BUSINESS STUDIES

Chapter 8: SOURCES OF BUSINESS FINANCE

Important Questions

Multiple Choice Questions -

Question 1.Sources of finance can be categorised as _____________

(a) Source of Generation Basis

(b) Period Basis

(c) Ownership

(d) All of the above

Question 2.Expand ADR

(a) American Depository Receipts

(b) American Direct Receipts

(c) American Domestic Receipts

(d) None of the above

Question 3. Industrial Finance Corporation of India (IFCI) was established in _______

(a) July 1948

(b) July 2001

(c) July 1956

(d) July 1991

Question 4._________ is an example of short term finance

(a) Trade Credit

(b) Debenture

(c) Share

(d) None of the above

Question 5.__________ was the first company in India to issue convertible zero interest debentures in January 1990

(a) Reliance Limited

(b) Adani Enterprise

(c) Tata Motors

(d) Mahindra and Mahindra

Question 6.Expand GDR

(a) Global Depository Receipts

(b) Gross Domestic Receipts

(c) Government Direct Receipts

(d) None of the above

Question 7.Money obtained by issue of shares is known as ____________

(a) Debts

(b) Loans

(c) Reserve Funds

(d) Share Capital

Question 8.A person who purchases the common stock of a corporation is known as:

(a) Preferred stockholder

(b) Creditor

(c) Bondholder

(d) Common stockholder

Question 9.ICICI was established in __________________

(a) 1985

(b) 1975

(c) 1965

(d) 1955

Question 10.Commercial papers can be issued only by large and creditworthy companies because

(a) It is protected by the Government

(b) It is an Unsecured Debt

(c) It is Fully Secured Debt

(d) None of the above

Question 11.Which of the following is a commercial bank?

(a) Punjab National Bank

(b) Canara bank

(c) State Bank of India

(d) All of the above

Question 12.State Industrial Development Corporations were established by ________

(a) Ministry of Finance

(b) the Different States

(c) Central Government

(d) None of the above

Question 13.Under the lease agreement, the lessee gets the right to

(a) Use the asset for a specified period

(b) Share profits earned by the lessor

(c) Sell the assets

(d) Participate in the management of the organisation

Question 14.When one party grants the other party the right to use the asset in return for a periodic payment, it is known as __________

(a) Lease Financing

(b) Public Deposits

(c) Debts

(d) Factoring

Question 15.The term 'redeemable' is used for

(a) Public deposits

(b) Commercial paper

(c) Equity shares

(d) Preference shares

Very Short Questions –

QUESTION 1 Define ploughing back of profits.

QUESION 2 Risk capital is defined as which type of capital?

QUESTION 3 State the return given to debenture holders for using their funds.

QUESTION 4 Give one feature of retained earnings that the other source of finance does not have.

QUESTION 5 Mention one similar function of Public deposits and ADR.

QUESTION 6 Mention one similar function between preference share capital and equity share capital.

QUESTION 7 Which term is concerned with the redemption and conservation of capital funds in matching the financial need of a company?

QUESTION 8 In the business sector which organization provides both medium and long term loans and has been set up by both the state and central government.

QUESTION 9 Name the two companies in India offer factoring services.

QUESTION 10 Mention two rights of preference shareholder.

Short Questions –

1. What preferential rights are enjoyed by preference shareholders?
2. What factors influence the working capital need in a business? write any three
3. Define Share and write any two advantages of it.
4. Write any two differences between share and debentures.

5. Write any three limitations of equity share capital.

6. Write any three advantages of Retained Earnings

Long Questions –

1. From which source a firm can raise long-term funds as loans when not provided by a commercial bank? Discuss its merits.

2. What do you mean by owner's fund? When it is not suitable?

3. Write the main advantages and disadvantages of Public Deposits.

4. Comment on the following sources of International finance

(i) I.D.R.

(ii) F.C.C.B

5. ''Ojas Auto Ltd. '' is a very well-known auto company in the industry having more equity share capital than long term debt in its capital structure. It is willing to expand and establish a new unit in the backward region and wants to train the tribal women in skill Development to empower them. It has a huge amount of cash reserve of Rs. 1000 crores.

(a) What is the status of the capital structure of the above company?

(b) According to you, which source of finance should be used by the company in establishing new units? Give any two reasons in support of your answer.

(c) What values does the company exhibit in the above case?

6. ''Avika Ltd.'' company, an IT giant company registered in India wants to top the huge amount of resources for its growth and expansion from U.S.A. for long term needs. It also needs money for a period of fewer than 3 years to meet its medium cum short term needs. The company is following the practice of educating and giving employment to underprivileged youth. 50% of its office electricity is generated through solar power.

(a) Which two sources of finance should be used by the company to meet its requirement. Write any two characteristics of each source.

(b) What values does the company exhibit in the above case?

(Hints- ADR and Public Deposits, Employment Generation, Concern for the environment)

Case Study Questions –

1. Read the following text and answer the questions on the basis of the same:

Faulad Steel Ltd. is a multi-product company, manufacturing steel pipes in wide range for wide spectrum of application. Recently the company received a big order from an MNC for which it requires additional funds. The finance manager reported that the company is not in a position to bear extra burden of explicit cost and equity shareholders insisted not to issue more shares as it can affect their control consideration. Now, the company has only one option, i.e., ploughing back of profit.

(i) 'Company is not in a position to bear extra burden of explicit cost.' Identify the meaning of explicit cost in the context of equity shares.

a) Dividend

b) Interest

c) Market value of shares

d) Operating expenses

(ii) Right to control is enjoyed by which of the following sources of finance?

a) Debentures

b) Equity shares

c) Retained earnings

d) Preference shares

(iii) '............. can affect their control consideration.' What is the meaning of control consideration in this context?

a) Control over funds

b) Control over management

c) Control over risks

d) Control over the activities of the company

(iv) In the above case, which of the following sources of finance is most suitable?

a) Shares

b) Debentures

c) Retained earnings

d) Bank loans

2. Read the following text and answer the questions that follow:

Saksham Ltd., a firm manufacturing textiles, needs to finance its day-to-day expenses, like, wages, rent, maintain stock of raw material, etc. Other than this, the company also decides to set up a new plant at an estimated cost of ` 5 crores. The finance manager of the company, Mr. Ramakant was asked by the management to do the financial planning by identifying most suitable source of raising long-term funds for financing the investment decision and short-term sources for working capital decision. As per the suggestions of Mr. Ramakant, the company approached their raw material supplier to give them credit for three months, so that the company can get cloth for making garments without making immediate payment. For long-term investment, the company had issued equity and preference shares to meet its requirement. This decision resulted in payment of large amount of taxes to government as dividend on shares is not deducted from total income of the company before calculating income tax. But this situation could be avoided if company had chosen borrowed funds as a source of finance.

(i) State the source of finance, suggested by Mr. Ramakant to finance working capital decision.

a) Trade credit

b) Public deposits

c) Equity and Preference shares

d) Retained earnings

(ii) State the factors which have not been kept in mind for selecting source of long-term finance.

a) Risk involved

b) Financial capacity of the firm

c) Time period

d) Tax benefits

(iii) State the source of finance which can give the benefit of tax saving.

a) Equity Shares

b) Debentures

c) Both (a) and (b)

d) Neither (a) nor (b)

(iv) Identify the fund needed for the day-to-day operations of business.

a) Working capital

b) Trading capital

c) Equity capital

d) Debt capital

MCQ Answers –

1. Answer: (d) All of the above
2. Answer: (a) American Depository Receipts
3. Answer: (a) July 1948
4. Answer: (a) Trade Credit
5. Answer: (d) Mahindra and Mahindra
6. Answer: (a) Global Depository Receipts
7. Answer: (d) Share Capital
8. Answer: (d) Common stockholder
9. Answer: (d) 1955
10. Answer: (b) It is an Unsecured Debt
11. Answer: (d) All of the above
12. Answer: (b) the Different States

13. Answer: (a) Use the asset for a specified period

14. Answer: (a) Lease Financing

15. Answer: (b) Commercial paper

Very Short Answers –

1. Answer: In a company, a part of the net incomes is retrained for future use is known as retained earnings. It is used as a source of internal financing, self-financing, or ploughing back of profits.

2. Answer: Risk capital is defined as equity share capital.

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3. Answer: Fixed rate of interest is given to debenture holders for using their funds.

4. Answer: Retained earnings save a portion of the net incomes for future use is retained earnings. The retained earnings have the ability to self-finance and it doesn't involve any explicit cost.

5. Answer: In both public deposits and ADR, the depositors doesn't have a voting right.

6. Answer: The one similar function between preference share capital and equity share capital is that both capitals are a part of the owner's share.

7. Answer: The retained earning is concerned with the redemption and conservation of capital funds in matching the financial need of a company.

8. Answer: The organization which provides both medium and long term loans and has been set up by both the state and central government is the development bank.

9. Answer: The two companies in India offer factoring services are SBI Factors and Commercial Service Ltd.

10. Answer: The two rights of preference shareholder are

- Getting a fixed rate of dividend from the net profit of an organization, before declaring any dividends for equity stockholder.
- At the time of liquidation, receiving funds after the organization creditor's claim has been resolved.

Short Answers –

1. Ans: Preference shareholders have the following preferred rights:

- Preference in Dividend: They receive dividends at a fixed rate, and dividends on these shares are paid before dividends on equity shares.
- Preference in Repayment: When a corporation closes, preference shares are paid out first, followed by equity shares.
- Excess Profits: Preference shares have the right to partake in any excess profits that remain after equity shares have been paid.
- Preference in case of dissolution: They have the preference over equity shareholders

in the share capital refund in the event of company dissolution.

2. Ans: The factors influencing the working capital need in a business are:

- Nature of Business: Manufacturing business requires more working capital as compared to trading business or service provider.
- Business Cycle: During boom period firms require a large amount of working capital to manage the increased sales and production.
- Seasonal Factors: Seasonal businesses require more working capital during their season time.
- Scale of Operations: Businesses operating on a large scale require larger amounts of working capital as compared to small business firms.
- Credit Allowed: A business extending a longer credit period to its buyers will need more working capital as compared to a business doing cash business or offering a lesser credit period.
- Production Cycle: Businesses with longer production cycles require more working capital as compared to businesses with short-term production cycles.
- Credit Availed: A business organisation receiving longer credit period from their supplier will require lesser working capital as compared to business purchases goods for cash or receive short credit period.

3. Ans: A company needs huge investments to start a business, this amount is known as capital. Since, it is impossible for one individual to bring in such a huge amount of capital, the entire capital is divided into small units known as shares, where each person holding shares is referred to as a shareholder.

Advantages

- It serves as permanent capital as it has to be repaid at the time of liquidation.
- Democratic control over the management of the company is given to shareholders through voting rights.
- Equity capital establishes a company's creditworthiness and gives prospective loan providers trust.

4. Ans: The difference between shares and debentures are:

Basis	Shares	Debentures
Meaning	Owners' funds are referred to as shares	Borrowed funds are referred to as debentures

Returns	In the case of shares, the dividend payment is not fixed, and is based on the profits of the company	In the case of debentures, the corporation pays a fixed rate of interest.

5. Ans: The three limitations of equity share capital are:

- The returns are fluctuating in nature so investors who need steady income may not prefer equity shares.
- Cost of raising funds from equity shares is quite high as compared to other sources.
- It is more of a complicated process and may take longer time to raise funds.
- The issuance of additional equity shares dilutes current equity shareholders' voting power and earnings.

6. Ans: The Merits of Retained Earnings are:

- No initial fees: These funds are not subject to any explicit fees, such as floatation costs or interest, because they are raised internally.
- Positive share price: A large quantity of retained earnings can cause the price of equity shares to rise.
- Loss Absorption: Because these are surplus profits retained in the business, they serve to mitigate the impact of unanticipated losses.

Long Answers -

1. Ans: Financial Institutions

There are numerous financial institutions established by the government of India across the country. These institutions finance the businesses and are set up by both state and central governments. There are development banks especially established to promote industrial development in the country.

Merits

- Provide long term funds which are not provided by the commercial banks
- Provide various services such as managerial advice, financial and technical advice to the companies.
- Increases the goodwill of the borrowing company in the capital markets.
- Funds can be made available even at the time of contingency and can be paid in easy installment without being a burden to the company.

2. Ans: Funds provided by the owners of the organization are known as Owners' funds. It includes profits that are reinvested into the business. The important sources of owners' funds are

- Retained earnings
- Issue of equity shares.

The non-suitability of using owner's funds is based on the following factors:

- Dilution of Control: The choice of what source from which financing has to be procured also depends upon the extent to which firm is ready for the dilution of control. Such as if existing equity shareholders aren't willing to dilute the control they enjoy, in such a case the company may issue finance from sources other than equity share capital.
- Tax Advantages: Some sources of finance are tax deductible, and hence firms can enjoy tax advantage using those sources. For example interest on debentures is a tax deductible expense, hence firms wanting to enjoy tax benefits may go for these sources. In such a situation, using the owners' fund is not suitable.
- Cost: There are two types of costs: the cost of obtaining funds and the cost of putting these funds to use. Both of these costs should be considered when deciding on a funding source. If the cost of the owner's fund exceeds the prospective returns, it should not be issued.
- Cash Flow Position: Before raising finance business must consider the projected flow to ensure that it has sufficient cash to pay fixed cash obligations.A company with high liquidity and a good cash flow position can issue debt capital, as the company will have less chances of facing financial risk than the company with a low cash position.
- Purpose and time frame: The business should plan for the time frame in which the finances are needed. A short-term requirement, for example, can be addressed by borrowing cash at a low-interest rate via trade credit, commercial paper, or other means. Long-term financing is best accomplished through the issuance of shares and debentures.
- Stock Market Conditions: If the stock market is flourishing, and there is a condition of boom then the companies may prefer more equity over debt in the capital structure. However, in the case of a bear market, to avoid any more risks, the companies will prefer more debt over equity in the capital structure.
- Ease of issuance of finance: The flexibility and ease with which the firm is able to procure finance also affects the choice of source of finance. Excessive documents, legal restrictions, heavy investigation and other reasons may discourage the company from using a particular source of finance. Hence, if the issue of such a source is difficult, the firm should not go for it.

Ans: Public deposits:

Organizations raise public deposits from the general public to fund their short- term and medium-term financial needs. The interest rate on these deposits is usually higher than the interest rate on bank deposits. If a person wishes to invest in a business (by making a deposit), he or she must complete and submit a required form together with the deposit. The organization issues a deposit receipt as a mark of debt acknowledgment in exchange for the money borrowed.

Merits of Public Deposits:

- Minimal Restrictions: Accepting public deposits as a means of raising funds is a straightforward process with minimal restrictions.
- Low cost: The cost of raising funds through public deposits is generally lower than the cost of borrowing money from a commercial bank.
- No dilution of control: There are no voting or management rights for depositors. As a result, accepting public deposits does not affect the business's ownership structure.

Demerits of Public Deposits:

- Restricted financing: The quantity of money that may be raised from public deposits is restricted because it is dependent on the availability of capital and people's desire to invest in the company in question.
- Not suitable for new firms: Because people have little faith in new businesses, it is difficult for them to raise capital through public deposits.

4. Ans: (i) An Indian Depository Receipt (IDR) is a financial instrument in the form of a Depository Receipt that is denominated in Indian Rupees. An Indian Depository creates it for a foreign firm to raise capital from the Indian securities market. IDRs are issued to Indian residents in the same way that domestic shares are issued, according to SEBI norms. Residents can bid in the same style and technique as they can for Indian shares when the issuer company makes a public offering in India.

(ii) FCCB (Foreign Currency Convertible Bonds) are debt securities with an equity component that can be converted into equity or depository receipts after a set length of time. FCCB holders can choose to convert their bonds into equity shares at a predetermined price or exchange rate or keep the bonds. They have a fixed interest rate that is lower than any other non-convertible debt instrument with a similar interest rate. FCCBs are listed on overseas stock exchanges and traded there.

5. Ans: (a) The company's financial structure is robust, with more equity share capital than long-term debt in its capital structure and a large cash reserve.

(b) As the company has huge cash reserves with itself, it should use retained earnings, or the self-financing technique for the establishment of new unit

When a company earns profit, a certain amount or percentage of those profits is retained within the business for future use and this is known as retained earnings. When the business is financed through this source it is known as ploughing back of profit or internal financing. Retained earnings is a percentage of net earnings that is kept in the business for future usage.

Reasons

- No initial fees: These funds are not subject to any explicit fees, such as floatation costs or interest, because they are raised internally.
- Positive share price: A large quantity of retained earnings can cause the price of equity shares to rise.
- Loss Absorption: Because these are surplus profits retained in the business, they serve

to mitigate the impact of unanticipated losses.

(c) The following values are displayed by the company:

- Balanced Regional Development: The company is willing to expand and open new units in underdeveloped areas, and it contributes to regional development.
- Women Empowerment: The company intends to empower indigenous women by training them in skill development.

6. Ans: (a) ADR and Public Deposits can be used to satisfy the company's needs.

- Public Deposits: Public deposits are deposits that are raised directly from the public by organizations. While depositors receive a greater interest rate than banks, the cost of deposits to the company is lower than the cost of bank borrowings. RBI is in charge of regulating it. Companies typically solicit public contributions over a three-year term.
- ADR (American Depository Receipt): This instrument is issued by the American companies and can be traded in American markets. It can be issued to only citizens of America and can only be traded in US stock exchanges. This instrument is like a regular stock which is purchased and sold in American markets.

(b) The following values are demonstrated by the company:

Environmental stewardship: The company uses solar power to generate 50% of its office electricity. As a result, resources are conserved.

Employment Generation: The company is committed to teaching and employing underprivileged youngsters, hence creating job possibilities for them.

Case Study Answers –

1.

(i) d) Operating expenses

Solution: Explicit costs are typical business costs which appear in the general ledger and have a direct impact on the profitability of a company. Examples of explicit costs include salaries, raw materials, utilities, lease payments, and other direct costs.

(ii) b) Equity shares

Solution: Equity shares are long-term financing sources for any company. These shares are issued to the general public and are non-redeemable in nature. Investors in such shares hold the right to vote, share profits and claim assets of a company.

(iii) a) Control over funds

Solution: Control Consideration means the amount per Company Share to be received by Company Shareholders in connection with a Change of Control Transaction, with any non-cash consideration valued as determined by the value ascribed to such consideration by the parties to such transaction.

(iv) c) Retained earnings

Solution: Retained earnings (RE) is the amount of net income left over for the business after it has paid out dividends to its shareholders. The decision to retain the earnings or distribute them among the shareholders is usually left to the company management.

2.

(i) a) Trade credit

Solution:

• Trade credit is the loan extended by one trader to another when the goods and services are bought on credit.

• Trade credit facilitates the purchase of supplies without immediate payment.

• Trade credit is commonly used by business organizations as a source of short-term financing.

(ii) d) Tax benefits

Solution:

• Long-term finance can be defined as any financial instrument with maturity exceeding one year (such as bank loans, bonds, leasing and other forms of debt finance), and public and private equity instruments.

• Equity, which has no final repayment date of a principal, can be seen as an instrument with non finite maturity.

(iii) b) Debentures

Solution:

• Debentures are a debt instrument used by companies and government to issue the loan.

• Debentures are also known as a bond which serves as an IOU between issuers and purchaser.

• Companies use debentures when they need to borrow the money at a fixed rate of interest for its expansion.

(iv) a) Working capital

Solution:

Working capital is the money used to cover all of a company's short-term expenses, which are due within one year. Working capital is the difference between a company's current assets and current liabilities. Working capital is used to purchase inventory, pay short-term debt, and day-to-day operating expenses.