# Unit 1: Introduction to finance

1. **Aims and Objectives**

This unit aims at presenting the meaning of finance, classification of finance, evolution of finance and sources of finance.

After completing this unit, you will be able to:

* understand the term finance
* explain the importance of finance
* list out the various sources of finance
* distinguish between public finance and business finance.

**1.1 Introduction**

In simple language finance is money. To start any business we need capital. Capital is the amount of money required to start a business. The mobilization of finance is an important task for an entrepreneur therefore, finance is one of the significant factors which determine the nature and size of any enterprise. This is to be noted that identification of sources of finance from time to time to finance the assets of an enterprise is critical as it avoids the financial hardships of an enterprise. The finance is required to acquire various fixed assets and current assets. This course discusses the meaning of finance types of finance need of finances, objectives, and functions of financial management is detail.

**1.2 Meaning of finance**

Finance is the study of money. Finance means to arrange payment for. It is basically concerned with the nature, creation, behavior, regulation and problems of money. It focuses on how the individuals, businessmen, investors, government and financial institutions deal. We need to understand what money is and does is the foundations of financial knowledge. In this content it is relevant to study the structure and behavior of financial system and the role of financial system in the development of economy and the profitability of business enterprises.

**1.3 Classification of Finance**

The finance is classified into three categories

1. Personal finance
2. Public finance
3. Business finance
4. ***Personal finance: -*** This deals with the mobilization of funds from own sources. Here funds may imply cash and non-cash items also.
5. ***Public finance:*** - This kind of finance deals with the mobilization or administration of public funds. It includes the aspects relating to the securing the funds by the government from public through various methods viz. taxes, borrowings from public and foreign markets.
6. ***Business finance:*** - Financial management actually concerned with business finance. Business finance is pertaining to the mobilization of funds by various business enterprises. Business finance is a broad term includes both commerce and industry. It applies to all the financial activities of trade and auxiliaries of trade such as banking, insurances, mercantile agencies, service organizations, and the manufacturing enterprises.

The following are the basic forms of organizations

* 1. Sole trading
  2. Partnership
  3. Corporation
  4. Co-operative

In olden days the individual as a sole trader used to bring in his capital and manage with the help of family members. This system has suffered with certain constraints like limited resources, lack of expertise etc. Later, partnership form come into existences to overcome some of the defects of sole trading. The partners used to contribute in the form of money, assets expertise, management etc and profits will be shared on agreed terms.

With the growth of industrialization, many business establishments have preferred to set up corporate form of organization to overcome the major defects of sole trading and partnership form of organization. In case of corporate form of organization the finances are raised through shares, bonds, banks, financial institutions, suppliers etc. We do come across another form of organization i.e. co-operatives. The co-operatives raise funds through the members, government and financial institutions. Thus business finances can be classified into four categories

1. Proprietary finance
2. Partnership finance
3. Corporate finance
4. Industrial finance
5. ***Proprietary finance*** – This refers to the procurement of finds by the individuals, organizing themselves as sole traders.
6. ***Partnership finance*** – It is concerned with the mobilization of finances by the partners of a business organizations/partnership firms
7. ***Corporation finance*** – It deals with the raising of finances by corporate organizations. It includes the financial aspects of the promotion of new enterprises and their administration during early period, the accounting, administration problems arising out of growth and expansion.
8. ***Industrial finance*** – This deals with raising of finances from all sources. It is the study of principles relating to securing the finances from the financial institutions and other institutional sources like banks and insurance companies.

**1.4 GROWTHS and Evolution of Finance**

The Economics is the mother of finance. It emerged as a separate discipline few years back. Economics is used to deal with all the aspects of finance as an integral part of it. It is only in the recent past, i.e. 1920 it has emerged as an independent subject. Many authors like Thomas Greene and Edward S. Meade written on corporation finance. A landmark in this period by author S. Dewing titled ‘Financial policy of corporations. Later period it is witnessed large scale corporate failures and therefore attention was focused on the financial aspects of liquidation, mergers and amalgamations. Finance during forties and fifties was dominated by issues like capital budgeting, capital structure and cost of capital. The sixties saw the portfolio theory in finance. The period of seventies and eighties saw working capital management, problems of small-scale industries and public enterprises. The development in this discipline is continuing.

Day by day, it is gaining importance because it is useful to the business organization. To acquire all the factors of production, finance plays key role. One cannot think of setting up a business or an establishment without finance. For a business organization finance is lifeblood. In a corporate activity mobilization of funds and their administration pose a great challenge.

The profitability is dependent on the optimal utilization of funds. A well financially managed company will have many advantage over other company in addition to earning higher rate of return moreover, the survival or closure will purely depend on the financial decisions. The corporation finance assumes further importance because of the dichtonomy between the ownership and management of the organizations, a feature of the corporate form of organization.

All sections of the society will be benefited by the understanding of the principles of corporation finance. With effective principles of financial management, the consumers will get products at lower prices, workers can get higher wages and stock holders will get higher dividend.

**1.5 Financial Markets Instruments - Institutions**

* 1. ***Financial Markets***

Financial markets is a place where the business houses can raise their long and short-term financial requirements. The development of financial markets indicate the development of economic system. For mobilization of savings and for rapid capital formation, healthy growth and development of these markets are crucial. These markets help promotion of investment activities, encourage entrepreneurship and development of a country. The financial markets are broadly divided as

1. Capital market and
2. Money market

### Capital market

Capital market is defined as a place where all buyers and sellers of capital funds as well as the entire mechanism for facilitating and effecting long term funds. It provides the long-term funds that are needed for investment purpose. Thus, the capital markets are concerned with long-term finance. This also includes the institutions, facilities and arrangements for the borrowing and lending of long-term funds.

Further the capital markets are divided into two categories one is primary market other one is secondary market.

*Primary market* – In the primary market only new securities are issued to the public. It is a place where borrowers exchange financial securities for long-term funds. It facilitates the formation of capital. The securities may be issued directly to the individuals, institutions, through the underwriters etc.

*Secondary market* – The shares subsequent to the allotment are traded in the secondary market. Any body can either buy or sell the securities in the market. Secondary market consists of stock exchange. In the stock exchange outstanding securities are offered for sale and purchase.

### Money Market

Money market deals with short-term requirements of borrowers. It is concerned with the supply and demand for a commodity or service. It handles transactions in short-term government obligations, bankers acceptances and commodity papers. In money market funds can be borrowed for short period varying from a day to a year. It is a place where the lending and borrowing of short-term funds are arranged and it comprises short-term credit instruments and individuals who participate in the lending and borrowing business.

* 1. ***Financial Instruments***

There are mainly two kinds of securities namely ownership securities and loan securities. Further ownership securities are classified into two (a) common stock and (b) preference stock. These securities or instruments are being traded in capital markets.

*Common stock* – It is also known as equity shares, who are the real owners of the business will enjoy the profit or loss suffered by the company. Dividend payment is not compulsory as discussed in unit 2.

*Preferential stock* – By name these holders have two preferential rights I) to get fixed rate of dividend at the end of every year irrespective of profits / losses of the company II) to get back the investment first when the company goes into liquidation.

*Bonds* – Bondholders are the money suppliers to a business unit entitled for a fixed rate of interest at the end of each year. Their are stake is confined to the interest only.

##### FINANCIAL INSTRUMENTS

Owners Loan

Bonds

Common stock

Preference stock

Bearer

Registered

Transferability

Secured

Unsecured

None-convertible

Convertible

Irred

eemable

Redeemable

Security

Non-cumulative

Cumulative

Redeemable

Irredemandable

Convertible

Redeemability

Participating

Non -participating

* 1. ***Financial Institutions***

The financial institutions include banks, development banks, investing institutions at national and international level that provide financial services to the business organizations. These financial institutions provide long-term, short-term finances and extend under writing, promotional and merchant banking services.

**1.6 Sources of Finance**

The finance required for any organization could be primarily divided into two one is ling-run finance to acquire the fixed assets that are useful to the business organization over a period of time i.e. more than a year, usually we call fixed capital. The other one is short-term finance which is required to keep running the fixed assets or to made them finance which is required to keep running the fixed assets or to make them working. This is called the working capital.

*Long-term sources* – The important long-term sources are common stock, preference stock bonds, loans from financial institutions and foreign capital.

*Short-term sources* – The short-term sources are bank loans, public deposits trade credits provisions and current liabilities.

The requirements of above nature could be financed either through external sources or internal sources if it is an existing company.

1. **External** – These are the funds drawn from outsiders. Among them the prominent are discussed below.
   1. *Share Capital* – This is the primary source of finance to a corporate form of organization. It is the sale of equity or common stock and preference stock to the public. Which serves as a permanent capital to an organization. These holders will get dividend in return for their investment.

*Common stock* – The holders of these shares are owners of the company. They are the risk takers. They get dividend when the company earns profits, otherwise they do not get any dividend. Whatever profit is left after meeting all the expenses belongs to them. In the event of closure of the company they are the last people to get their claim.

*Preference stock* – Preference shares carry two preferential rights one is to get a fixed dividend at the end of each year irrespective of the profits, other one is to get back the original investment first when the company goes into liquidation.

*Change par bonds* – Another source of finance to a company is issue of bonds/ debentures. These holders are eligible to get fixed interest at the end of each year. The holders of these bonds do not wish to take any risk public deposits. The term is also mentioned while issuing bonds.

*Public deposits* – This is another mode of finance where the company will advertise and accept deposits for specified period at a fixed rate of interest.

*Borrowings* – The companies may borrow funds from banks, financial institutions etc for their requirements at the interest chargeable by the lender institution.

*Foreign capital* – The concept of liberalization is attracting many foreign companies to participate in the domestic companies. It can be either in the form of direct participation in the capital or collaboration in a project in the equity of the company and also provide loans some time.

*Trade credits* – The common means of short-term external finance is trade credits Normally, every company gets its raw material and other supplies on credit basis. This is known as trade credit. This is an important source of financing.

1. **Internal Sources –** This is applicable for only those companies which are in existence. By virtue of their existence, they are in a advantageous position to generate some of the finance internally.
   1. ***Retained earnings*** – These are the funds that are retained out of the profits for meeting future contingencies. It can be either to meet the uncertainty or future growth and expansion of business. The company would be free to utilize this source. The retained profits enable a company to withstand seasonal reactions and business fluctuations. The large accumulated savings facilitate a stable dividend policy and enhance the credit standing of the company. However, the quantum of retained earnings depend on the volume of the profits made by the company.
   2. ***Provisions*** – Generally companies, in order to meet the legal and other obligations, create some funds for future use. These are known as provisions. They include depreciation, taxation, dividends and various current and non-current liabilities. The amount set apart in these form would be required to be paid only on certain dates. Till then the company can use them for its own purpose. For instance, taxes payable to the government are used in the business until these are paid on due date. Therefore, though for a short-while provisions would serve as a good source of internal finance.

#### Check Your Progress –1

* 1. What are the external sources of finance?

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* 1. List out the internal sources of finance?

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**1.6 Summary**

Finance is a study of money management and deals with the wages in which business men, investors, governments, individuals and financial institutions deal/ handle their money. There are various types of finance Viz. proprietor finance, partnership finance, business finance, public finance etc.

The business unit requires capital for two kinds of needs namely long term requirement and short-term requirement. The external source of finance are share capital, bonds, borrowings, public deposits, trade credits and foreign capital. The internal sources of finance are retained earnings, provisions depreciation etc.

**1.7 Answers to check Your progress**

* 1. a) Common stock
  2. Preferred stock
  3. Bonds/debentures
  4. Public deposits
  5. Trade credits
  6. Banks/financial institutions borrowings
  7. Foreign capital
  8. Foreign Loans
  9. a) Retained earnings

b) Provisions

c) Sale of unused assets