Chapter 8

Sources of Business Finance

Multiple Choice Questions

Q. 1 Equity shareholders are called

A. Owners of the company

B. Partners of the company

C. Executives of the company

D. Guardian of the company

Answer:

Equity shares represent the ownership of a company and capital raised by the issue of such shares is known as owner's fund.

Q. 2 The term 'redeemable' is used for

A. Preference shares

B. Commercial paper

C. Equity shares

D. Public deposits

Answer:

Redeemable shares issued on the terms that the company will buy them in future. It is used for preference shares.

Q. 3 Funds required for purchasing current assets is an example of

A. Fixed capital requirement

B. Ploughing back of profits

C. Working capital requirement

D. Lease financing

Answer:

The capital used for the day-to-day operation in business is called working capital.

Q. 4 ADRs are issued in

A. Canada

B. China

C. India

D. the USA

Answer:

The depository receipts issued by a company in the USA are known as American Depository Receipts.

Q. 5 Public deposits are the deposits that are raised directly from

A. The public

B. The directors

C. The auditors

D. The owners

Answer:

The deposits that are raised by organizations directly from the public are known as public deposits.

Q. 6 Under the lease agreement, the lessee gets the right to

A. Share profits earned by the lesser

B. Participate in the management of the organization

C. Use the asset for a specified period

D. Sell the assets

Answer:

A lease is a contractual agreement whereby the owner of an asset (lessor) grants the right to use the asset to the other party.

Q. 7 Debentures represent

A. Fixed capital of the company

B. Permanent capital of the company

C. Fluctuating capital of the company

D. Loan capital of the company

Answer:

Debentures are an instrument for raising long term debt capital that a company can raise funds through the issue of debentures and bear a fixed rate of interest.

Q. 8 under the factoring arrangement, the factor

A. Produces and distributes the goods or services

B. Makes the payment on behalf of the client

C. Collects the client's debtor account receivables

D. Transfer the goods from one place to another

Answer:

The factor becomes responsible for all credit control and debt collection from the buyer and protects against any bad debt losses to the firm.

Q. 9 The maturity period of a commercial paper usually ranges from

A. 20 to 40 days

B. 60 to 90 days

C. 120 to 365 days

D. 90 to 364 days

Answer:

Commercial paper is an unsecured promissory note issued by a firm to raise funds for a short period, varying from 90 days to 364 days.

Q. 10 Internal sources of capital are those that are

A. Generated through outsiders such as suppliers

B. Generated through loans from commercial banks

C. Generated through an issue of shares

D. Generated within the business.

Answer:

Internal sources of funds are those that are generated from within the business.

Short Answer

Q. 1 What is business finance? Why do businesses need funds? Explain.

Answer:

The fund used in business to carry out various activities is called business finance.

The business required funds for:

- To start a business one requires funds to purchase assets such as raw materials, machinery etc. The funds are invested for a long period.
- The financial requirements of an enterprise do not end with the procurement of fixed assets. No matter how small or large a business is, it needs funds for its day-to-day operations. This is known as the working capital of an enterprise.

Q. 2 List sources of raising long-term and short-term finance.

Answer:

Long-term source of raising finance are- Equity shares, Retained earnings, Preference shares, Debentures, Loans from financial institutions, Loans from Banks.

Short-term finances are- Trade credits, Factoring, Banks, Commercial paper.

Q. 3 What is the difference between internal and external sources of raising funds? Explain.

Answer:

The difference between internal and external sources of raising funds are-

S. No.	Internal sources	External sources
1.	Internal sources of funds are those that are generated from within the business.	External sources of funds include Those sources that lie outside an Organization such as suppliers, lenders and investors.
2.	A business, for example, can generate funds internally by accelerating collection of receivables, disposing of surplus inventories and	When a large amount of money is required to be raised, it is generally done through the use of external sources

	ploughing back its profit.	
3.	The internal sources of funds can fulfil only limited needs of the business.	External funds may be costly as compared to those raised through internal sources.

Q. 4 What preferential rights are enjoyed by preference shareholders? Explain.

Answer:

Preferential rights are enjoyed by preference shareholders are-

- They receive a fixed rate of dividend out of the net profit of the company.
- They receive their capital after the claims of the company's creditors have been settled at the time of liquidation.

Q. 5 Name any three special financial institutions and state their objectives.

Answer:

The three special financial institutions and their objectives are as follows-

- Industrial Finance Corporation of India (IFCI) - It contributed to the development of management education in the country. Its activities included assistance towards balanced regional development and encouraged new entrepreneurs to enter in new economic development.
- Unit Trust in India (UTI) - To mobilize the community's savings and channelize them into productive ventures. It sanctions direct assistance to industrial concerns, invests in their shares and debentures and participates with other financial institutions

- Industrial Credit and Investment Corporation of India (ICICI) - It assists the creation, expansion and modernization of Industrial enterprise especially in the private sector. It also encouraged the participation of foreign capital in India.

Q. 6 What is the difference between GDR and ADR? Explain.

Answer:

The difference between GDR and ADR are as follows-

S. No.	GDR (Global Depository Receipts)	ADR (American Depository Receipts)
1.	The local currency shares of a company are delivered to the depository receipts against these shares. Such depository receipts denominated in US dollars are known as GDR (Global Depository Receipts	The depository receipts issued by a company in the USA are known as ADR (American Depository Receipts)
2.	GDR is an instrument issued abroad by an Indian company to raise funds in some foreign currency and is listed and traded on a foreign stock exchange.	ADRs are bought and sold in American markets, like regular

Long Answer

Q. 1 Explain trade credit and bank credit as sources of short-term finance for business enterprises.

Answer:

Trade credit-

a. Trade credit is the credit extended by one trader to another for the purchase of goods and services.

b. Trade credit facilitates the purchase of supplies without immediate payment. Such credit appears in the records of the buyer of goods as 'sundry creditors' or 'accounts payable'.

c. Trade credit is commonly used by business organisations as a source of short-term financing. It is granted to those customers who have a reasonable amount of financial standing and goodwill.

d. The volume and period of credit extended depend on factors such as the reputation of the purchasing firm, the financial position of the seller, volume of purchases, record of payment and degree of competition in the market.

e. Terms of trade credit may vary from one industry to another and from one person to another. A firm may also offer different credit terms to different customers.

f. Trade credit is a convenient and continuous source of funds and needs to promote the sales of an organisation.

Bank credit-

a. Bank credit is not a permanent source of funds. Though banks have started extending loans for longer periods, generally such loans are used for medium to short periods.

b. The borrower is required to provide some security or create a charge on the assets of the firm before a loan is sanctioned by a commercial bank.

c. Secrecy of business can be maintained as the information supplied to the bank by the borrowers is kept confidential

d. Formalities such as the issue of prospectus and underwriting are not required for raising loans from a bank, thus it became an easier source of funds.

Q. 2 Discuss the sources from which a large industrial enterprise cans raise capital for financing modernisation and expansion.

Answer:

A large industrial enterprise cans raise capital for financing modernisation and expansion from the following sources:

i. Industrial Finance Corporation of India- IFCI Ltd. was set up in 1948 as Industrial Finance Corporation of India, a Statutory Corporation, through The Industrial Finance Corporation of India Act, 1948' of Parliament to provide medium and long term finance to industry. The primary business of IFCI is to provide medium to long term financial assistance to the manufacturing, services and infrastructure sectors.

ii. State Financial Corporation- State Finance Corporations (SFCs) are an integral part of institutional finance structure of a country. SEC promotes small and medium industries of the states and helps in ensuring balanced regional development, higher investment, more employment generation and broad ownership of various industries.

iii. Industrial Credit and Investment Corporation of India- Industrial Credit and Investment Corporation of India (ICICI) was established in 1955 as a public limited company under Indian Company Act, for developing medium and small industries of the private sector. One of the important objectives of the ICICI is to provide loans to industrial projects in the private sector.

iv. Industrial Development Bank of India- Industrial Development Bank of India (IDBI) established under Industrial Development Bank of India Act, 1964, is the principal financial institution for providing credit and other facilities for developing industries and assisting development institutions. IDBI is the tenth largest bank in the world in terms of development. The National Stock Exchange (NSE), the National Securities Depository Services Ltd. (NSDL), Stock Holding Corporation of India (SHCIL) is some of the Institutions which have been built by IDBI.

v. State Industrial Developmental Corporations- State Industrial Development Corporations have been set up by the State Governments as companies wholly owned by them. SIDCs are not merely financing agencies, but are intended to act as instruments for accelerating the pace of industrialization in the respective States. Besides providing financial assistance to industrial concerns by way of loans, guarantees and underwriting of or direct subscriptions to shares and debentures, the SIDCs undertake various promotional activities such as conducting techno-economic surveys, project identification, preparation of feasibility studies, selection and training of entrepreneurs. They also promote joint sector projects in association with private promoters

Q. 3 What advantages does the issue of debentures provide over the issue of equity shares?

Answer:

Debentures are an instrument for raising long term debt capital that a company can raise funds through the issue of debentures and bear a fixed rate of interest. Debenture holders are termed as creditors of the company.

The advantages do the issue of debentures provide over the issue of equity shares are –

i. The issue of equity shares means a reduction of ownership of a firm while debentures holders do not have to pay any rights in the company. They do not have any membership or voting rights, they just have to fixed amount as payment.

ii. Debentures carry a fixed rate of return from the profit they earned and the company has to pay only the interest to its holders whereas the company that issue shares have to pay dividends to the shareholders.

iii. Financing through debentures is less costly as compared to the cost of preference or equity capital as the interest payment on debentures is tax-deductible.

Q. 4 State the merits and demerits of public deposits and retained earnings as methods of business finance.

Answer:

The deposits that are raised by organisations directly from the public are known as public deposits. Public deposits are beneficial to both medium and short-term financial requirements of a business. The acceptance of public deposits is regulated by the Reserve Bank of India.

Merits of Public deposit:

(i) The procedure of obtaining deposits is simple and easy.

(ii) Cost of public deposits is generally lower than the cost of borrowings from banks and financial institution.

(iii) It does not usually create any charge on the assets of the company. The assets can be used as security for raising loans from other sources

(iv) The depositors do not have voting rights and hence the control of the company is not reduced.

Demerits:

(i) New companies generally find it difficult to raise funds through public deposits

(ii) It is an unreliable source of finance as the public may not respond when the company needs money

(iii) Collection of public deposits may prove difficult, particularly when the size of deposits required is large.

Retained earnings: When a portion of the net earnings is retained in the business for the future use, this is known as retained earnings. Generally, a company does not distribute all its earnings amongst the shareholders as dividends. They kept it as is a source of internal financing or self-financing.

Merits

i. Retained earnings are 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 freedom and flexibility.

iv. It enhances the capacity of the business to absorb unexpected losses.

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

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 the business are fluctuating.

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

Q. 5 Discuss the financial instruments used in international financing.

Answer:

The financial instruments used in international financing are as follows:

i. Global Depository Receipts (GDR's): The local currency shares of a company are delivered to the depository bank. The depository bank issues depository receipts against these shares. Such depository receipts denominated in US dollars are known as Global Depository Receipts (GDR).

ii. American Depository Receipts (ADRs): The depository receipts issued by a company in the USA are known as American Depository Receipts. ADRs are bought and sold in American markets, like regular stocks.

iii. Indian Depository Receipt (IDRs): An Indian Depository Receipt is a financial instrument denominated in Indian Rupees in the form of a Depository Receipt. It is created by an Indian Depository to enable a foreign company to raise funds from the Indian securities market. The IDR is a specific Indian version of the similar global depository receipts.

iv. Foreign Currency Convertible Bonds (FCCBs): Foreign currency convertible bonds are equity-linked debt securities that are to be converted into equity or depository receipts after a specific period. The FCCB's are issued in a foreign currency and carry a fixed interest rate which is lower than the rate of any other similar non-convertible debt instrument.

Q. 6 What is commercial paper? What are its advantages and limitations?

Answer:

Commercial Paper is a source of short term finance since the early nineties. Commercial paper is an unsecured promissory note issued by a firm to raise funds for a short period, varying from 90 days to 364 days. It is issued by one firm to other business firms, insurance companies, pension funds and banks. Its regulation comes under the purview of the Reserve Bank of India.

Advantage:

(i) A commercial paper not contains any restrictive conditions and sold on an unsecured basis.

(ii) It is a freely transferable instrument

(iii) It provides more funds compared to other sources.

(iv) A commercial paper provides a continuous source of funds.

(v) Companies can park their excess funds in commercial paper and can earn some good return on the same.

Limitation:

i. Only financially sound and highly rated firms can raise money through commercial papers. New and moderately rated firms could not raise funds.

ii. The size of money that can be raised through the commercial paper is limited to the excess liquidity available with the suppliers of funds at a particular time

iii. Commercial paper is an impersonal method of financing. As such if a firm is not in a position to redeem its paper due to financial difficulties, as the maturity of a Commercial Paper is not possible.