

BUSINESS — Sources of Business Finance

Financial Management · Short-term · Long-term · Debt vs Equity · Conventional & Islamic Banking

PAGE 1 · CHAPTER ROADMAP, DEFINITIONS & CORE CONCEPT

1 CHAPTER OVERVIEW — THE ROADMAP

CENTRAL IDEA Financial management decides which type of financing is required to **maximise shareholders' value** — through a mix of **debt or equity**, or **short-term and long-term** financing. The ultimate decision rests on an **optimal capital structure** and **value maximisation** for shareholders.

AREA 1 Financial management

Role of the financial manager

AREA 2 Short-term financing

< 1 year · working capital

AREA 3 Long-term financing

Debt & equity

AREA 4 Debt vs equity

Pecking order

AREA 5 Conventional & Islamic banking

2 KEY DEFINITIONS

Teal terms = high exam priority

Financial management

The **art and science** of managing a company's funds to meet its goals — **science**: analysing data & cash flows; **art**: optimal use of resources.

Equity capital

Funds raised by **selling ownership** (shares) to existing or new investors; also **retained earnings**.

Long-term finance

Funds **paid back after more than one year**; finances capital projects & expansion.

Committed line of credit

Legal agreement obliging a financial institution to **lend up to a specified amount** within a period, if conditions are kept.

Factoring / discounting

Selling **accounts receivable** outright to a **factor** at a discount for quick funds.

Finance lease

Lessor transfers **all risks and rewards** of the asset to the lessee; ownership may transfer at expiry.

Preference shares

Shares with a **fixed dividend**, **priority** over ordinary shareholders; often **no voting rights**.

Islamic banking

Banking based on **Sharia** — ethics, justice, fairness; **prohibits interest (Riba)**.

Debt capital

Borrowed funds — privately (bank loans) or publicly (**corporate bonds**); interest must be paid.

Short-term finance

Needed for **less than a year**; finances **working capital** & day-to-day operations; a **current liability**.

Trade credit

Accounts payable — amounts owed to suppliers for goods/services received but not yet paid.

Lease

Contract where the owner grants another party the **right to use an asset** for periodic payments.

Bonds

Long-term debt instruments — fixed **coupon** interest at intervals; **principal (par value)** repaid at maturity.

Retained earnings

Profits after tax & preference dividends **reinvested** in the business instead of distributed.

Pecking-order theory

Finance order: **retained earnings** → **debt** → **new equity** (last resort).

3 CORE CONCEPT — WHY EVERY BUSINESS NEEDS FINANCE

FIRST — FUNDS OUTFLOW Spend money

Inventory & supplies, equipment & facilities, wages & salaries

THEN Make sales

From a small grocery shop to a large FMCG company

FUNDS INFLOW Make money

Revenue through sales

THEREFORE Finance is critical to success

Less visible than marketing/production — equally essential

4 TWO WAYS TO CLASSIFY SOURCES OF FINANCE

① BY NATURE — DEBT vs EQUITY

DEBT

Bank loans · corporate bonds · finance lease — **borrowing**

EQUITY

Issuing shares · preference shares · retained earnings — **ownership**

② BY TIME-DURATION / MATURITY

SHORT-TERM

Typically **less than a year** — working capital

LONG-TERM

More than one year — capital projects, expansion

PAGE 2 · FINANCIAL MANAGEMENT, FINANCIAL MANAGER & SOURCES OF FINANCE

5 FINANCIAL MANAGEMENT

ART + SCIENCE

Science → analysing data & cash flows

Art → optimal use of resources

Goal → funds managed so the company meets its **goals and objectives**.

A SHARED RESPONSIBILITY

All business decisions have **financial consequences** → all stakeholders are involved, **not only the finance department**.
e.g. **sales rep** — affected by credit & collection policies; **IT head** — must justify new computers/laptops.

KEY INFORMATION SOURCES

Financial statements — **Balance Sheet, Income Statement, Cash Flow Statement** — mostly prepared by professional accountants. Financial managers focus on **financial planning & cash flow management**.

6 BALANCE SHEET — USES vs SOURCES OF FINANCE

Study Text report format

USES OF FINANCE → ASSETS

Current assets (short-term)
convertible into cash within one year

Non-current assets (long-term)
of a more permanent nature

TOTAL ASSETS

SOURCES OF FINANCE → LIABILITIES + EQUITY

Current liabilities — due within one year

Non-current liabilities — due beyond one year

Shareholders' equity (permanent) — capital & retained earnings

TOTAL LIABILITIES + EQUITY

AIM — AN EFFICIENT CAPITAL STRUCTURE (Self-Test Q2: all three) ① suitable balance of **short-term & long-term funding** ② **adequate cash** for day-to-day expenses ③ appropriate balance of **equity & debt** in the long-term structure

7 ROLE OF A FINANCIAL MANAGER (CFO)

PRIMARY OBJECTIVE

Maximise the company's **value for its owners** — typically measured by the **share price** (Self-Test Q3).

- Integral member of **top management**
- Needs deep business & industry knowledge, **leadership** and **creativity**
- Goes beyond planning, investing & raising funds

SHORT-TERM

e.g. managing cash flow

LONG-TERM

e.g. assessing new projects; choosing optimal financing methods

RISK-RETURN TRADE-OFF

Higher risk demands higher return. Tools such as **scenario analysis** evaluate risks — shifts in market demand, interest rates, economic conditions.

8 3 KEY ACTIVITIES OF A FINANCIAL MANAGER

Self-Test Q7: all three

① FINANCIAL PLANNING

Prepare a financial plan

Project revenues, expenditures & financing needs over a period

② INVESTMENT

Spending funds

In projects & securities with high returns relative to risk

③ FINANCING

Raising funds

Timely funding; optimal balance of debt & equity

GOAL

Maximise value for owners

9 WHY RAISE EXTERNAL FINANCE?

REASONS (Q5: ALL)

Expand into new markets / locations

Invest in R&D

Competitive campaigns

Revenues & profits are preferred, but sales funds don't always arrive when required (Q4: TRUE) → often better to seek **external lenders or investors**. Only a **limited number** of sources exist.

10 DEBT CAPITAL vs EQUITY CAPITAL — FIRST LOOK

DEBT CAPITAL

Borrow **privately** (bank loans) or **publicly** (debt issue — **corporate bonds**; investors become lenders/creditors)

- ✓ Interest usually **tax-deductible**
- ✓ Often **costs less** than other capital
- ✗ **Interest** must be paid
- ✗ Failure to pay → **default or bankruptcy**

EQUITY CAPITAL

Sell **ownership (shares)** to existing or new investors; or reinvest profits as **retained earnings**

- ✓ **No interest payments** required
- ✗ Future profits **shared** as dividends among all shareholders
- ✗ **Voting rights** → dilution of management control

PAGE 3 · SHORT-TERM & LONG-TERM FINANCING

11 SHORT-TERM FINANCING — KEY FEATURES

WHAT

- Typically needed for **less than a year**
- Finances **working capital** & day-to-day operations
- Shown as a **current liability**
- Secured or unsecured** — based on creditworthiness

WHY NEEDED

- Cash flow fluctuations
- Seasonal business patterns
- Specific one-time orders

COMMONLY FINANCES

- Inventory
- Accounts receivable

12 5 SHORT-TERM FINANCING OPTIONS

1

Trade credit (accounts payable) — owed to suppliers; generally **unsecured**; **no direct cost** → attractive. Negotiate favourable terms, but **pay on time** — excessive credit & late payment is not sound.

2

Bank loans — for a **specific purpose**; unlike an overdraft, granted for a **defined period** with a **set repayment schedule**. **Term loans** (fixed assets, e.g. machinery; **3–10 years**) are **long-term**, secured or unsecured.

3

Committed lines of credit — lender **must lend** if conditions are kept; borrow **up to a specified amount** within a period (e.g. up to Rs1,000,000, repaid within one year). Useful when future need is **uncertain in timing & amount**.

4

Operating leases — similar to **rental agreements** for non-current assets, though possibly longer term; may be an **alternative to short-term finance**.

5

Factoring / discounting of receivables — sell receivables outright to a **factor** (bank / finance company) **below actual value**. **More expensive than a bank loan** but **quick access to funds** — popular with steady orders but short of cash for payroll.

13 LONG-TERM FINANCING

MEANING & PURPOSE

- Funds **paid back after more than one year**
- Some form part of **permanent capital** — **no repayment obligation**
- Finances **capital projects** & expansion — modernisation, expansion, diversification, development
- Used when cash is **inadequate** over a longer period
- Internal (equity) or external (debt)

OBJECTIVES OF LONG-TERM FINANCE (8)

- Purchase new assets / equipment
- Permanent part of working capital
- Enhance cash flow
- Invest in R&D
- Construct new projects
- Develop a new product
- Marketing strategies / facilities
- Expand operations

Financial managers choose the **mix of long-term debt and equity** that best balances cost and risk.

14 DEBT FINANCING — 3 CONDITIONS & 3 EXAMPLES

① RECEIVES FUNDS

For a **specific period** or in **perpetuity**

+

② PAYS INTEREST

For as long as the debt is **outstanding**

+

③ REPAYS

The **amount borrowed** at **maturity**

=

EXAMPLES

Term loans · Bonds · Finance lease

TERM LOANS

See bank loans — finance **fixed assets** (machinery); **3–10 years**; secured or unsecured.

BONDS

Issuer (government, local body, corporation) → lender/investor. Fixed **coupon** interest periodically; **principal / par value** at **maturity**. Bond certificate = proof. Issued against **collateral** → **highly secured**.

FINANCE LEASE

Lessor buys the asset for the lessee and rents it for an agreed period; **all risks & rewards (control)** pass to the lessee; ownership may transfer at expiry. Common for **computers & electronics** (fast obsolescence). Compare **cost of leasing vs owning**.

Lease type	OPERATING LEASE	FINANCE LEASE
Classified as	May be an alternative to short-term finance	A form of long-term debt financing
Nature	Similar to a rental agreement for non-current assets (possibly longer term)	Lessor transfers all risks & rewards ; ownership may pass at expiry

PAGE 4 • SHORT vs LONG-TERM, EQUITY & ISSUING SHARES

15 SHORT-TERM vs LONG-TERM FINANCE

Study Text comparison table

Basis	SHORT-TERM FINANCE	LONG-TERM FINANCE
Duration	Repayable within one year or less	Longer span — 1 to 30 years
Requirements	Temporary shortfalls in working capital; repay current liabilities	Growth, property/plant/equipment, large capital projects
Collateral	Do not create a charge on company assets	Collateral generally a primary requirement
Terms of loan	Interest rates unstable , vulnerable to inflation; terms not very flexible	Rates generally stable ; flexible terms — prepayment, re-negotiation on better credit rating
Volume of funds	Limited amounts (repayable soon)	Large volume — limited by securities & credit rating
Examples	Overdraft, credit cards, line of credit	Leasing, term loans, public deposits, bonds
Approval	Simple & fast ; higher chance — less to verify	Complex & slow ; slightly harder — more to verify
Repayment schedule	Lower flexibility	Higher flexibility
Financing cost	Higher interest rate	Lower interest rate
Selection criteria	Borrower in a liquidity crunch ; needs funds quickly to bridge cash-flow timing gaps	Borrower is stable ; needs funds for strategic goals at the best rate (better credit position)

16 EQUITY FINANCING

EQUITY

The **owners' investment**. In corporations the **preferred and common** shareholders are the owners.

TWO ROUTES

External → selling new ownership shares
Internal → retaining earnings

EXAMPLES

Retained earnings Issuing shares for cash
 Preference shares

17 RETAINED EARNINGS

WHAT & WHO DECIDES

Profits **after taxes & preference dividends** reinvested — e.g. paying off debt, buying capital assets. The **board of directors** decides how much to retain vs pay as dividends (cash or stock). Increases **equity reserves**.

✓ **BENEFITS**

- ✓ **No issue costs** — no new shares issued
- ✓ **Readily available** — no case to a bank or new shareholders
- ✓ **No shareholder approval** needed

✗ **LIMITS ON RETENTION**

- ✗ Company might **not earn large profits** — only profitable firms can retain
- ✗ Retaining = **withholding dividends**; must be used efficiently, or shareholders may demand **higher dividends**

Study Text says "three main reasons" but lists these two.

18 ISSUING SHARES FOR CASH

Basis	PRIVATE COMPANY	PUBLIC COMPANY
Shares traded on stock exchange?	No — cannot offer to the general public	Yes — may offer to the public; stock market
Worth of ownership	Value of shares	Share price
Raising new equity	Much more restricted — private sale to investors is difficult; existing owners may lack capital → a limited source	Stock market = market for new issues + secondary market for existing shares

① **IPO**

New shares for purchase by the **general investing public** — **initial public offer**

② **PLACING**

New shares to a **relatively small number of selected investors** — **private placement**

③ **RIGHTS ISSUE**

New shares to **existing shareholders**

Two main types of shares issued to raise equity: **ordinary shares** and **preference shares**.

PAGE 5 · PREFERENCE SHARES, PECKING ORDER & DEBT vs EQUITY

19 PREFERENCE SHARES (PREFERRED STOCK)

BASIC FEATURES

- Most issued with a **fixed rate** of annual dividend
- Dividends paid out of **after-tax profits**
- Paid **before** ordinary (equity) dividends
- In liquidation: rank **ahead of ordinary** shareholders but **after debt providers**
- Often **no voting rights**; sometimes **convertible** into ordinary shares (Q8: TRUE)
- Relatively uncommon**, with a few exceptions

COST FOR THE ISSUING COMPANY

Ordinary shares — most expensive

Preference shares — in between

Debt — cheaper

Pref. dividends are **not tax-deductible** and claims rank behind debt
→ dearer than debt, cheaper than ordinary shares.

20 PECKING-ORDER THEORY — PREFERRED FINANCING ORDER

1ST

Retained earnings (internal)

Signal: company is **performing well**

2ND

Debt

Signal: management **confident** it can meet obligations

LAST RESORT

New equity

Usually a **negative signal** — company overvalued; raising funds before price falls

BUT ULTIMATELY The financing decision should always rest on an **optimal capital structure** and **value maximisation** for shareholders.

21 DEBT vs EQUITY FINANCING

STUDY TEXT EXAMPLE An aerospace company plans to spend **\$2 billion over four years** on new jet-aircraft factories → top management weighs debt vs equity, then considers possible sources of long-term finance.

DEBT

- ✓ Interest **tax-deductible** → lower cost & cash outflow
- ✓ **No loss of ownership**
- ✗ **Financial risk** — may fail to pay interest & principal → lender can force **bankruptcy**
- ✗ Loan agreements include **restrictions**

EQUITY

- ✓ **Permanent** financing; **few restrictions**
- ✓ No requirement to pay dividends or repay
- ✗ Ordinary shareholders get **voting rights**
- ✗ **Costlier** than debt — dividends **not tax-deductible**

Area	DEBT FINANCING	EQUITY FINANCING
Say in management	Creditors: none unless default; may restrain management on default; covenants (e.g. minimum current & quick ratios)	Ordinary shareholders have voting rights
Right to income & assets	Rank ahead of equity; interest & principal are contractual obligations	Residual claim ; no obligation to pay dividends
Maturity	Stated maturity ; principal repaid by a date	No maturity ; not required to repay
Tax treatment	Interest is tax-deductible	Dividends not tax-deductible ; paid from after-tax income

22 BUSINESS APPLICATION — WHICH SOURCE FITS?

Situations described in the Study Text

Situation	Best-fit source
Need funds quickly to bridge cash-flow timing gaps (liquidity crunch)	Short-term finance
Future need uncertain in timing and amount	Committed line of credit
Steady orders but short of cash for payroll	Factoring / discounting
Buying machinery over 3–10 years	Term loan
Computers & electronics that become obsolete quickly	Finance lease
Avoid issue costs and shareholder approval	Retained earnings

PAGE 6 • CONVENTIONAL & ISLAMIC BANKING • HOW THIS CHAPTER IS TESTED

23 CONVENTIONAL BANKING — KEY CHARACTERISTICS

i Interest-based

Lend at interest; pay interest to depositors — **primary income**

ii Profit maximisation

Charge **higher** rates on loans than paid to depositors

iii Risk & return

May engage in **speculative** trading & investment

iv Regulation

Central banks / government — stability & liquidity; **not ethics** specifically

v Products

Personal loans, mortgages, credit cards, savings, investments

24 ISLAMIC BANKING — KEY FEATURES (SHARIA-BASED)

i No Riba

Paying & receiving **interest prohibited**; profit via **trade** or **risk-sharing**

ii Profit & loss sharing

e.g. Mudarabah, Musharakah

iii Asset-backed

Linked to **tangible assets** or **services** — real activity, no speculation

iv Ethical investment

Avoid alcohol, gambling, adult entertainment, interest-based finance

v Sharia compliance

Overseen by **Sharia boards / committees**

MURABAHA

Cost-plus sale — bank buys an asset and sells it to the customer at a profit

IJARA

Lease — bank purchases an asset and leases it to the client

MUDARABAH

Profit-sharing — one party gives capital, the other expertise & effort

MUSHARAKAH

Joint venture — both contribute capital; share profit/loss

25 CONVENTIONAL vs ISLAMIC BANKING

Basis	CONVENTIONAL BANKING	ISLAMIC BANKING
Interest	Charged on loans, paid on deposits	Interest (Riba) prohibited
Profit generation	Lending money at interest (Q12)	Partnerships, asset-backed transactions, profit-and-loss sharing (Q11)
Ethical standards	Profit maximisation; limited ethical restrictions	Must follow Sharia ethical guidelines
Regulation	Central banks & government authorities	Central banks + Sharia supervisory boards
Investment	Free to invest in any industry	Avoids Haram industries (alcohol, gambling)
Contract types	Interest-based loans, mortgages, credit facilities	Murabaha, Mudarabah, Musharakah, Ijara

26 APPLY IT — IDENTIFY THE BANKING ARRANGEMENT

Descriptions from the Study Text

Arrangement described	Answer
Bank earns the spread between loan and deposit interest	Conventional banking
Bank buys an asset and sells it to the customer at a profit	Murabaha
Bank buys an asset and leases it to the client	Ijara
One party gives capital, the other expertise and effort	Mudarabah
Both contribute capital and share profit/loss	Musharakah

27 HOW THIS CHAPTER CAN BE TESTED

1 Definition-based — financial management, trade credit, bonds, finance lease, retained earnings

3 True / False — preference shares often lack voting rights (T); time-based classification (T)

5 "Which is NOT..." — preference shares paid **after** equity in liquidation → NOT a feature

7 Sequence — pecking order — retained earnings → debt → new equity

2 Fill in the blank — "___ management is the art and science of managing funds" → financial

4 Multiple statements — features of an efficient capital structure (i, ii & iii)

6 Comparison — short vs long-term; debt vs equity; conventional vs Islamic; operating vs finance lease

8 Scenario — choose the best source for a described funding need

PAGE 7 • EXAM TRAPS, DECISION TREE & MCQ CLUES

28 **! EXAM TRAPS**

- 1** **Role of financial manager** — To **maximise value** for shareholders (share price) — not organising the finance dept or managing salaries (Q3).
- 2** **Shared responsibility** — Financial management involves **all stakeholders**, not just the finance department.
- 3** **Term loan** — Listed under bank loans but is **long-term** (3–10 years).
- 4** **Bank loan vs overdraft** — Bank loan: **defined period** + set repayment schedule; overdraft does not.
- 5** **Trade credit** — **No direct cost** — but late payment / excessive credit is not sound.
- 6** **Factoring cost** — **More expensive** than a bank loan (receivables bought below value) — but quick.
- 7** **Operating vs finance lease** — Operating ≈ **rental** (short-term alternative); finance lease transfers **risks & rewards** (long-term debt).
- 8** **Collateral** — Short-term: **no charge** on assets; long-term: collateral a **primary requirement**; bonds **highly secured**.
- 9** **Cost of finance** — Short-term = **higher** rate; long-term = **lower** rate.
- 10** **Preference in liquidation** — Ahead of **ordinary** shareholders but **after** debt providers (Q9).
- 11** **Preference dividend** — **Fixed** rate from **after-tax** profits (Q10) — not variable, not tax-deductible.
- 12** **Cost ranking** — Debt < preference shares < ordinary shares.
- 13** **Pecking order** — Retained earnings → debt → **new equity last** (negative signal).
- 14** **Debt tax effect** — **Interest** is tax-deductible; **dividends** are not.
- 15** **Retained earnings** — **No issue costs** and **no shareholder approval** — but only if profitable.
- 16** **Islamic profit** — Via **profit-and-loss sharing** & trade — never interest (Q11 vs Q12).

29 **DECISION TREE — CHOOSE THE SOURCE OF FINANCE**

STEP 1 • HOW LONG ARE THE FUNDS NEEDED?

< 1 YEAR → SHORT-TERM (working capital)

- A** Owed to suppliers, no direct cost → **TRADE CREDIT**
- B** Specific purpose, defined period, repayment schedule → **BANK LOAN**
- C** Need uncertain in timing/amount; lender committed up to a limit → **LINE OF CREDIT**
- D** Rental-like use of an asset → **OPERATING LEASE**
- E** Sell receivables to a factor for quick cash → **FACTORING**

> 1 YEAR → LONG-TERM • STEP 2: BORROW OR SELL OWNERSHIP?

- F** Borrow — fixed assets 3–10 yrs → **TERM LOAN**; fixed coupon, par at maturity, collateral → **BONDS**; risks & rewards transferred → **FINANCE LEASE**
- G** Ownership — reinvest profits → **RETAINED EARNINGS**; new shares (IPO / placing / rights) → **SHARE ISSUE**; fixed dividend, priority, no vote → **PREFERENCE SHARES**

CHECK Pecking order; interest must be **avoided?** → Islamic contracts (Murabaha, Ijara, Mudarabah, Musharakah).

30 **MCQ QUICK-CLUE SECTION**

All 12 Self-Test questions

Art & science of managing funds	Financial management (Q1)	Features of efficient capital structure	i, ii and iii (Q2)
Best summary of financial manager's role	Maximise value for shareholders (Q3)	Sales funds don't always come when required	TRUE (Q4)
Reasons for external funding	All of the above (Q5)	Classify sources by time duration	TRUE (Q6)
Key activities of financial manager	Planning, investing, financing (Q7)	Pref. shares: often no vote, convertible	TRUE (Q8)
NOT a feature of pref. shares	Paid after equity in liquidation (Q9)	A feature of pref. shares	Dividends from after-tax profits (Q10)
Key characteristic of Islamic banking	Profit-and-loss sharing (Q11)	Conventional bank profit	Interest on loans vs deposits (Q12)

PAGE 8 • KEY NUMBERS, MEMORY MAP & 60-SECOND REVISION

31 KEY NUMBERS & MEMORY AID

< 1 yr short-term finance	> 1 yr long-term finance	1–30 years — LT span	3–10 years — term loan
5 ST options	3 share-issue methods	3 FM key activities	4 Islamic contracts

MNEMONIC — 5 SHORT-TERM OPTIONS

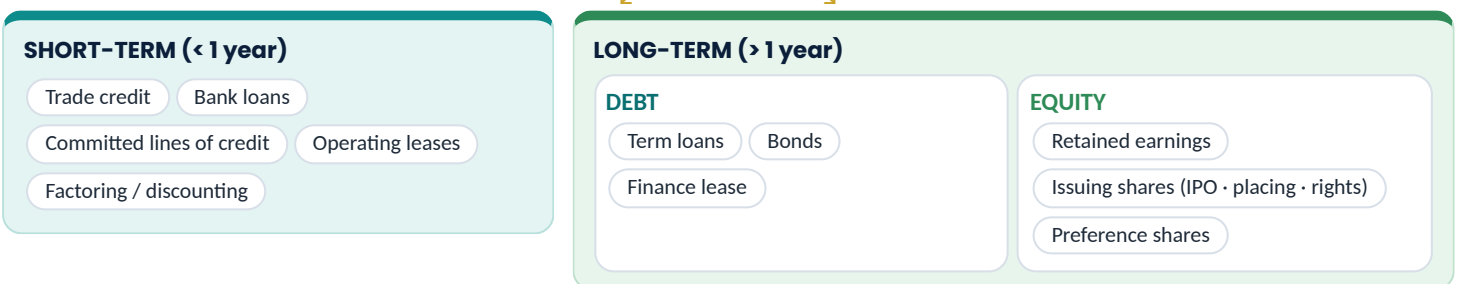
“The Bank Credits Our Factory”

T Trade credit • B Bank loans • C Committed lines of credit •
 O Operating leases • F Factoring / discounting

Memory aid only.

32 ONE-GLANCE MAP — SOURCES OF BUSINESS FINANCE

SOURCES OF BUSINESS FINANCE



33 QUICK MEMORY MAP

Concept	Key words	Core idea
Financial management	art + science · shared · statements	manage funds to meet goals
Financial manager	planning · investing · financing	maximise owners' value
Capital structure	ST/LT balance · cash · debt/equity	efficient mix of sources
Short-term	< 1 yr · working capital · 5 options	bridge timing gaps; costlier
Long-term	> 1 yr · collateral · 1–30 yrs	growth & capital projects
Debt	interest · maturity · tax-deductible	cheaper but financial risk
Equity	ownership · dividends · voting	permanent, costlier
Banking	Riba · Sharia · asset-backed	conventional vs Islamic

34 BUSINESS — SOURCES OF BUSINESS FINANCE IN 60 SECONDS

🕒 **MANAGING FINANCE**

- FM = art + science; everyone's job
- Goal: maximise owners' value (share price)
- Plan · invest · finance
- Efficient structure: ST/LT, cash, debt/equity
- Risk–return trade-off

🕒 **SHORT vs LONG**

- ST: trade credit, bank loan, credit line, operating lease, factoring
- ST: fast, no collateral, higher rate
- LT: term loans, bonds, finance lease, equity
- LT: collateral, 1–30 yrs, lower rate

🕒 **DEBT · EQUITY · BANKING**

- Pecking order: RE → debt → equity
- Debt: tax-deductible, maturity, priority
- Equity: permanent, residual, voting
- Pref: fixed dividend, after debt
- Islamic: no Riba, PLS, asset-backed