7. Financial Requirements and Investment Opportunities

This chapter discusses the following themes.

7.1 Financial requirements of business organizations
7.2 Sources of finance
7.3 Evaluation of financial sources
7.4 Selection of financial sources
7.5 Evaluation of investment decisions
7.6 Different types of returns from investments
7.7 Factors that should be considered in selecting investment types

Let us take suitable decisions, by investigating the capital market

The following conversation was extracted from a television programme.

Today, on "Hasini with Dilini" programme, you will be meeting Mr. Bhanu Muthukumarana. Mr. Muthukumarana is a finance manager of a well-known company in Sri Lanka.

Hasini : Good morning Mr. Muthukumarana. We would like to welcome you for the programme.

Banu : Good morning!

Dilini : I would like to thank you for participating in the programme. As an introduction to our discussion I would like to know that we can observe the basic features of financial management theories even at our household levels. Do you agree with me?

Banu : Absolutely yes. Even in a household or in a business organization what is happening is that we have to fund our financial requirements from various sources and invest them in various investments.

Hasini : Could you please explain it further?

Banu : People can meet their financial requirements from various sources such as from their salaries and wages from employment, rent or leasing from properties, personal loans from various institutions etc.

Hasini : Does everyone spend money in the same manner?

Banu : Although people spend money on different items, we can observe similarities in their expenditure patterns.

Dilini : What are these similarities in the expenditure patterns?

Banu : We can classify these patterns under two broad categories. The first category is the expenditure on day-to-day activities such as expenditure on food items, medicines etc. These are also called recurring expenditure.

Hasini : What is the other category?

Bhanu : Sometimes we spend on items that can be used for a long period of time such as refrigerators, televisions, washing machines etc. Expenses on these kinds of equipment are not very frequent since we can use them over a period of time.

According to the above conversation you may understand the requirements of finance and the sources of finance. By reading this chapter you will understand that there are different types of financial requirements for different individuals as well as for different business organizations and they use various methods in financing these requirements.

Introduction

Each individual has to spend money on different types of goods and services In order to finance these requirements they have to use different types of sources of funds. Funds will be reinvested in the business itself or may be invested in different types of investments externally. These types of investments are beneficial to the investors as well as to the country as a whole. Different sources of finance, different types of investments available will be discussed in this chapter.

Your attention is drawn on the following basic terms in this chapter.

- Long term financial requirements
- Short term financial requirements
- Ordinary shares
- Preference shares
- Formal investments
- Savings deposits
- Time/Fixed deposits
- Share market
- Capital gains
- Bonus shares
- Rights issues
- Risks and Returns

7.1 Financial requirements of business organisations

At present, people have complex needs and wants. In this context, it is important to study the various market conditions and identify different business opportunities available. Selection of sources of finance for an organization and invest them profitably should be carefully decided. In this section, we will identify various types of financial requirements of an organization.

i. Initial capital requirements

It is required to buy assets and incur certain expenditures when starting up a new business.Therefore, funds are required to finance initial capital requirements of a company for properties, equipment, furniture, buildings etc.

ii. Business expansion requirements

Funds are also required for business expansion activities. The company may require opening of new departments or branches for which the company has to invest in more equipment, furniture, buildings etc.

iii. Acquisition of other businesses

Funds may also be required in financing acquisition of another operating business as a strategic move. For example, a furniture shop owner may acquire a carpentry workshop. This will help him in supplying materials, opening another sales outlet etc.

In addition to the above mentioned basic needs, following requirements too, play an important role.

❉ To carry out day-to-day activities

Example : ⊙ For purchasing stocks
For Sundry expenses

❉ To face unexpected incidents

Example : ⊙ Getting unexpected orders
Bad debts

It is clear that a business organization may find different types of financial requirements in carrying out its business operations. On the other hand, there can be different types of investment objectives also.

Accordingly, the financial requirements of an organization can be discussed under two main categories based on time.

01. Financial requirements to meet long term investment opportunities

Long term financial requirements are to invest in assets which are long term in nature such as acquisition of lands, buildings, properties etc. These are called long term financial requirements.

02. Financial requirements to meet short term investment opportunities

Short term financial requirements are to meet financial requirements of carrying out day-to-day activities such as paying salaries and wages, insurance premium, traveling charges, electricity, taxes, settling trade debts etc.

The above financial requirements may vary from organization to organization depending on their nature and size of the organization. For example, there can be more short term financial requirements for a grocery shop whilst there can be more demand for long term financial requirements for a construction company.

7.2 Sources of finance

Various financial requirements of an organization are funded by different sources of finance. Accordingly,

i. Long term investments can be financed by long term sources
ii. Short term investments can be financed by short term sources

Therefore, it signifies that there is a relationship between the term of the investment and the term of the sources of financing.

Identifying the source of finance according to the nature of the organisation

There are different forms of business organisations. Whilst some organisations have access to wide range of sources of financing, other organisations may find it difficult to finance their requirements. The higher the access to different sources of financing the higher the growth potential of the organisation.

Sole proprietorship

Savings of the proprietor, pooled money from family members and close relations are the key sources of financing of a sole proprietor. Most of these funds are interest free. Sole proprietor has the access to the personal loans, banking loans and overdraft facilities too.

Partnerships

The main source of finance is the capital invested by partners of the partnership. The capital invested by different partners is agreed at the time of formation of the partnership. In addition to the capital invested, the partnership can also borrow funds from its partners. Partnerships also have the access to banking and other financial system and obtain loans. Thus you will be able to understand that partnerships have comparatively more ability to find source of finance than sole proprietorships.

Limited liability companies/Listed companies

Limited companies have access to a wide range of sources of funding than other forms of business organizations. They can

- Issue shares
- Issue debentures
- Obtain mortgaged loans
- Obtain Bank loans
- Obtain loans from non banking corporative sector
- Enter into leasing and Hire purchase contracts etc

Co-operative societies

Membership fees paid by the members of the society are the main source of funds of the co-operative societies. In addition to member fees, they have the access to bank loans, corporate loans and Government grants.

Public enterprises

The businesses which are maintained and controlled by the Government, provincial councils, local authorities and other Government institutions fall into public enterprise category. The main source of finance of public enterprise is the Government grants. In addition to this, certain local public enterprises have been permitted to issue shares to the public for its financial requirements.

Activity 1

Assume that you are planning to start a furniture shop and in order to commence operations,

i. Identify the resources you need to commence the business

ii. Explain how you would plan to fund these requirements.

7.3 Evaluation of financial sources

As discussed, the business organizations can finance their financial requirements from various sources of finance. Each of these sources should be carefully evaluated before selecting as the source of finance.

Bank loans

Bank loans are a formal type of sources of funding. The bank may impose certain terms and conditions on the borrower to make sure that the loan is repaid promptly. Bank loans can be obtained comparatively at low rates. The bank will charge different interest rates from different borrowers considering their financial stability, nature of the business and other factors that the bank may consider important. In certain instances, the bank will grant loans on less condition considering the economic priorities of the country. Accordingly, bank loans are considered as a reliable source of finance.

Selling properties/renting out/pawning

A business organization can use its own properties to fund different requirements. If there are excess or unutilized assets, the company can sell them out or rent/ lease them out and fund the requirements. This method of financing enables the organization to meet the financial requirements at low cost and comparatively easily since the company uses some existing assets.

Personal loans

This is one of the informal methods of financing. Although personal loans are subject to higher interest rates, the ability to obtain loans with less documentation requirements and with no guarantors, these loans are comparatively an attractive method of financing.

Issuing shares

Shares are issued by the limited companies as the main source of capital. The capital of the company will be divided into number of small units and will be sold the ownership of the company to the persons who purchase the shares.

Shares issued by a company can be classified into two broad categories such as ordinary shares and preference shares.

Ordinary shares

Ordinary shares are issued without specifying a particular dividend payout percentage. Dividends will be declared based on the annual operational profit of the company. Ordinary share capital is a form of long term capital. (equity share capital)

Preference shares

Preference shares are issued specifying the dividend payout percentage.

As a source of finance, the issue of ordinary shares will give the following benefits to the business.

- **The ability to raise more funds**

  Limited liability companies can invite the general public to subscribe for share issues and thereby raise higher amount of capital.

- **Long term nature of the capital**

  Share capital can be retained until the liquidation of the company as it is paid out at last.

- **No interest is paid**

  Interest is not paid for capital raised by issuing ordinary shares. Although dividend is paid, it is subject to the operational performances of the company. Therefore, there is no committed cost of capital as other loans.

- **Enhances the transparency of business operations**

  It is legally required to publish financial information of the limited liability companies as at stipulated period of time by different statutes. Since the financial information is published periodically and they are subject to audit, the investor awareness of these companies is comparatively higher than other companies.

Accordingly, by evaluating different financial sources, it is possible to identify the most appropriate and economical source of financing for the company.

7.4 Selection of financial sources

In selecting the best method of financing for an organization, the following factors should be considered. It is important to select the most economical and appropriate source of financing.Therefore let us consider some important factors in selecting sources of financing.

- The nature of the requirement
- Collateral requirements
- Terms and conditions imposed on the borrower
- Flexibilities in obtaining the facility
- Ability to repay
- Costs of financing
- The nature of the business organization
- Tenure of the facility
- The nature of the business activities

The nature of the requirement

It is required to identify the exact requirement that is to be financed. Short term financial requirements should be financed by short term means whilst long term financial requirements are financed from long term means.

Collateral requirements

It is required to produce securities/ collateral in obtaining loans specially from banks and other private sector institutions. Generally, the most of securities are lands, buildings and other types of fixed assets. The ability to produce acceptable securities will enhance the ability to meet financial requirements.

Terms and conditions imposed on the borrower

Lending institutions will impose different terms and conditions on the operations of the business. Sometimes, the lending institution can order the borrower to cease the use of the mortgaged property and recover the loan if the borrower defaults in paying interest and/or capital on time. In addition to this, the lending institution can charge a penal rate on defaults or delays in meeting these requirements.

Flexibilities in obtaining the facility

The documentation requirements and the processes that the borrower has to go through in obtaining the loan is also an important factor to be considered. In this process, it is required to produce various documents, guarantees etc. The time taken for these activities varies from one lending institution to another.

- **Ability to repay**

  It is required to be vigilant about the movements and patterns of the cash flow of the company. Therefore, the income earned on operating activities that are funded by the borrowed funds should be adequate to meet capital and interest repayments on time. Failure to do so will cause numerous problems to the organization.

- **Costs of financing**

  Various costs have to be incurred from initial stage of fund raising to the final repayment. Few of these costs are costs on documentations, advertising, legal fees, stamp charges etc. In addition to these costs, the borrower has to meet capital, interest/dividend repayments periodically on time depending on the types of the borrowing. Therefore, it is essential to analyze the costs and benefits of financing a particular financial requirement.

- **The nature of the business organization**

  All the financing sources are not accessible to all the types of business organizations. For example, a sole proprietor and a partnership cannot raise funds by issuing ordinary shares to the public. Therefore, an organization should always select the best and the authorized sources to fund its financial requirements without going for easily accessible unauthorized sources of financing.

- **Period of time given to repay**

  Certain funding should be repaid within one year whilst some other funding allows them along period of time to repay. If the repayable time is shorter the monthly installment of paying back is higher. Then a considerable amount of the income has to be paid back as installments. It may be a hindrance to the improvement and existence of a business. If the repayable time is longer such inconveniences may not occur.

- **The nature of the business activities**

  When funding, it is essential to understand the nature of the business that the company carries out. For example, the source of funds available for a grocery shop owner may not be appropriate for a wholesale dealer mainly due to the differences in their nature of the business.

Accordingly, the optimum source of funding for the organisation should be selected after careful evaluation of the various factors affecting the decision. This provides much comfort, profitability and liquidity conditions for the organisation.

Activity 2

Funding sources available for a limited liability company are more than that for other forms of business organizations. Comment on the above statement.

Activity 3

Limited liability companies prefer to raise capital by issuing shares more than other sources of funding. Comment on the above statement.

Activity 4

You are required to prepare an article to the commerce magazine of your school on the topic, **"factors that should be considered when selecting a source of financing".**

7.5 Evaluation of different modes of investment

Organizations have to carry out their business activities in a very dynamic and complex environment. At the same time, the opportunities available for investments are numerous and wide. Placing excess funds available with individuals and organizations in various instruments with the intention of earning income can be defined as an investment. One mode of classifying the investments is the tenure of the investment. Therefore,

investments can be categorized as follows considering the tenure or maturity.

- Short term investments
- Long term investments

Short term investments are the investments with maturity period less than one year. Other investments that have a maturity period of more than one year are categorized as long term investments.

Another method of classifying investments is the legal form of investments. Accordingly, investments can be categorized considering its legal form as follows.

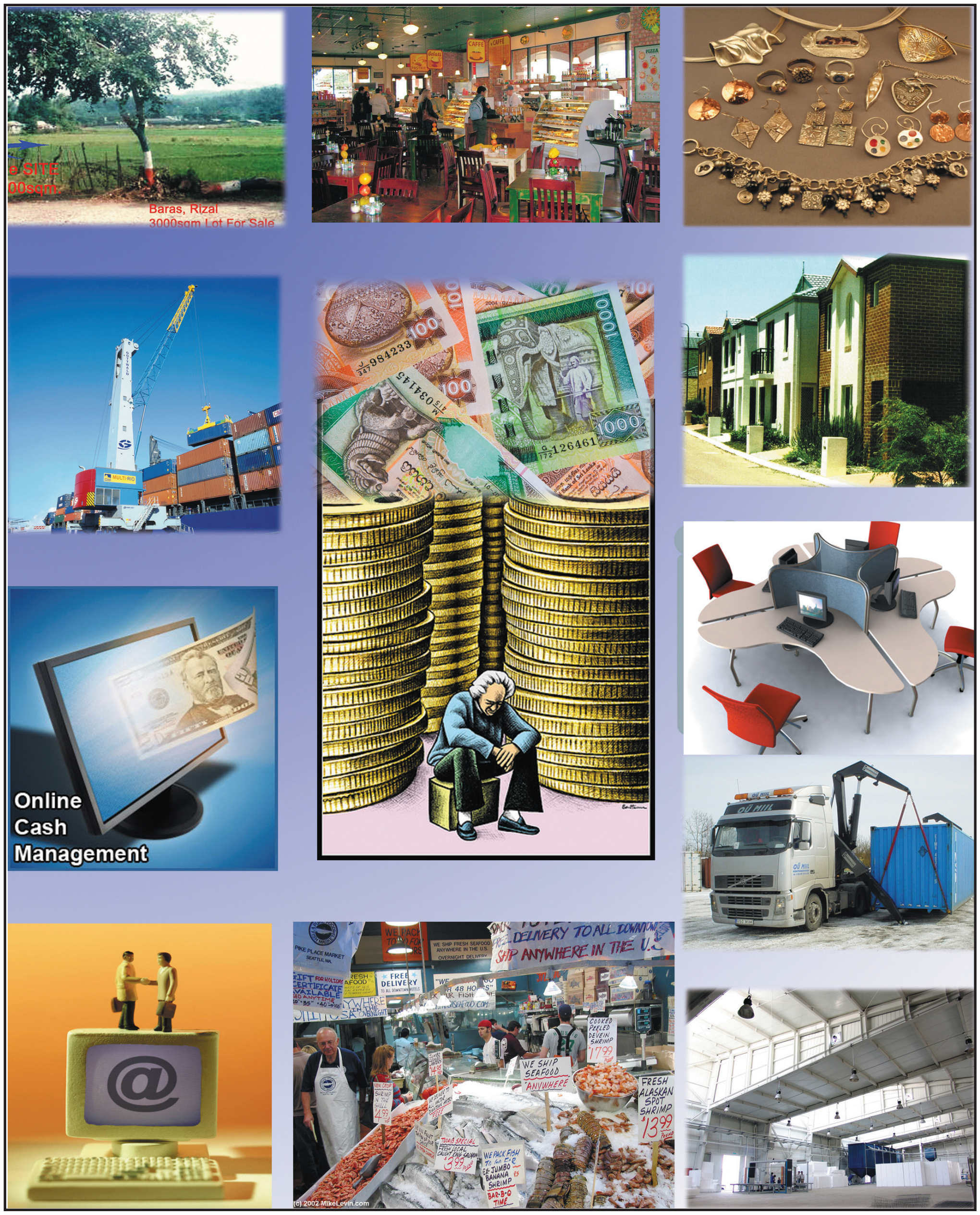
- Formal investments
- Informal investments

In the following sections, we will be focusing more on the formal methods of investments. This does not mean that informal types of investments are not popular among investors. Investment methods that do not have an acceptable legal basis can be grouped as informal methods of investments. Investing in *Seettu*, deposits made at different places expecting higher interest rates are few examples of informal types of investments. The absence of legal acceptance and the potential risk of defaulting are the key factors to be considered before deciding in investing in informal methods of investments.

In contrast, the formal methods of investments are carried out by organizations with acceptable legal basis and are effectively monitored by another Government regulatory body.

At present, investors tend to make investments in the formal methods of investments due to following reasons.

- Acceptable legal basis
- Low risk of default the capital deposited
- Low risk of default the interest due
- Other non-financial benefits



Varoius avenues of investment

Types of formal investment

Some types of formal investment are as follows.

- Deposits
- Purchases of assets
- Purchase of shares

Deposits

Deposits are accepted by the banks and other financial institutions registered in the Central Bank of Sri Lanka. This is a very popular form of investment among small scale investors. Financial institutions have introduced various types of deposit products with numerous other benefits built into deposits to attract depositors. Some of these deposit products are as follows.

i. Savings Deposits
ii. Time/Fixed Deposits
iii. Certificates of Deposit

Savings Deposits

Savings are made with the intention of earning an interest and to withdraw money as and when required. This is a very feasible form of investment to any scale of investor due to following reasons.

- It is comparatively easy to open a savings account
- Deposits can be made at any time during the working hours
- Convenient physical arrangements made by the financial institutions

Example : ⊙ Post offices
School Co-operative societies and other school banks
Co-operative Rural Banks
Commercial Banks
Non banking other financial institutions

- Ability to withdraw funds anytime

Time/Fixed Deposits

A fixed amount will be invested at a fixed rate over a fixed term and this is called a fixed deposit. If the fixed deposit is withdrawn before the maturity date, the agreed interest might not be paid. Interest may be withdrawn before the maturity of the fixed deposit in frequencies such as monthly, quarterly, bi annually and annually or may be withdrawn fully at the maturity together with the capital amount. The interest rates will vary according to the tenor and the value of the deposit. The following benefits can be enjoyed in investing in fixed deposits.

❋ Receiving the interest at the end of the term at the agreed rate
❋ A higher interest than savings will be paid on fixed deposits
❋ The longer the tenure of the deposit, the higher the interest rate on the deposit

Certificate of Deposits (CDs)

Certificate of deposits can be made over a fixed term at a bank or at another financial institution. CDs will also earn a higher interest than savings and the tenor of CDs are generally one year. In addition to the interest, various other gifts will be given to depositors on drawings.

It is advisable to save money in a bank or a financial institution which has been approved and supervised by the monetary board of the central bank of Sri Lanka or in a bank or a financial institution which has been registered under the Banking Act or Finance Companies Act.

Activity 5

If there is a savings bank in your school, study with your friends the operations and business activities of that bank and answer the following questions.

i. The types of deposits you can make at the bank
ii. The minimum deposit amount that is required to open a deposit.
iii. Rates of interest given for different types of deposits
iv. The steps that you have to follow in making a deposit
v. The methods available in withdrawing funds
vi. The other types of benefits given to depositors when the deposited amount increases.

Purchases of assets

With the interest rates declining environment, individuals and institutions prefer to invest in properties as a method of investment. Since there is a downward trend in the value of money, the demand for properties is increasing. Assets can be grouped as follows.

- Fixed assets
- Movable assets

Fixed assets

Fixed assets are the assets that cannot be physically moved from place to place. As a method of investment, there is a higher tendency to acquire fixed assets, specially in lands. This is mainly due to scarcity of land as a resource and its unlimited use of economic life. Therefore, high capital gains are expected by investing in lands.

In addition to this, investments in buildings are also an attractive method of investments. However, the economic life time of buildings is limited and it is a depreciable asset in nature.

Moveable assets

Another investment option available is to invest in moveable properties. Moveable assets are the assets which are not fixed to a fixed asset and physically moveable in nature. Investment on gold jewelery is another attractive method of investment due to following reasons.

- The increasing price movement pattern
- The ability to sell/pawn them any time and to convert into cash

In addition to gold jewelery , investments are also made in precious stones such as diamonds, gems and other antique assets.

Purchase of shares

Investing in shares of companies is one of the formal methods of investment. These trading activities take place at a stock exchange. Investors can buy shares from an initial public offer made by companies and from the secondary market, which is the stock exchange.

The secondary market operations in Sri Lanka are handled by the Colombo Stock Exchange and shares of all the listed companies are traded here. The companies which are registered in the Colombo Stock Exchange are also called the listed companies. The Colombo Stock Exchange manages all the trading activities of the stock exchange and the Securities and Exchange Commission of Sri Lanka regulates all the activities of the Colombo Stock Exchange.

A company can issue two types of shares.

- Ordinary shares
- Preference shares

As an investment method, ordinary shares have a cashable easily market and therefore ordinary shares are more attractive than other types of shares. Ordinary shareholders are treated as the owners of the company and the capital is called the owners' equity due to the features attached to the ordinary shares.

Ordinary shares

Ordinary share holders of a company are entitled to the following benefits.

- **Dividend payments:**
  Dividends are paid out of the net profit of the company at the discretion of the management. Dividends are not paid out at the periods of not earning net profits but will be paid at a higher percentage when the company earns higher profits.

- **Ownership and management:**
  Limited companies are managed by the board of directors. The company directors are appointed from the shareholders of the company. Therefore, the shareholders have the opportunity to participate in decision making process of the company.

- **Voting rights:**
  Ordinary shareholders are able to attend the different types of meetings of the company and they enjoy the voting rights at such meetings based on their number of shares holding.

Investment Portfolios

Instead of investing only in one type of asset category, investors can invest in number of assets as a basket of investments. This is called a portfolio of investment. It gives the investor an opportunity to diversify his investments. A portfolio may comprise deposits in banks and other financial institutions, shares and other types of investments. Investing in a portfolio will reduce the various risks inherent to different types of instruments and ensures stable level of income over the period of time.

Unit Trusts

Unit trusts are trusts build up by the funds received from its unit holders. Unit holders will purchase units from the trust. Since unit prices are comparatively affordable than other types of investments, even small scale investors can invest in unit trusts. The unit trusts are managed by expert professionals in the various investment fields. Therefore, high returns can be expected at comparatively low risks.

7.6 Different types of returns from investments

The various types of returns that can be earned from investing in different investments are discussed below.

Returns from deposits

The investors can enjoy the following types of returns/benefits by investing in deposit products.

- **Interest** :- Income that is earned by depositing funds is called interest. Banks and other financial institutions pay attractive rates to depositors based on the term and the amount deposited.
- **Safety** :- The ability to receive money so deposited and the interest thereon is an important factor. The risk of defaulting capital and/or interest is very low if the deposit is placed at banks and other authorized financial institutions.
- **Other benefits**:- Banks and other financial institutions offer various types of gifts and benefits for its deposit holders.

Example : ⊙ Gifts offered on lottery drawings, free insurance covers, ability to keep as collateral when obtaining a loan etc.

Returns from acquiring assets/properties

Investing in assets/properties will provide following returns to the investors.

❋ Capital gains

It is possible to earn capital gains by selling properties at a higher price than the purchase price. For example it is possible to earn a capital gain of Rs. 50,000 by selling a property purchased at Rs. 800,000 for Rs. 850,000.

❋ Other types of income

It is possible to earn rent and/or lease incomes by using assets/properties purchased. At the same time, it is possible to use the natural resources in the property.

❋ Other benefits

Assets/properties are well accepted as collateral when obtaining loans from other parties.

Returns from ordinary shares

By investing in ordinary shares, the following returns/benefits can be gained.

❋ Dividends

Dividends are paid out of profit of the company. At the end of a financial year of the company, the dividend pay out ratio will be declared. Sometimes, dividends are paid during a financial year and are called interim dividends. The higher the net profit of the company, the higher the dividend pay out percentage.

❋ Capital gains

Capital gains can be earned by selling the shares at a higher price than the purchase price.

Example : ⊙ An investor has purchased 800 ordinary shares of a company at Rs. 12 and sold them at Rs. 16. The capital gain earned on this transaction is **Rs. 3,200.** {(Rs. 16 – Rs. 12) × 800}

❋ Bonus shares

Bonus shares are free shares given to existing ordinary shareholders in a company, based upon the number of shares that the shareholder already owns. Though monetary contribution is not done for this, rights can be gained for all the shares.

❋ Rights issues

As an option, a company can go for a rights issue to raise additional capital. With the issued rights, existing shareholders have the privilege to buy a specified number of new shares from the company at a specified price within a specified time. Ability to buy the shares for a lower price than the price in the existing share market is the benefit that can be gained in such instances.

❋ Other benefits

Ordinary shares can also be collateralized as a security in obtaining loans. At the same time, the ordinary shareholder becomes the owners of the company and they can be appointed as a member of the Board of directors. They may also enjoy discounts when purchasing goods and services as shareholders of the company.

7.7 Factors that should be considered in selecting an investment type

An investor should consider a number of factors in selecting a method of financing. In this case, more attention should be given to risks and returns of the investment.

❋ Return

The term return refers to the ratio of money gained or lost (realized or unrealized) on an investment relative to the amount of money invested. The amount of money gained or lost may be referred to as interest, profit/loss, gain/loss, or net income/loss. The money invested may be termed as the assets, capital, principal or the cost of the investment. If the return on investment does not compensate the risks absorbed by investing in such instrument, companies do not consider investing in such assets.

❋ Risk

The uncertainty where the investments made by an individual or a company will result in not receiving the capital and/or the returns on investment.

The relationship between risk and return can be summarized as follows.

Return		Risk	
high	↑	high	↑
low	↓	low	↓

As shown in the above table, the higher the return, the higher the risk that the investor has to face. Accordingly, the factors that affect investment decision should be carefully analyzed. However, attitude of investor may be different from investor to investor due to following reasons.

- Investor's competencies in making investment decision
- Risk appetite of investor
- Financial and non financial objectives of the investor
- Economic, social and political environment affecting the investments
- Entrepreneurial skills of the investor

As discussed throughout the chapter, it is essential to study the factors affecting the investment decision and should always invest only with the properly regularized institutions. At the same time, it is vital be aware of the business directions of the company that you have already invested and be alert on the economic, social and political environment that affect the investments.

Activity 6

Prepare an article on the topic of "The risk of investing in informal methods of investments expecting higher returns" and present it in the school morning assembly.

Activity7

'Investing in investment portfolios reduces the risk of investments whilst enhancing the returns from various types of investments.' Discuss:

Activity 8

'The high level of investment opportunities enables a country to attain economic growth.' Discuss the above statement by producing factors supporting the statement.

Activity 9

You are required to discuss with your teacher and prepare an article to the wall paper of the school on the following topic.
"The short term and long term investment opportunities available in Sri Lanka"