CHAPTER 8

Sources of Business Finance

VERY SHORT ANSWER TYPE QUESTIONS :

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

Solution: The fund required to carry the load of the organisation and its daily operations is called business finance. Businesses need funds due to the following reasons:

1. An organisation needs machinery, buildings, furniture, etc., to set up operations, and to purchase all these items, funds are needed. This is called fixed capital requirement. The amount varies with the type of business.

2. To run day-to-day operations like purchasing raw materials requires regular funds, also called working capital requirement.

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

Solution: The long-term finance sources are listed below:

1. Equity Shares

2. Debentures

3. Retained earnings

4. Preference shares

5. Loans from banks and other financial institutions

The short-term finance sources are listed below:

1. Commercial papers

2. Trade credit

3. Short-term loans from banks

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

Solution:

Basis of Comparison	**Internal Source**	**External Source**
Source	Funds generated from within the business	Funds generated from outside sources, such as suppliers and investors.
Need Fulfilment	Able to fulfil limited needs	Can gather many links to raise capital
Security	No security required	Security required in the form of mortgaging assets

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

Solution: The following rights are enjoyed by preference shareholders:

1. At the time of dividend declaration, be the first to receive a fixed rate of dividend from profits.

2. In case of liquidation, the preference is to receive capital after creditor claims are settled.

3. In case of company dissolution, the preference share capital will be refunded before equity share capital.

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

Solution: 1. Unit Trust of India (UTI): Established in 1964 as per the Unit Trust of India Act, 1963. The objective of setting up UTI was to mobilise savings and make the funds that are available towards investment in profitable ventures.

2. Life Insurance Corporation of India (LIC): It was set up in 1956 under the LIC Act, 1956, making all existing insurance companies nationalised. The objective is to encourage savings as a premium towards insurance and invest it in the form of loans to industrial units.

3. Industrial Finance Corporation of India (IFCI): It was established in the year 1948 under the Industrial Finance Corporation Act 1948. Its objective was to provide assistance in balanced regional development and encourage entrepreneurs to explore rising sectors of the economy and also contribute towards management education development.

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

Solution: Global Depository Receipts (GDR): GDR is the receipts that are shared by depository banks against company shares. GDR are denoted in US dollars and can be easily converted into shares at any time. They can be listed and traded on all stock exchanges over the world.

American Depository Receipts (ADR): These receipts are issued by companies which are US based and, like other securities, get traded in the market. The only factor is that the trading is restricted to the US Securities market, and these receipts are only sold to US citizens.

LONG ANSWER TYPE QUESTIONS:

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

Solution:

Trade Credit: The credit offered by one supplier to a purchaser of goods is called trade credit. This helps in promoting the sale of goods and services, as the purchaser is not required to make payment at that time in the form of cash. Such credit is granted only to creditworthy customers. There are factors that influence the volume and period of the credit, and they are as follows:

1. Financial position of the seller

2. Past payment record

3. Volume of purchases

Benefits of Trade Credit

1. It helps a company accumulate inventories for increasing sales in future.

2. Trade creditors do not have any rights over company assets. Therefore, assets can be mortgaged to raise money from other sources.

Bank Credit: Commercial banks provide a source of funds, and these funds are used for different purposes and time periods in the form of overdrafts, cash credits, and discounting bills. These loans need to be paid in a lump sum or by paying in instalments.

Benefits of Bank Credit

1. There is secrecy in providing information about their customers.

2. Provides flexibility in terms of loan repayment.

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

Solution:

The following sources of capital are suitable for raising capital for expansion:

1. Equity Shares: These are the shares that are part of the owner's capital. The persons holding such shares are known as equity shareholders, and they enjoy decision-making capacity in management, they also get high returns when the profits of the business get higher.

2. Preference Shares: This is a type of share that gives shareholders a preferential right with regard to the repayment of capital and earning payments after a period of time. The payment to preference shareholders is done as per Section 80 of the Companies Act, 1956.

3. Loans: A business can borrow funds from banks and similar financial institutions for a fixed time at a fixed rate/variable rate, and they have to pay interest.

4. Retained Earnings: These are parts of profit that are kept for use in the future.

5. Debentures: These are instruments that are helpful in raising long-term capital. Debentures are like loans having a fixed rate of return.

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

Solution:

Debentures provide the following advantages over equity shares:

1. Issuing equity shares makes the shareholders own the company, and they become entitled to voting rights, while debenture holders do not have any rights in the organisation. They get a fixed amount in the form of payment. Debentures, thus, do not contribute towards the dilution of ownership of the company and can be issued without any risk.

2. For issuing shares, the company has to bear huge costs; also, dividends payment is not tax deductible. For interest paid to debentures, the company receives tax deductions, so issuing debentures is beneficial.

3. Debentures have a fixed rate of return. So, if no profit is also earned, then also the company needs to pay the dividend, which is at a fixed rate. On the other hand, a company issuing equity shares and making profit needs to share more with the shareholders, which varies with the profit earned. Thus, it is better to issue debentures.

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

Solution:

Public deposits are raised by organisations directly from the public and which helps them to finance short and medium-term requirements. These deposits provide higher returns than bank deposits. Anyone interested in doing an investment needs to submit a prescribed form along with the amount to be deposited. A deposit receipt will be issued as acknowledgement.

Merits

1. Requires very few regulations.

2. Fundraising from the public is less costly than borrowing loans from banks.

3. As depositors do not have any voting rights, ownership is not diluted.

Demerits

1. Amount of money raised from the public is limited as it depends on willingness and availability of funds.

2. New companies find it difficult to raise funds as trust is less among people.

3. For a firm with a high capital requirement, this will not be a good option.

Retained Earnings: Firms keep a part of profit before distributing the dividends to the shareholders; such profits are kept for future use in business and are called retained earnings.

Merits

1. Funds are raised from internal sources and, therefore, do not involve any cost.

2. As retained earnings increase, the price of equity shares also increases.

3. As these are profits which are surplus, it reduces the chances of unexpected loss.

Demerits

1. Business profits can fluctuate, so retained earnings are uncertain.

2. Investing a large amount of profit into a business can make shareholders unhappy.

3. Funds are misused sometimes as firms do not cash in on the opportunity at the right time.

5. Discuss the financial instruments used in international financing.

Solution:

The following three financial instruments are mainly used in international financing:

1. American Depository Receipts (ADR): These receipts are issued by companies which are US based and, like other securities, get traded in the market. The only factor is that the trading is restricted to the US Securities market, and these receipts are only sold to US citizens.

2. Foreign Currency Convertible Bonds (FCCB): These are debt securities which are qualified to be converted into depository receipts and equity shares after a certain time period. The terms of conversion and price are specified in advance, and returns on such securities are fixed prior, which is lower than returns on securities that are non-convertible.

3. Global Depository Receipts (GDR): It is the receipts that are shared by depository banks against company shares. GDR are denoted in US dollars and can be easily converted into shares at any time. They can be listed and traded on all stock exchanges over the world.

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

Solution:

One type of credit instrument that is used by creditworthy firms to raise short-term finance for their business is called commercial paper. It is a type of unsecured promissory note with a maturity ranging from 90 to 364 days. It is issued to insurance companies, banks, business firms and pension funds, and it is regulated by RBI (Reserve Bank of India).

Advantages

1. Lower cost than securing bank loans from commercial banks.

2. A highly liquid asset that can be transferred to anyone.

3. Companies earn good returns by investing the surplus earnings.

4. Provides a continuous source of finance for firms.

Limitations

1. Firms that have a strong market hold can only raise money.

2. Time period cannot be extended in case funds are not available.