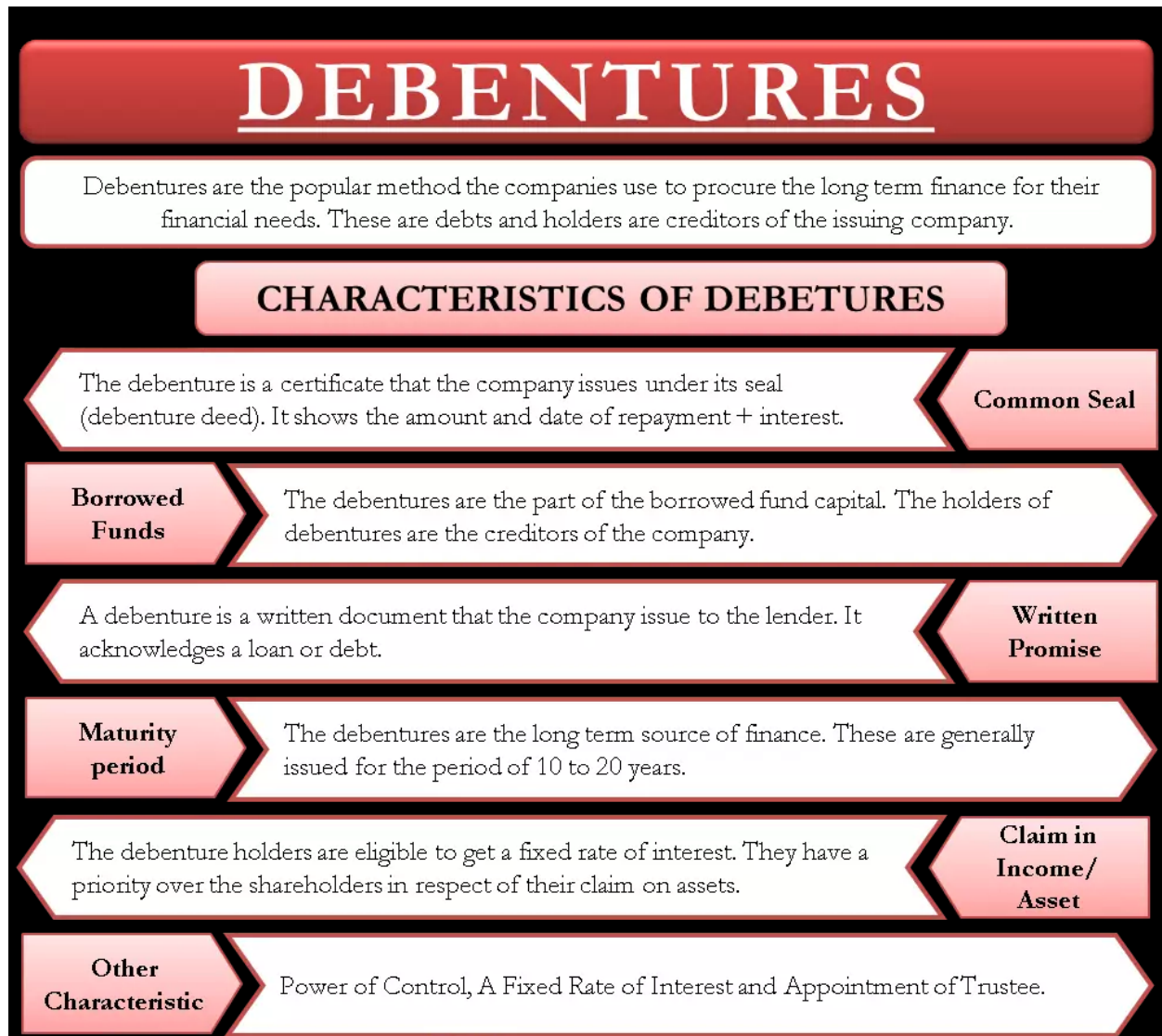
The basic characteristics of debentures are as follows:

WRITTEN PROMISE

A debenture is a written document that the company issue to the lender. It acknowledges a loan or debt.

COMPANY SEAL

The debenture is a certificate that the company issues under its seal (debenture deed). It shows the amount and date of repayment of the debt along with the rate of interest.



BORROWED FUNDS

The debentures are the part of the borrowed fund capital. The holders of debentures are the creditors of the company.

MATURITY PERIOD

The debentures are the long term source of finance. They consist of long term pre-set maturity period. Normally, the debentures have the maturity period of 10-20 years and are repayable at the end of the maturity period. At the maturity, the company repays the principal investment amount to the holder.

CLAIM IN INCOME

The debenture holders are eligible to get a fixed rate of interest at the end of every financial year. The debenture holders have a priority of claim in the income of the company. Assume that a company does not have sufficient funds to pay interest on debenture as well as dividend on preference shares and equity share. The company will have to pay interest to debentures first and then with remaining funds, it can do the other payments. They can legally enforce their rights. They get the priority over the equity and preference shareholders.

PRIORITY CLAIM ON ASSETS

The debenture holders also have a priority over the equity and preference shareholders in respect of their claim on assets. These claims arise at the time of liquidation or reorganization of the company. The creditors are entitled to get only the principal amount that they had given along with any unpaid interest.

To reduce the risk of losing the principal amount, the debenture holders prefer to secure the loan against the specific asset. However, if the creditors have the trust in the earnings of the company that it will satisfy their claims, they may not ask for the security of loan and may accept the debenture without having a specific asset pledged.

The debentures that have a charge against the specific asset are treated as secured creditors and others as unsecured creditors.

NO CONTROLLING POWER

Debenture holders are the creditors of the company. Therefore, they do not have the power to control the operations of the company. The debenture holders do not have the right to vote to elect the directors and to determine any managerial policy.

FIXED RATE OF INTEREST

The rate of interest on debentures is fixed and is paid every financial year. Therefore, investors also call debentures as fixed cost bearing capital.

APPOINTMENT OF TRUSTEE

When the company sells a large number of debentures to the general public then usually, they appoint a trustee. The bank or financial institutions can be work as a trustee. They appoint the trustee to ensure the firms that are borrowing will fulfill the contractual obligations.

Difference Between Operating and Financial Lease

The differences between two basic forms of lease viz. operating lease and finance (capital) lease, are mainly related to who owns the leased asset, what accounting and tax treatment is given, who bears the expenses and running costs, whether a purchase option is present, and the length of the lease term

Aspects of Difference	Operating Lease	Financial (Capital) Lease
DEFINITION	A lease in which all risks and rewards related to asset ownership remain with the lessor for the leased asset is called an operating lease. In this type of lease, the asset is returned by the lessee after using it for the agreed-upon lease term. Read more about Operating Lease for in-depth coverage.	In a financial lease (also known as a capital lease), the risks and rewards related to ownership of the asset being leased are transferred to the lessee. Read this article on Finance Lease for more in-depth coverage.
OWNERSHIP	The ownership of the asset remains with the lessor for the entire lease period.	The ownership transfer option at the end of the lease period is available to the lessee. The title may or may not be transferred eventually.
ACCOUNTING EFFECT	An operating lease is generally treated like renting. That means the lease payments are treated as operating expenses and the asset does not show on the balance sheet.	A financial lease is generally treated like loan. Here, asset ownership is considered by the lessee, so the asset appears on the balance sheet.
PURCHASE OPTION	In an operating lease, the lessee does not have an option to buy the asset during the lease period.	A financial lease allows the lessee to have a purchase option at less than the fair market value of the asset.
LEASE TERM	The lease term extends to less than 75% of the projected useful life of the leased asset.	The lease term is generally the substantial economic life of the asset leased.
EXPENSES BORNE	The lessee pays only the monthly lease payment in an operating lease.	In a financial lease, the lessee bears the cost of insurance, maintenance, and taxes.
TAX BENEFIT	Since an operating lease is as good as renting, the lease payment is considered an expense. No depreciation can be claimed.	The lessee can claim both interest and depreciation, as a financial lease is treated as a loan.
RUNNING COST	In an operating lease, no running or administration costs are borne by the lessee, including registration, repairs etc., since this lease gives only the right to use the asset.	In a financial lease, running costs and administration expenses are higher and are born by the lessee.
EXAMPLE	Projectors, Computers, Laptops, Coffee Dispensers, etc.	Plant and Machinery, Land, Office Building, etc.

Capital Structure Theory – Modigliani and Miller (MM) Approach

Capital Structure Theory – Modigliani and Miller (MM) Approach

The Modigliani and Miller approach to capital theory, devised in the 1950s, advocates the capital structure irrelevancy theory. This suggests that the valuation of a firm is irrelevant to the capital structure of a company. Whether a firm is highly leveraged or has a lower debt component has no bearing on its market value. Rather, the market value of a firm is solely dependent on the operating profits of the company.

The capital structure of a company is the way a company finances its assets. A company can finance its operations by either equity or different combinations of debt and equity. The capital structure of a company can have a majority of the debt component or a majority of equity, or an even mix of both debt and equity. Each approach has its own set of advantages and disadvantages. There are various capital structure theories that attempt to establish a relationship between the financial leverage of a company (the proportion of debt in the company's capital structure) with its market value. One such approach is the Modigliani and Miller Approach.

MODIGLIANI AND MILLER APPROACH

This approach was devised by Modigliani and Miller during the 1950s. The fundamentals of the Modigliani and Miller Approach resemble that of the Net Operating Income Approach. Modigliani and Miller advocate capital structure irrelevancy theory, which suggests that the valuation of a firm is irrelevant to the capital structure of a company. Whether a firm is highly leveraged or has a lower debt component in the financing mix has no bearing on the value of a firm.

The Modigliani and Miller Approach further states that the market value of a firm is affected by its operating income, apart from the risk involved in the investment. The theory stated that the value of the firm is not dependent on the choice of capital structure or financing decisions of the firm.

ASSUMPTIONS OF MODIGLIANI AND MILLER APPROACH

- There are no taxes.
- Transaction cost for buying and selling securities, as well as the bankruptcy cost, is nil.
- There is a symmetry of information. This means that an investor will have access to the same information that a corporation would and investors will thus behave rationally.
- The cost of borrowing is the same for investors and companies.
- There is no floatation cost, such as an underwriting commission, payment to merchant bankers, advertisement expenses, etc.
- There is no corporate dividend tax.

The Modigliani and Miller Approach indicates that the value of a leveraged firm (a firm that has a mix of debt and equity) is the same as the value of an unleveraged firm (a firm that is wholly financed by equity) if the operating profits and future prospects are same. That is, if an investor purchases shares of a leveraged firm, it would cost him the same as buying the shares of an unleveraged firm.

MODIGLIANI AND MILLER APPROACH

The theory stated that the value of a firm is not dependent on the choice of capital structure or financing decision of firm. On the contrary, it is affected by its operating income apart from the risk involved in the investment. This approach was devised by Modigliani and Miller during 1950s. It resembles Net Operating Income Approach.

ASSUMPTIONS

- Tax Rate = 0%
- Transaction Cost = 0
- Same information access to investors and corporates
- Floatation Cost = 0
- CDT Rate = 0%.

P
1

- The capital structure does not influence the value of firm.
- Debt holders & equity shareholders have same priority.

P
2

- Financial leverage is in direct proportion to Cost of Equity (K_e).
- With rise in debt, the equity shareholders perceive a higher risk.

PROPOSITIONS WITH TAXES

- It assumes existence of taxes, therefore, tax benefits due to interest payments are recognized.
- So, Cost of Debt reduces by Interest Tax Shields
- Therefore, change in debt component can affect value of a firm.

MODIGLIANI AND MILLER APPROACH: TWO PROPOSITIONS WITHOUT TAXES

PROPOSITION 1

With the above assumptions of “no taxes”, the capital structure does not influence the valuation of a firm. In other words, leveraging the company does not increase the market value of the company. It also suggests that debt holders in the company and equity shareholders have the same priority, i.e., earnings are split equally amongst them.

PROPOSITION 2

It says that financial leverage is in direct proportion to the cost of equity. With an increase in the debt component, the equity shareholders perceive a higher risk to the company. Hence, in return, the shareholders expect a higher return, thereby increasing the cost of equity. A key distinction here is that Proposition 2 assumes that debt shareholders have the upper hand as far as the claim on earnings is concerned. Thus, the cost of debt reduces.

MODIGLIANI AND MILLER APPROACH: PROPOSITIONS WITH TAXES (THE TRADE-OFF THEORY OF LEVERAGE)

The Modigliani and Miller Approach assumes that there are no taxes, but in the real world, this is far from the truth. Most countries, if not all, tax companies. This theory recognizes the tax benefits accrued by interest payments. The interest paid on borrowed funds is tax deductible. However, the same is not the case with dividends paid on equity. In other words, the actual cost of debt is less than the nominal cost of debt due to tax benefits. The trade-off theory advocates that a company can capitalize its requirements with debts as long as the cost of distress, i.e., the cost of bankruptcy, exceeds the value of the tax benefits. Thus, the increased debts, until a given threshold value, will add value to a company.

This approach with corporate taxes does acknowledge tax savings and thus infers that a change in the debt-equity ratio has an effect on the WACC (Weighted Average Cost of Capital). This means that the higher the debt, the lower the WACC. The Modigliani and Miller approach is one of the modern approaches of Capital Structure Theory.

Types of Letter of Credit (LC)

Types of Letter of Credit (LC)

There are various types of letter of credit (LC) prevails in the trade transactions. In this post, we are classifying them by their purpose. They are Commercial, Export / Import, Transferable and Non-Transferable, Revocable and Irrevocable, Stand-by, Confirmed, and Unconfirmed, Revolving, Back to Back, Red Clause, Green Clause, Sight, Deferred Payment, and Direct Pay LC.

A letter of credit is an important financial tool in trade transactions. Both, domestic as well as international market, trades use the LC to facilitate the payments and the transactions. A bank or a financial institution acts as a third-party between the buyer and the seller and assures the payment of funds on the completion of certain obligations.

DEFINITION OF LETTER OF CREDIT

An LC is a financial document provided by a third-party (with no direct interest in the transaction), mostly a bank or a financial institution, that guarantees the payment of funds for goods and services to the seller once the seller submits the required documents. A letter of credit has three important elements – the beneficiary/seller who is the recipient of the LC, the buyer/applicant who buys the goods or services and the issuing bank that issues the LC on the buyer's request. At times, there is an involvement of another bank as an advising bank that advises the beneficiary.

LETTER OF CREDIT TYPES	
COMMERCIAL LC	A standard LC, also called as documentary credit
EXPORT /IMPORT LC	LC depending on who uses it. If used by exporter, he will name it to be exporter L/c and vice-versa.
TRANSFERABLE LC	As the name says, it is transferrable to the next supplier in chain & that allows the beneficiary to provide its own documents. The beneficiary is only an intermediary for actual supplier
UN-TRANSFERABLE LC	The beneficiary is the recipient & cannot further use LC to pay anyone. In short, he is not allowed to transfer it to third parties
REVOCABLE LC	Can be altered at any time by the issuing bank/ buyer without informing the seller. Not used frequently, no shield to seller.
IRREVOCABLE LC	Without consent of seller, no alterations can be made by anyone.
STANDBY LC	It ensures the payment to seller if anything wrong happens
CONFIRMED LC	When the advising bank also guarantees the payment to the beneficiary, it is called Confirmed LC
UNCONFIRMED LC	This is assured only by issuing bank & not in need of second bank
REVOLVING LC	These can be used be used for many payments instead of issuing for each of them
BACK TO BACK LC	Two LCs are issued- one by the bank of buyer to the intermediary & second by the bank of an intermediary to the seller.
RED CLAUSE LC	Partial payment before the goods are shipped like an advance against a written confirmation from the seller & the receipt
GREEN CLAUSE LC	Same like Red Clause LC, but the only difference is proof of warehousing is also given to the seller.

TYPES OF LETTER OF CREDIT

There are various types of letters of credit in trade transactions. Some of these are classified by their purpose. The following are the different types of letters of credit:

COMMERCIAL LC

A standard LC also called as a documentary credit. For more information click on [Commercial LC](#)

EXPORT/IMPORT LC

The same LC becomes an export or import LC depending on who uses it. The exporter will term it as an exporter letter of credit whereas an importer will term it as an importer letter of credit.

TRANSFERABLE LC

A letter of credit that allows a beneficiary to further transfer all or a part of the payment to another supplier in the chain or any other beneficiary. This generally happens when the beneficiary is just an intermediary for the actual supplier. Such LC allows the beneficiary to provide its own documents but transfer the money further.

UN-TRANSFERABLE LC

A letter of credit that doesn't allow the transfer of money to any third parties. The beneficiary is the only recipient of the money and cannot further use the letter of credit to pay anyone.

REVOCABLE LC

An LC that issuing bank or the buyer can alter any time without any notification to the seller/beneficiary. Such types of letters are not used frequently as the beneficiary is not provided any protection.

IRREVOCABLE LC

An LC that does not allow the issuing bank to make any changes without the approval of all the parties.

STANDBY LC

A letter of credit that assures the payment if the buyer does not pay. After fulfilling all the terms under SBLC, if the seller proves that the promised payment was not made. In this situation, the bank will pay to the seller. In a nutshell, it does not facilitate a transaction but guarantees the payment. It is quite similar to a bank guarantee.

CONFIRMED LC

Which the seller or exporter acquires the guarantee of payment from a confirming bank (also called the second bank). This is primarily to avoid the risk of non-payment from the first bank.

UNCONFIRMED LC

A letter of credit that is assured only by the issuing bank and does not need a guarantee from the second bank. Mostly the letters of credit are an unconfirmed letter of credit.

REVOLVING LC

When a single LC is issued for covering multiple transactions in place of issuing separate LC for each transaction is called revolving LC. They can be further classified into Time Based (Could be Cumulative or Non-Cumulative) and Value-Based.

BACK TO BACK LC

Back to back LC is an LC which commonly involves an intermediary in a transaction. There are two letters of credit, the first issued by the bank of the buyer to the intermediary and the second issued by the bank of an intermediary to the seller.

RED CLAUSE LC

A letter of credit that partially pays the beneficiary before the goods are shipped or the services are performed. The advance is paid against the written confirmation from the seller and the receipt.

GREEN CLAUSE LC

An LC that pays advance to the seller just not against the written undertaking and a receipt, but also a proof of warehousing the goods.

SIGHT LC

A letter of credit that demands payment on the submission of the required documents. The bank reviews the documents and pays the beneficiary if the documents meet the conditions of the letter.

DEFERRED PAYMENT LC

An LC that ensures payment after a certain period. The bank may review the documents early but the payment to the beneficiary is made after the agreed-to time passes. It is also known as Usance LC.

DIRECT PAY LC

A letter of credit where the issuing bank directly pays the beneficiary and then asks the buyer to repay the amount. The beneficiary may not interact with the buyer.

Conclusion

As mentioned above, a letter of credit can be of various types depending on its purpose. It is in the interest of both the buyer and the seller, to understand all the different types thoroughly and then pick the one which serves the purpose completely

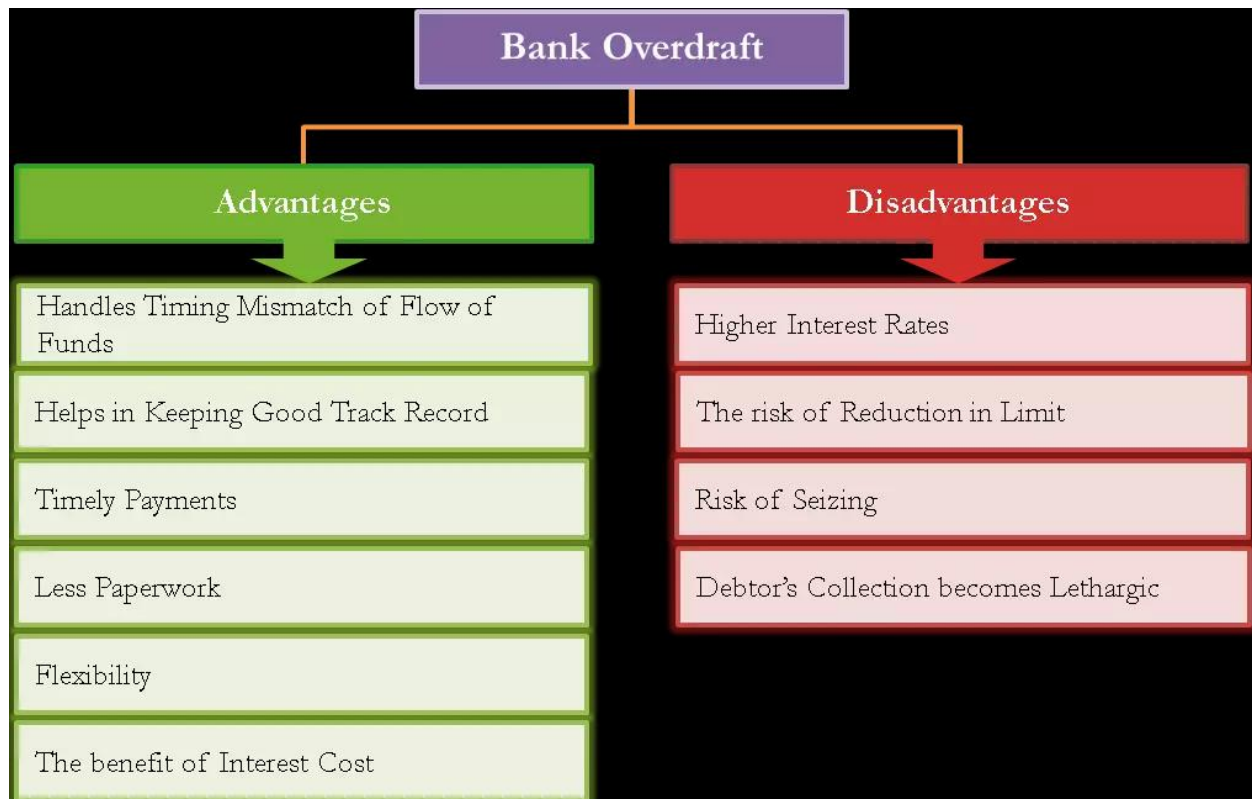
Advantages and Disadvantages of Bank Overdraft

Working Capital Financing

Advantages and Disadvantages of Bank Overdraft

A bank overdraft is a facility extended by a bank to corporates and other clients to withdraw funds from their account in excess of the balance. This facility is provided by the bank for a fee and/or interest is charged on the excess amount that is withdrawn for the length of the time. It is important to know the advantages and disadvantages of the bank overdraft facility in order to use it effectively.

An overdraft facility allows the facility holder to withdraw money from the account despite having no balance. There is a limit on the amount that can be overdrawn from the account. The overdraft limit is usually set by the bank basis the amount of working capital, creditworthiness of borrower and security offered by borrower.



ADVANTAGES OF BANK OVERDRAFT

HANDLES TIMING MISMATCH OF FLOW OF FUNDS

A bank overdraft is usually the best for businesses with greater movement of cash flow in a given time frame. An overdraft can help reset a skipped cycle of rotation of inflow and outflow of cash. In other words, if sales proceeds and purchases result in a flow of money in and out many times during a week/month; an overdraft facility allows managing cash flow gaps that might arise due to timing mismatch.

HELPS IN KEEPING GOOD TRACK RECORD

If a check was made on the basis of some amount to be received, and if it is delayed, the check does not bounce due to inadequacy of funds. Hence, overdraft facility allows for a better payment history.

TIMELY PAYMENTS

It also ensures timely payments and avoidance of late payments penalties as payments can be made even if there is a lack of sufficient balance in the account.

LESS PAPERWORK

It requires less paperwork that would usually be required in long-term loans as overdraft facility is easy to avail.

FLEXIBILITY

Overdraft facility has the advantage of flexibility as one may take it at any time, for any amount (up to the limit allotted), and for even as less as one or two days.

BENEFIT OF LESS INTEREST COST

The interest is calculated only on the amount of funds used. This allows for greater savings in the interest cost compared to a normal loan taken for a fixed time period. While in other loans, interest is required to be paid even if the money remains unused. In this case, the charging of interest starts with the amount over drawn and it stops instantly when it is paid off.

DISADVANTAGES OF BANK OVERDRAFT HIGHER INTEREST RATES

Overdraft facility comes at a cost. At times, the cost is usually higher than the other sources of borrowing.

RISK OF REDUCTION IN LIMIT

Overdraft facility is a temporary loan and undergoes regular revisit by the bank. Hence, it runs a risk of a decrease in the limit or withdrawal of the limit. Reduction in the withdrawal of limit may happen usually when company financials may represent poor performance; hence, the facility may be withdrawn especially when the company may require it the most.

RISK OF SEIZING

Bank overdraft facility may at times be secured against inventory or other collaterals like shares, life insurance policies etc. The company may run a risk of those assets being seized if it fails to meet payments.

DEBTOR'S COLLECTION BECOMES LETHARGIC

At times, availability of overdraft facility may make the company less strict on the collection of debtors' payment. In other words, a company may not be too much on their feet to collect payments from debtors, as immediate payment outflows can be managed by overdraft facility.

Conclusion:

Overdraft is a temporary facility obtained by the companies to meet their ultra-short term cash shortage/requirement. One needs to bear in mind that such facility comes with a high cost and should be used as a stop-gap management of funds or as an emergency activity rather than a routine funding activity. Higher dependence on overdraft for working capital financing indicates poor working capital management and a liquidity constraint faced by the company. Only temporary working capital should be financed by bank overdraft. The permanent working capital should be financed by long-term financing.

Sources of Finance

Difference between Overdraft and Cash Credit

Overdraft and cash credit are widely used external sources of finance for availing short term borrowing at some cost. Both cash credit and overdraft are used by businesses to manage short-term working capital requirements. The difference between overdraft / Bank overdraft and cash

credit are on various aspects which include nature of the account, charges, and fees, amount, purpose, type of security, use of funds, interest rate, etc.

Both these facilities are repayable on demand and therefore classified as sources of finance payable on demand or loans payable on demand. However, these facilities are rarely recalled in real-life scenario except in very rare circumstance like customer's business and financial position is going from bad to worse phase as time passes by or in a case when the value of the security is found extremely low during period re-valuation of the security or during the renewal of the facility.

Although both these facilities are very similar in nature, one needs to understand cash credit vs. overdraft difference in order to understand them better.

	OVERDRAFT	CASH CREDIT
ACCOUNT REQUIREMENT	Overdraft can be availed on the existing current account. It is a facility of "excess withdrawal" given in current account and at times even in the savings account.	One needs to usually open a separate cash credit account with a bank to avail cash credit facility.
SECURITY REQUIREMENT	Overdraft facility does not necessarily require current assets as security. An overdraft facility may be extended by taking shares, other investments like FDs, insurance policies as security. At times even based on the credibility of the person, overdraft limit may be approved.	Company inventory and receivables are usually taken as security for allowing cash credit facility.
LIMITS SANCTIONING RATIONALE	The limit is usually allotted taking into consideration the assets collateralized and also on the basis of financial statements of the company.	The limit is usually a percentage of the stocks or receivables.
END USE	Overdraft Facility can be used for any purpose and not necessarily for business.	This is generally given specifically for the purpose of the business operation (as working capital).
LENGTH OF CREDIT PERIOD	Overdraft facility is allowed for a very short duration at times (Say a month or even for a week in some cases), but can be allowed for a period of up to 1 year.	Cash Credit is usually for a short period. That means, the limit is allowed for a period of 1 year and is renewed every year. In some cases, renewals

		or review may be stipulated half-yearly as well.
LIMITS AVAILABILITY	The amount or the overdraft limit that the customer gets remains constant since limits sanctioned is not based on current assets. However, if OD is against shares or insurance policy surrender value, the limit changes based on the underlying security value at periodic intervals.	The cash credit withdrawal limit keeps changing with the change in the amount of current assets kept as security. Withdrawal limit from the CC facility is called drawing power.
RATE OF INTEREST	The rate of interest charged under overdraft facility is higher than what is usually charged under the cash credit facility.	The rate of interest charged under cash credit facility is lesser than what is usually charged under the overdraft facility.

Sources of Business Finance

Commercial Paper

The introduction of Commercial Paper in India was considered the beginning of financial reforms in India. Post liberalization the Indian government introduced many short-term instruments one of which was Commercial papers.

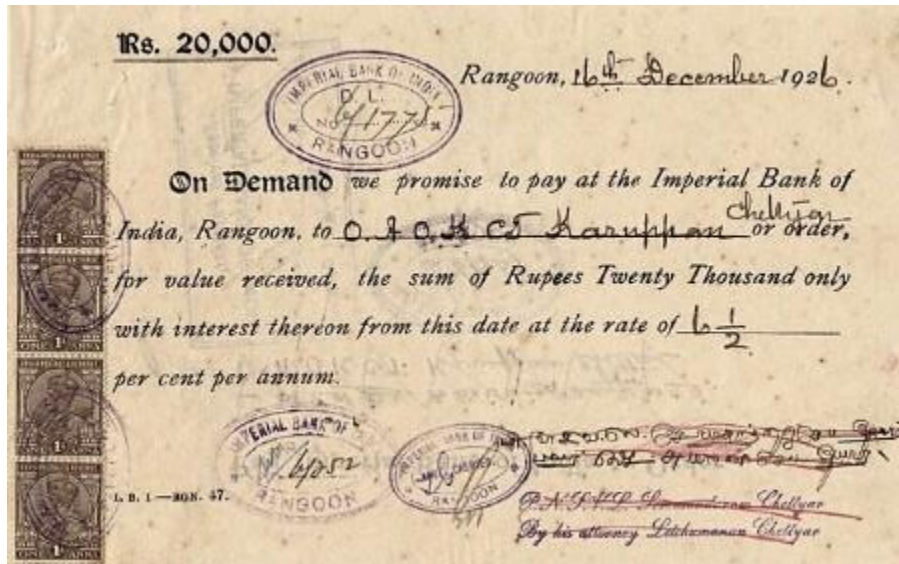
Imagine this scenario to get an idea of what a commercial paper is; You had lunch in a restaurant and the bill is ₹900, you give ₹2000 note but the cashier does not have a chance to give back. He gives you a paper and writes on it, “We are to give Mr. You ₹1100 in cash or either You can have a meal worth ₹1100 from one of our branches within the one-month duration.” He signs it and issues a stamp of the restaurant on it. Should you accept it? Definitely.

This was just an example to give you an idea of what commercial papers are. Commercial papers are usually issued at a high value. It is unsecured money market instrument issued in the form of a promissory note and transferable between Primary Dealers (PDs) and the All-India Financial Institutions (FIs).

Individuals, banking companies, other corporate bodies (registered or incorporated in India) and unincorporated bodies, Non-Resident Indians (NRIs) and Foreign Institutional Investors (FIIs) etc. can invest in Commercial Papers. However, investment by FIIs would be within the limits set for them by Securities and Exchange Board of India (SEBI) from time-to-time.

Commercial Papers emerged as a source of short-term finance in India in the early nineties. As we discussed, Primary Dealers (PDs) and the All-India Financial Institutions (FIs) issue commercial papers which is an unsecured promissory note to raise funds for a short period of 90 days to 364 days. The money raised by the commercial paper is generally very large. It is generally issued by one firm to another business firms, insurance companies, pension funds and banks. Its regulation comes under

the purview of the Reserve Bank of India (RBI). As the RBI does not want to risk the funds, only the firms having good credit rating can issue the commercial paper.



source: kt5

Merits of Commercial Paper

Technically, it provides *more funds* compared to other sources. The cost of commercial paper to the issuing firm is lower than the cost of commercial bank loans.

It is in *freely transferable* nature, therefore it has high liquidity also a wide range of maturity provide more flexibility.

A commercial paper is *highly secure* and does not contain any restrictive condition.

Companies can save their extra funds on commercial paper and also earn some *good return* on the same.

Commercial papers produce a *continuing source of funds*. This is because their maturity can be tailored to suit the needs of issuing firm. Again, commercial paper that matures can be repaid by selling the new commercial paper.

Limitations of Commercial Paper

Only financially secure and highly rated organizations can raise money through commercial papers. New and moderately rated organizations are not in a position to raise funds by this method. The amount of money that we can raise through commercial paper is *limited to the deductible liquidity* available with the suppliers of funds at a particular time.

Commercial paper is an *odd method of financing*. As such if a firm is not in a position to redeem its paper due to financial difficulties, extending the duration of commercial paper is not possible.

What is an Equipment Lease Buyback?

Many businesses rely on expensive, professional-grade equipment to conduct their day-to-day operations. But the cost of this equipment is often too much for startups to handle, forcing them to seek alternative options. So what is an equipment lease buyback and how can it help your business?

How do Equipment Lease Buybacks Work?

Also known as a leaseback, an equipment lease buyback is an arrangement between two parties in which one party sells equipment to a leasing company, and that leasing company leases the equipment back to the original owner. This allows the original owner of the equipment to acquire cash for purchasing new equipment instead of using the cash/assets he or she already owns.

Of course, another option is to acquire a small business loan to fund the purchasing of new equipment. There are several problems with this option, however, one of which is the down payment. Many banks and financial institutions require a large down payment when financing new equipment. In contrast, there is no down payment associated with an equipment lease buyback.

Disadvantages of an Equipment Lease Buyback

When the business owner sells his or her equipment to a leasing company, they forfeit ownership. So while they can continue using the equipment, as specified in the equipment lease buyback agreement, the leasing company has legal ownership of the equipment. This means the business owner cannot sell the equipment if he or she needs fast cash (or any other reason).

Equipment lease buybacks are a particularly attractive form of equipment financing in the construction industry. However, they can be used in all industries, assuming the business owner needs equipment to perform their regular operations. According to Wikipedia, equipment lease buybacks are frequently used in real estate transactions in France, the United States, United Kingdom, India, Australia & Asia. They are also used in the aviation industry, where equipment comes with a hefty price tag.

Is an equipment lease buyback the right financing option for your business? There are many different factors to consider when answering this question, such as your current assets and cash flow; the importance of equipment in running your business; your ability to acquire financing through traditional means; and more. With that said, an equipment lease buyback is certainly a viable option to consider when funding your business.

Equipment Factoring: What is a Lease Buyback?

Equipment plays a major role in many companies. Take a construction company as an example. The trucks, back hoes, and other heavy equipment is a necessity if the construction company wants to remain in business. There is a lot of money invested in that equipment.

But, what happens if the company would rather have that money in hand, instead of tied up in equipment?

This is where equipment factoring can come into play. Lease buyback is one way this works.

What is lease buyback?

With lease buyback, the company can leverage the value of the equipment it already has on the books. The owner of the company sells the equipment to a leasing company for what it is worth. Then, the leasing company leases that equipment right back to the original owner.

This allows the business owner to get an infusion of cash that can be used in whatever manner is best for the business. It can be used to buy or lease additional equipment. It can be used to buy more inventory. It can be used to expand to new office or warehouse space.

Lease buyback can happen with all kinds of equipment used by businesses. Heavy equipment used by construction companies is only one example. Companies that have a large inventory of computer equipment can also use lease buyback to raise cash. Other examples of equipment that can work with lease buyback include commercial cooking equipment as well as cars and trucks.

What are the advantages of lease buyback?

Equipment factoring, in the form of lease buyback, offers several advantages:

It preserves existing cash. Many companies have enough cash to do business and expand at a steady rate. Taking out a large amount of cash for a down payment on new equipment or as a deposit on a new office space can be too much for a company's bottom line. Doing a lease buyback on existing equipment can preserve that cash.

It frees up cash that is otherwise tied up in company equipment. You have a lot of money invested in that equipment, but that is money you could use elsewhere. Use a lease buyback to get that cash back into play. You will still have use of the equipment, but you will get a nice cash infusion as well.

It shifts the responsibility for maintenance and repairs to the leasing company. Part of most lease buyback agreements is that the leasing company will take over the maintenance and repairs. Those expenses are factored into the monthly lease payments the business pays to the leasing company. It opens up the possibility of future equipment upgrades. Once the lease buyback agreement ends, the leasing company will likely offer the business a chance to lease upgraded equipment to replace the outdated ones. That is a major advantage that leasing has over buying equipment. There is a regular opportunity to update computers, get a new vehicle, or better equipment.

It improves the business's balance sheet. Equipment is treated as a fixed asset on the balance sheet. When the equipment is sold and leased back under a lease buyback agreement, this changes the balance sheet. The equipment is removed completely from the fixed asset section. The lease payment is treated as an expense. This increases the business' ratio of current assets to current liabilities, a key indicator of a business' ability to service short-term debt.

It can offer tax savings. In many cases, the lease payments can be treated as a business expense that is completely written off each year. This is usually better than only being able to deduct the depreciation and equipment upkeep expenses. For many smaller companies, this is a major advantage.

Don't let limited cash stop you from making the business moves that you need for healthy growth and expansion. Equipment factoring can get you the cash you need without compromising your business stability or cash flow.

Lease Finance and Public Deposits

Have you heard about rent or lease? It is an agreement between two parties where one party rents and other takes possession for an agreed period. Landlord and tenants sign lease agreements while renting property. Companies do that all the time to raise funds. It is called as Lease Financing. It is one of the most interesting sources of finance. Let's learn more about it.

Lease Finance

A lease is a contractual agreement whereby one party that is the owner of an asset grants the other party the right to use the asset in return for a periodic payment. In simpler terms, leasing is renting an asset of the company for a specified period. The 'lessor' is the owner of the party and the 'lessee' is the party that uses the assets. The lessee pays a fixed periodic amount called 'lease rental' to the lessor for the use of the asset.

Lease contract mentions the terms and conditions involving lease arrangement. The asset is returned to the lessor at the end of lease period. Leasing is more widespread in the acquisition of assets as computers and electronic equipment which become obsolete quicker be of rapid development in technology in the sector. It is very important while making the leasing decision to compare the cost of leasing the asset with the cost of owning the same.

Lease Finance and Public Deposits

The Lessors

Specialized leasing companies: Some companies have primarily evolved in the leasing business. There are 400-odd large companies which have an organizational focus on leasing. They are known as leasing companies. These companies generate their revenue through leasing.

Banks and bank-subidiaries: RBI allowed banks to directly enter leasing in February 1994. Till then, only the bank subsidiaries were permitted to engage in leasing activities. Leasing operations of banks were regarded by the RBI as a non-banking activity.

Specialized financial institutions: A number of financial institutions in India use the lease instrument along with traditional financing instruments. ICICI is one of the pioneers in Indian leasing sector.

Manufacturer-lessors: A manufacturer finds the best way to sell the product on the lease when competition forces him to add value to the sales. Vendor leasing is gaining a vital scope in India. Currently, vendors of automobiles, consumer durables, etc have alliances with leasing companies to offer lease finance against their products.

The Lessees

Public sector undertakings: The public sector has seen a notable rate of growth in the past. There is an increasing number of both centrally as well as state-owned institutions which have turned towards lease financing.

Mid-market companies: The mid-market companies (i.e. companies with reasonably good creditworthiness but with lower public profile) have chosen lease financing as an alternative to bank/institutional financing.

Consumers: Recent bad cases with corporate financing have focused the limelight towards the retail funding of consumer durables. For instance, car leasing is a dominant market in India today. Government departments and authorities: The government itself is the latest player in leasing markets. Department of Telecommunications of the central government took the lead by floating tenders for lease finance worth about Rs. 1000 crores.

Merits of Lease Finance

- Lease rentals paid by the lessee are cut from taxable profits.
- Leasing provides finance without diluting the ownership of the asset.
- It enables the lessee to obtain the asset with a lower price rather than owning it.
- Easy documentation makes it simpler to finance assets
- The lesser carries the risk of obsolescence. This allows flexibility to the lessee to replace the asset.
- The lease agreement does not affect the debt raising capacity of an enterprise.

Limitations of Lease Finance

- It may result in higher payout obligation in case the equipment is not found useful and the lessee opts for premature termination of the lease agreement.
- Financial activities of business may be affected in case the lease is not renewed.
- There are chances that a lease arrangement might impose certain restrictions on the use of assets. For example, it may not allow the lessee to make any alteration or modification in the asset.
- The lessee never becomes the owner of the asset. It denies him of the residual value of the asset.

Public Deposits

The deposits that are raised by organizations directly from the public are known as public deposits. Companies offer higher rates of interest offered on public deposits are usually than that offered on bank deposits. Any person who prefers depositing money in an organization does so by filling up a prescribed form. The organization in return issues a deposit receipt as an acknowledgement of the debt. Public deposits take care of both medium and short-term financial requirements of a business.

As the depositors receive higher interest rate than that offered by banks, the cost of deposits to the company is less than the cost of borrowings from banks. The deposits are profitable to both the depositor as well as to the organization. Companies generally invite public deposits for a period up to three years. The acceptance of public deposits is regulated by the Reserve Bank of India.

Merits of Public Deposits

Public deposits do not usually create any charge on the assets of the company. The assets can be used as security for raising loans.

As the depositors do not have voting rights, the control of the company is not further diluted. The procedure of depositing is easy and does barely contains restrictive conditions.

Cost of public deposits is lower than the cost of borrowings from banks and financial institutions.

Limitations of Public Deposits

Newborn companies find it difficult to obtain funds through public deposits.

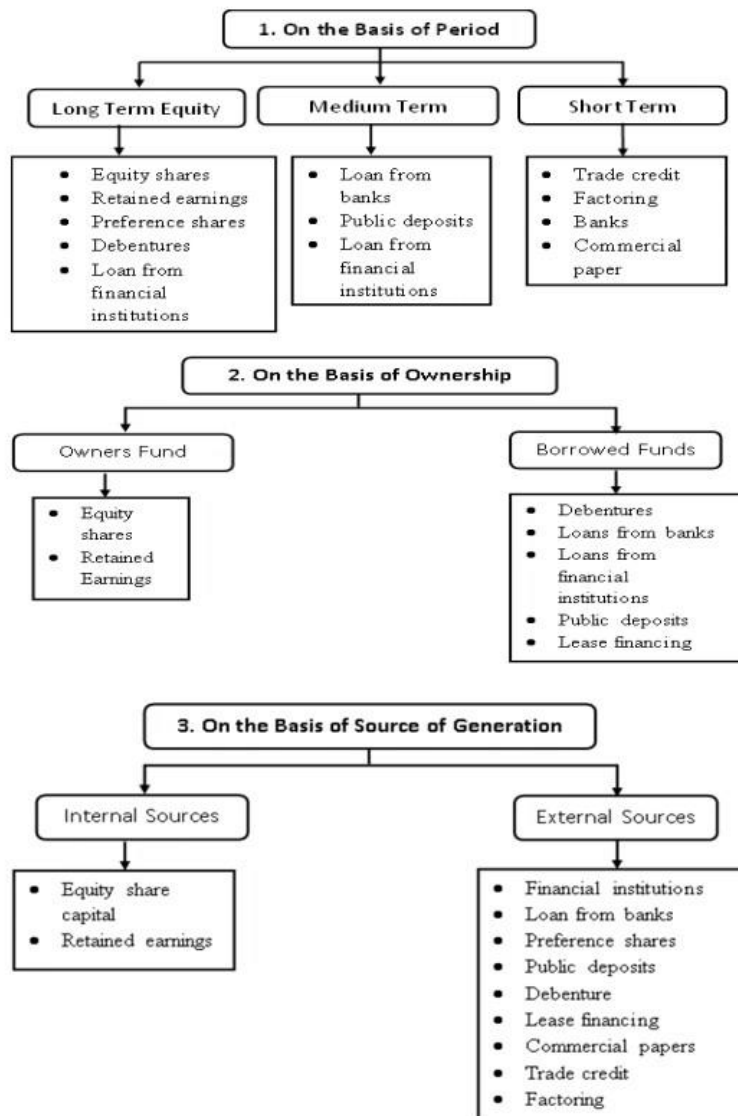
It is an untimely source of finance as the public may not respond when the company needs money. Collection of public deposits may prove difficult, particularly when the size of deposits required is large.

Classification of Sources of Funds

Have you ever been in a situation where you have to buy a gift for someone? The important aspects you consider are the budget of the gift and sources of fund required to fulfil that budget. Similarly, with managing a business, funds are extremely important for any business to sustain. Let us learn the sources of funds.

Sources of Funds

Business simply cannot function without money, and the money required to make a business function is known as business funds. Throughout the life of business, money is required continuously. Sources of funds are used in activities of the business. They are classified based on time period, ownership and control, and their source of generation.



Period Basis Sources

On the basis of the period, the different sources of funds can be classified into three parts. Which are:

- **Long-term sources** fulfil the financial requirements of a business for *a period more than 5 years*. It includes various other sources such as shares and debentures, long-term borrowings and loans from financial institutions. Such financing is generally required for the procurement of fixed assets such as plant, equipment, machinery etc.
- **Medium-term sources** are the sources where the funds are required for *a period of more than one year but less than five years*. The sources of the medium term include borrowings from commercial banks, public deposits, lease financing and loans from financial institutions.
- **Short-term sources:** Funds which are required for *a period not exceeding one year* are called short-term sources. Trade credit, loans from commercial banks and commercial papers are the examples of the sources that provide funds for short duration.

Short-term financing is very common for the financing of present assets such as inventories and account receivables. Seasonal businesses that must build inventories in terms of future prospects of selling requirements often need short-term financing for the interim period between seasons. Wholesalers and manufacturers with a major portion of their assets used in inventories or receivables also require a large number of funds for a short period.

Ownership Basis Sources

On the basis of ownership, the sources can be classified into Owner's funds and Borrowed funds. **Owner's funds** mean funds which are procured by the owners of a business, which may be a sole entrepreneur or partners or shareholders of a business. It also includes profits which are reinvested in the business. The owner's capital remains invested in the business for a longer duration and is not required to be refunded during the life period of the business.

This capital forms the base on which owners gain their right of control of management in the business. Some entrepreneurs may not like to dilute their ownership rights in the business and others may believe in sharing the risk. Equity shares and retained earnings are the two important sources from where owner's funds can be obtained.

Borrowed funds refer to the funds raised with the help of loans or borrowings. This is the most common type of source of funds and is used the majority of the time. The sources for raising borrowed funds include loans from commercial banks, loans from financial institutions, issue of debentures, public deposits and trade credit.

These sources provide funds for a specific period, on certain terms and conditions and have to repay the loan after the expiry of that period with interest. A fixed rate of interest is paid by the borrowers on such loans. Often it does put a lot of burden on the business as payment of interest is to be made even when the earnings are low or when the loss is incurred. These institutions don't take into consideration the activities of business after the loan is given. Generally, borrowed funds are provided on the security of some assets of the borrower.

Generation Basis Sources

The way of classifying the sources of funds is whether the funds are generated from within the organization or from external sources of the organization. **Internal sources** of funds are those that are generated inside the business. A business, for example, can generate funds internally by speeding collection of receivables, disposing of surplus inventories and increasing its profit. The internal sources of funds can fulfil only limited needs of the business.

Whereas, **External sources** of funds are the sources that lie outside an organization, such as suppliers, lenders, and investors. When a large amount of money is needed to be raised, it is generally done through the external sources. External funds may be costly as compared to those raised through internal sources.

In some cases, business is required to mortgage its assets as security while obtaining funds from external sources. The issue of debentures, borrowing from commercial banks and financial

institutions and accepting public deposits are some of the examples of external sources of funds commonly used by business organizations.

Q: How can a business generate funds internally?

Answer: A business can generate funds internally by speeding collection of receivables, disposing of surplus inventories and increasing its profit.

International Financing and Choice of Sources of Funds

Globalization has opened doors and opportunities that were never explored before. Activities of companies are not limited to one region or a single country. And wherever there are activities of companies, there is money involved in them. Let's understand the world of international financing.

International Financing

International Financing is also known as International Macroeconomics as it deals with finance on a global level. There are various sources for organizations to raise funds. To raise funds internationally is one of them. With economies and the operations of the business organizations going global, Indian companies have access to funds in the global capital market.

International finance helps organizations engage in cross-border transactions with foreign business partners, such as customers, investors, suppliers and lenders. Various international sources from where funds may be generated include the following.

(i) Commercial Banks

Global commercial banks all over provide loans in foreign currency to companies. They are crucial in financing non-trade international operations. The different types of loans and services provided by banks vary from country to country. One example of this is Standard Chartered emerged as a major source of foreign currency loans to the Indian industry. It is the most used source of international financing.

(ii) International Agencies and Development Banks

Many development banks and international agencies have come forth over the years for the purpose of international financing. These bodies are set up by the Governments of developed countries of the world at national, regional and international levels for funding various projects. The more industrious among them include International Finance Corporation (IFC), EXIM Bank and Asian Development Bank.

(iii) International Capital Markets

Emerging organizations including multinational companies depend upon fairly large loans in rupees as well as in foreign currency. The financial instruments used for this purpose are:

(a) American Depository Receipts (ADR's)

This a tool often used for international financing. As the name suggests, depository receipts issued by a company in the USA are known as American Depository Receipts. ADRs can be bought and sold in American markets like regular stocks. It is similar to a GDR except that it can be issued only to American citizens and can be listed and traded on a stock exchange of the United States of America.

(b) Global Depository Receipts (GDR's)

In the Indian context, a GDR is an instrument issued abroad by an Indian company to raise funds in some foreign currency and is listed and traded on a foreign stock exchange. A holder of GDR can at any time convert it into the number of shares it represents.

The holders of GDRs do not carry any voting rights but only dividends and capital appreciation. Many renowned Indian companies such as Infosys, Reliance, Wipro, and ICICI have raised money through issue of GDRs.

(c) Foreign Currency Convertible Bonds (FCCB's)

Foreign currency convertible bonds are equity-linked debt securities that are to be converted into equity or depository receipts after a specific period. A holder of FCCB has the option of either converting them into equity shares at a predetermined price or exchange rate or retaining the bonds. The FCCB's are issued in a foreign currency and carry a fixed interest rate which is lower than the rate of any other similar nonconvertible debt instrument.

FCCB's resemble convertible debentures issued in India. It is true that businesses need funds, but the funds required in business are of different types — long term, short term, fixed and fluctuating. That is the reason why business firms resort to different types of sources for raising funds.

Choice of The Source of Funds

Short-term borrowings offer the benefit of reduced cost due to the reduction of idle capital, but long-term borrowings are considered a necessity on many grounds. Equally, equity capital has a role to play in the scheme for raising funds in the corporate sector.

It is recommended to use combinations of sources as no source of funds is devoid of limitations, instead of relying only on a single source. The factors that affect the choice of source of finance are discussed below:

(i) Cost

There are two types of cost, the cost of obtaining of funds and cost of utilizing the funds. Both these costs should be considered while deciding about the source of funds that will be used by an organization.

(ii) Financial Strength

In the choice of source of funds, business should be in a good financial position to be able to repay the amount and interest on the borrowed amount. When the earnings of the organization are not stable, fixed charged funds like preference shares and debentures should be carefully selected as these add to the financial strain on the organization.

(iii) A form of Organization and Reputation

Type of business organization and reputation in the market influences the choice of a source for raising money. A partnership firm, for example, cannot raise money by issue of equity shares as these can be issued only by a joint stock company.

(iv) Purpose and Duration

Business needs to plan according to the time period for which the funds are required. A short-term need can be met through borrowing funds at a low rate of interest through trade credit, commercial paper, etc. For long-term finance, sources such as the issue of shares and debentures required. Also, the purpose for which funds have required the need to be considered so that the source is matched with the user.

(v) Risk Involved

Business evaluates each of the source of finance in terms of the risk involved while issuing them. For example, there is the least risk in equity as the share capital has to be repaid only at the time of winding up and dividends need not be paid if no profits are available. Whereas, a loan has a repayment schedule for both the principal and the interest. The interest is required to be paid irrespective of the firm earning a profit or going through loss.

(vi) Control over Management

A particular source of the fund may affect the control and power of the owners on the management of a firm. The issue of equity shares may mean a dilution of the control. For example, as equity shareholders enjoy voting rights, financial institutions may take control of the assets or impose conditions as part of the loan agreement.

(vii) Creditworthiness

The reliability of business on particular sources may affect its creditworthiness in the market. For example, issue of secured debentures may affect the interest of unsecured creditors of the company and may adversely affect their willingness to extend further loans to the company.

(viii) Flexibility

Another important aspect affecting the choice of finance is the flexibility and ease of obtaining funds. Restrictive provisions, detailed investigation, and documentation in case of borrowings from banks and financial institutions, for example, may be the reason that business organizations may not prefer it if other options are readily available.

(ix) Tax benefits

Various sources may also be weighed in terms of their tax benefits. For example, while the dividend on preference shares is not tax-deductible, interest paid on debentures and loan is tax deductible and may, therefore, be preferred by organizations seeking tax advantage.

Solved Question for You

Q: Discuss Foreign Currency Convertible Bonds (FCCB) used in international financing.

Answer: Foreign currency convertible bonds are equity-linked debt securities that are to be converted into equity or depository receipts after a specific period. A holder of FCCB has the option of either converting them into equity shares at a predetermined price or exchange rate or retaining the bonds. The FCCB's are issued in a foreign currency and carry a fixed interest rate which is lower than the rate of any other similar nonconvertible debt instrument. FCCB's resemble convertible debentures issued in India.

Lease Finance and Public Deposits

Have you heard about rent or lease? It is an agreement between two parties where one party rents and another takes possession for an agreed period. Landlord and tenants sign lease agreements while renting property. Companies do that all the time to raise funds. It is called as Lease Financing. It is one of the most interesting sources of finance. Let's learn more about it.

Suggested Videos

Lease Finance

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- The procedure of depositing is easy and does barely contains restrictive conditions.
- Cost of public deposits is lower than the cost of borrowings from banks and financial institutions.

Limitations of Public Deposits

- Newborn companies find it difficult to obtain funds through public deposits.
- It is an untimely source of finance as the public may not respond when the company needs money.
- Collection of public deposits may prove difficult, particularly when the size of deposits required is large.

Solved Questions for You

Q: Under the lease agreement, the lessee gets the right to

- Share profits earned
- Participate in the by the lessor management of the organization
- Use the asset for a specific time
- Sell the assets specified period

Answer: (c) Use the asset for a specific time

Q: Discuss the limitations of public deposits.

Answer: Newborn companies find it difficult to obtain funds through public deposits. Also, it is an untimely source of finance as the public may not respond when the company needs money. Collection of public deposits may prove difficult, particularly when the size of deposits required is large.

Retained Earnings, Trade Credit and Factoring

You have heard about credit card and debit card. But what is Trade Credit? What is Retained Earning? What is Factoring? Let's find out more about Retained Earning, Trade Credit and Factoring.

Retained Earning

The portion of profits of a business that are not distributed as dividends to shareholders but are reserved for reinvestment back into business is called Retained Earnings. Generally, these funds are for working Capital and fixed asset purchases or allotted for debt obligations.

These Earnings are reported on the Balance Sheet under the shareholder's equity at the end of each and every accounting period. To calculate Retained Earnings, the beginning Retained Earning balance is added to the net income or loss and dividend payouts are subtracted. A report called a statement of retained earnings is also maintained, outlining the changes in Retained earnings for a specific period

The Formula for Retained Earnings is

Retained Earnings (RE) = Beginning RE + Net Income – Dividends.

Beginning of Period Retained Earnings

Retained earnings are shown on the balance sheet as accumulated income from the prior year (including the current year's income) subtracts dividends paid to shareholders. Also, in the next accounting cycle, the Retained earnings ending balance from the previous accounting period will now become the retained earnings beginning balance.

Net Income Impacts on Retained Earnings

Any changes or movement with net income will directly impact the Retained Earning balance. Factors, such as increase or decrease in net income and incurrence of Net loss, will pave the way to either business profitability or deficit.

How Dividends Impact Retained Earnings

Distribution of dividend to shareholders can be in the form of cash or stock. Both forms can reduce the value of Retained earnings of the business. Cash dividends represent cash outflow and are recorded as reductions in the cash account. owns. Stock dividends, however, do not require cash outflow. Instead, they reallocate a portion of the RE to common stock and additional paid-in capital accounts

End of period Retained Earnings

In the end, we can calculate final retained earnings balance for the balance sheet by showing the beginning period, adding one of the Net income or net loss, and subtracting any dividends.

Trade Credit

It is an agreement or understanding between agents engaged in business with each other that allows an exchange of goods or services of goods and services without any immediate exchange of money. When the seller of goods or service allows the buyer to pay for the goods or service at a later date, the seller is said to extend credit to the buyer.

Trade credit is usually offered 7, 30, 60, 90 or 120 days but an exception to some businesses such as goldsmiths and jewelers may extend credit. For example, the customer is granted credit with terms of 4/10, net 30. This means that the customer has 30 days from the invoice date within which to pay the seller. In addition, a cash discount of 4% from the s sales price is to be given to the customer if payment is made within 10 days of invoicing.

Credit Period

Credit periods differ from industries to industries. A food wholesaler, selling fresh fruit and produce, may use net 7. Generally, a firm must consider three factors in setting credit period:

- **The probability that customer will not pay** – A firm whose customers are in high-risk businesses may find itself offering restrictive credit terms.
- **The size of the account** – If the account is small, the credit period will be shorter. Small accounts are more costly to manage.
- **The extent to which goods are perishable** – If the values of the goods are low and cannot be sustained for longer periods, less credit will be granted.

Credit Analysis

While providing Credit, a firm tries to find the difference between customers who will pay and customers who will not. There are many sources of to determine creditworthiness.

- **Financial Statements**– A firm can ask a customer to give financial statements. Rule of thumb financial ratios can be used.
- **Credit Reports on customer’s payment history with other firms** – Many organizations sell information showing credit strength of firms.
- **Banks** – Banks will generally provide help to their customers in gathering information on the creditworthiness of many other firms.
- **The customer’s payment history with the firm** – It is the way to obtain an estimate of a customer’s probability of non-payment is whether he or she has paid previous bills with the company granting credit.
- The 5 C’s of credit:
 - i. **Character**
 - ii. **Capacity**
 - iii. **Capital**
 - iv. **Collateral**
 - v. **Conditions**

Factoring

Factoring means a financial arrangement between the factor and client, in which the firm (client) gets advances in return for receivables, from a financial institution (factor). It is a technique, in which there is an outright selling of trade debts by a firm to a third party, i.e. factor at discounted prices.

Types of Factoring

- **Recourse and Non-recourse Factoring:** It is a type of arrangement, the financial institution, can resort to the firm when the debts are not recoverable. In non-recourse factoring, the factor cannot recourse to the firm, in case the debt turn out to be irrecoverable.
- **Disclosed and undisclosed Factoring:** This factoring is in which the factor’s name is shown on the invoice of the goods or services asking the purchaser to pay the factor, is called disclosed factoring.
- **Domestic and Export Factoring:** When three parties to factoring, i.e customer, client, and factor, live in the same country, it is called as domestic factoring.

Export factoring, also known as cross-border factoring. It is one where there are four parties involved, i.e. exporter (client), the importer (customer), export factor and import factor.

Advance and Maturity Factoring

In advance factoring, the factor gives an advance to the client, against uncollected receivables. In maturity factoring, the factoring agency does not provide any advance to the firm. Whereas, the bank collects the amount from the customer and gives to the firm.