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SOURCES OF FINANCE

A business can raise funds from various sources. Each of the source has unique characteristics, which must be properly understood so that the best available source of raising funds can be identified. There is not a single best source of funds for all organisations. Depending on the situation, purpose, cost and associated risk, a choice may be made about the source to be used. For example, if a business wants to raise funds for meeting fixed capital requirements, long term funds may be required which can be raised in the form of owned funds or borrowed funds. Similarly, if the purpose is to meet the day-to-day requirements of business, the short term sources may be tapped. A brief description of various sources, along with their advantages and limitations is given below.

Retained Earnings

A company generally does not distribute all its earnings amongst the shareholders as dividends. A portion of the net earnings may be retained in the business for use in the future. This is known as retained earnings. It is a source of internal financing or self- financing or 'ploughing back of profits'. The profit available for ploughing back in an organisation depends on many factors like net profits, dividend policy and age of the organisation.

Merits

The merits of retained earning as a source of finance are as follows:

(i) Retained earnings is a permanent source of funds available to an organisation;

(ii) It does not involve any explicit cost in the form of interest, dividend or floatation cost;

(iii) As the funds are generated internally, there is a greater degree of operational freedom and flexibility;

(iv) It enhances the capacity of the business to absorb unexpected losses;

(v) It may lead to increase in the market price of the equity shares of a company.

Limitations

Retained earning as a source of funds has the following limitations:

(i) Excessive ploughing back may cause dissatisfaction amongst the shareholders as they would get lower dividends;

(ii) It is an uncertain source of funds as the profits of business are fluctuating;

(iii) The opportunity cost associated with these funds is not recognised by many firms. This may lead to sub-optimal use of the funds.