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Business Studies

Class XI

SUBHASH DEY

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PART B

FINANCE AND TRADE

40 Marks

Unit	Marks
7. Sources of Business Finance	20
8. Small Business and Enterprises	
9. Internal Trade	20
10. International Trade	
TOTAL	40



Unit 7

Sources of Business Finance

CBSE Syllabus

- Concept of business finance
- Owners' funds- equity shares, preferences share, retained earnings, Global Depository receipt (GDR), American Depository Receipt (ADR) and International Depository Receipt (IDR) – concept
- Borrowed funds: debentures and bonds, loan from financial institution and commercial banks, public deposits, trade credit, Inter Corporate Deposits (ICD).

Learning Outcomes

After going through this unit, the student/ learner would be able to:

- State the meaning, nature and importance of business finance.
- Classify the various sources of funds into owners' funds.
- State the meaning of owners' funds.
- Understand the meaning of Global Depository receipts, American Depository Receipts and International Depository Receipts.
- State the meaning of borrowed funds.
- Discuss the concept of debentures, bonds, loans from financial institutions and commercial banks, Trade credit and inter corporate deposits.
- Distinguish between owners' funds and borrowed funds.

Business Finance: Meaning, Nature and Importance

Business Finance – Meaning and Nature

The requirements of funds by business to carry out its various activities is called business finance.

Nature/Features of Business Finance

1. A business cannot function unless adequate funds are made available to it. For carrying out various activities, business requires money.
2. The initial capital contributed by the entrepreneur is not always sufficient to take care of all financial requirements of the business. A business person, therefore, has to look for different other sources from where the need for funds can be met.
3. A clear assessment of the financial needs and the identification of various sources of finance, therefore, is a significant aspect of running a business organisation.
4. The need for funds arises from the stage when an entrepreneur makes a decision to start a business. Some funds are needed immediately say for the purchase of plant and machinery, furniture, and other fixed assets. Similarly, some funds are required for day-to-day operations, say to purchase raw materials, pay salaries to employees, etc. Also when the business expands, it needs funds.



Finance is called the life blood of any business



Note

Nature of Business Finance

- Necessary for all types of business
- Depends on size of business
- Includes all types of capital
- Fluctuating nature
- Determines the size of business

Importance/Significance of Business Finance

Finance is needed for the following reasons:

1. Fixed capital requirements

In order to start business, funds are required to purchase fixed assets like land and building, plant and machinery, and furniture and fixtures. This is known as *fixed capital* requirements of the enterprise.

The funds required in fixed assets remain invested in the business for a long period of time.

Different business units need varying amount of fixed capital depending on various factors such as the nature of business, scale of operations, growth and expansion of business, etc.

- **Nature of business:** A trading concern for example, may require small amount of fixed capital as compared to a manufacturing concern.
- **Scale of operations:** The need for fixed capital investment would be greater for a large enterprise, as compared to that of a small enterprise.
- **Growth and expansion of business:** The requirement for working capital increases with the growth and expansion of business.

2. Working Capital requirements

The financial requirements of an enterprise do not end with the procurement of fixed assets. A business needs funds for its day-to-day operations. This is known as *working capital* of an enterprise, which is used for holding

current assets such as stock of material, bills receivables and for meeting current expenses like salaries, wages, taxes, and rent.

The amount of working capital required varies from one business concern to another depending on various factors such as basis of sales, sales turnover, growth and expansion of business, technology upgradation, seasonal factors, etc.

- A business unit selling goods on credit, or having a slow sales turnover would require more working capital as compared to a concern selling its goods and services on cash basis or having a speedier turnover.
- The requirement for working capital increases with the growth and expansion of business.
- At times additional funds are required for upgrading the technology employed so that the cost of production or operations can be reduced.
- Similarly, larger funds may be required for building higher inventories for the festive season or to meet current debts or expand the business or to shift to a new location.

It is, therefore, important to evaluate the different sources from where funds can be raised.

Classification of Sources of Funds on the Basis of Ownership

On the basis of ownership, the sources can be classified into 'owner's funds' and 'borrowed funds'.

Differences between Owners' Funds and Borrowed Funds

Basis	Owners' Funds	Borrowed Funds
1. Meaning	Owner's funds means funds that are provided by the owners of an enterprise, which may be a sole trader or partners or shareholders of a company. Apart from capital, it also includes profits reinvested in the business.	Borrowed funds refer to the funds raised through loans or borrowings.
2. Sources	• Equity shares • Preference shares • Retained earnings • GDR • ADR • IDR	• Debentures and Bonds • Loan from Financial Institutions • Loan from Commercial Banks • Public Deposits • Trade Credit • Inter Corporate Deposits (ICD)
3. Time Period	The owner's capital remains invested in the business for a longer duration and is not required to be refunded during the life period of the business.	Such sources provide funds for a specified period on certain terms and conditions and have to be repaid after the expiry of that period.
4. Return	Return on Owner's funds (e.g. equity and preference shares) is called dividend, which is a part of profit after tax distributed among the shareholders. Dividend is payable only when there are profits available to the company.	A fixed rate of interest is paid by the borrowers on such funds. At times it puts a lot of burden on the business as payment of interest is to be made even when the earnings are low or when loss is incurred.
5. Security	It does not require any security.	Generally, borrowed funds are provided on the security of some fixed assets.
6. Control	Such capital forms the basis on which owners acquire their right of control of management.	It does not carry any right of control of management.

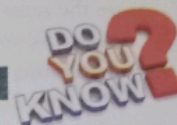
Various Sources of Owners' Funds – Concept

1. Equity Shares

Equity shares is the most important source of raising long term capital by a company.

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

- Equity share capital is a pre-requisite to the creation of a company.
- Equity shareholders do not get a fixed dividend but are paid on the basis of earnings by the company.
- They are referred to as 'residual owners' since they receive what is left after all other claims on the company's income and assets have been settled.
- They enjoy the reward as well as bear the risk of ownership.
- Their liability, is limited to the extent of capital contributed by them in the company.
- Through their right to vote, equity shareholders have a right to participate in the management of the company.



- The capital obtained by issue of shares is known as **share capital**.
- The capital of a company is divided into small units called **shares**.
- Each share has its **nominal value/face value/par value**. For example, if a company issues 1,00,000 shares of ₹ 10 each, then ₹10 is the face value/nominal value/par value of each share.
- The person holding the share is known as **shareholder**.
- There are two types of shares normally issued by a company. These are **equity shares** and **preference shares**.
- The money raised by issue of equity shares is called **equity share capital**, while the money raised by issue of preference shares is called **preference share capital**.

Features/Merits

1. Payment of dividend to the equity shareholders is not compulsory. Therefore, there is no burden on the company in this respect.
2. Equity capital serves as permanent capital as it is to be repaid only at the time of liquidation of a company. As it stands last in the list of claims, it provides a cushion for creditors, in the event of winding up of a company.
3. Funds can be raised through equity issue without creating any charge on the assets of the company. The assets of a company are, therefore, free to be mortgaged for the purpose of borrowings, if the need be.

2. Preference Shares

The capital raised by issue of preference shares is called preference share capital.

The preference shareholders enjoy a preferential position over equity shareholders in two ways:

- (i) receiving a fixed rate of dividend, out of the net profits of the company, before any dividend is declared for equity shareholders; and
- (ii) receiving their capital after the claims of the company's creditors have been settled, at the time of liquidation.

In other words, as compared to the equity shareholders, the preference shareholders have a preferential claim over dividend and repayment of capital.

✓ Top Tips

1. Preference shareholders generally do not enjoy any voting rights.
2. Preference shares resemble debentures as they bear fixed rate of return. Also as the dividend is payable only at the discretion of the directors and only out of profit after tax, to that extent, these resemble equity shares. Thus, preference shares have some characteristics of both equity shares and debentures.

Features/Merits

1. Preference shares provide reasonably steady income in the form of fixed rate of return. Thus, preference shares are useful for those investors who want fixed rate of return.
2. It does not affect the control of equity shareholders over the management as preference shareholders don't have voting rights.
3. Payment of fixed rate of dividend to preference shares may enable a company to declare higher rates of dividend for the equity shareholders in good times.
4. Preference shareholders have a preferential right of repayment over equity shareholders in the event of liquidation of a company.
5. Preference capital does not create any sort of charge against the assets of a company.

Extra Shots

Different types of preference shares

- **Cumulative and Non-Cumulative:** The preference shares which enjoy the right to accumulate unpaid dividends in the future years, in case the same is not paid during a year are known as cumulative preference shares. On the other hand, on non-cumulative shares, dividend is not accumulated if it is not paid in a particular year.
- **Participating and Non-Participating:** Preference shares which have a right to participate in the further surplus of a company shares which after dividend at a certain rate has been paid on equity shares are called participating preference shares. The non-participating preference are such which do not enjoy such rights of participation in the profits of the company.
- **Convertible and Non-Convertible:** Preference shares that can be converted into equity shares within a specified period of time are known as convertible preference shares. On the other hand, non-convertible shares are such that cannot be converted into equity shares.

3. 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.

Features/Merits

1. Retained earnings is a permanent source of funds available to an organisation.
2. It does not involve any explicit cost in the form of interest, dividend or floatation cost.
3. As the funds are generated internally, there is a greater degree of operational freedom and flexibility.
4. It enhances the capacity of the business to absorb unexpected losses.
5. It may lead to increase in the market price of the equity shares of a company.



Top Tip

Excessive ploughing back may cause dissatisfaction amongst the shareholders as they would get lower dividends.

4. Global Depositary Receipts (GDRs)

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 Depositary Receipts (GDR).

- GDR is a negotiable instrument and can be traded freely like any other security.
- In the Indian context, a 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.
- A holder of GDR can at any time convert it into the number of shares it represents.
- The holders of GDRs do not carry any voting rights but only dividends and capital appreciation.



Many Indian companies such as Infosys, Reliance, Wipro and ICICI have raised money through issue of GDRs.

5. American Depositary Receipts (ADRs)

- The depository receipts issued by a company in the USA are known as American Depositary Receipts.
- ADRs are bought and sold in American markets, like regular stocks.
- ADR is similar to a GDR except that it can be issued only to American citizens.
- ADRs can be listed and traded on a stock exchange of USA.



Note

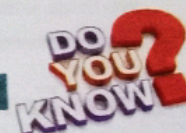
Features of ADRs

- US dollar denominated
- Listed on any American stock exchanges
- No right to vote in the company
- Right to get dividend

6. Indian Depositary Receipts (IDRs)

An Indian Depositary Receipt is a financial instrument denominated in Indian Rupees in the form of a Depositary 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.
- The foreign company issuing IDR deposits shares to an Indian Depository (custodian of securities registered with the Securities and Exchange Board of India). In turn, the depository issues receipts to investors in India against these shares.
- The benefits of the underlying shares (like bonus, dividends, etc.) accrue to the IDR holders in India.
- According to SEBI guidelines, IDRs are issued to Indian residents in the same way as domestic shares are issued. The issuer company makes a public offer in India, and residents can bid in exactly the same format and method as they bid for Indian shares.



'Standard Chartered PLC' was the first company that issued Indian Depositary Receipt in Indian securities market in June 2010.

Various Sources of Borrowed Funds – Concept

1. Debentures and Bonds

Debentures are an important instrument for raising long term debt capital. A company can raise funds through issue of debentures, which bear a fixed rate of interest.

- The debenture issued by a company is an acknowledgment that the company has borrowed a certain amount of money, which it promises to repay at a future date. Debenture holders are, therefore, termed as creditors of the company.
- Debenture holders are paid a fixed stated amount of interest at specified intervals say six months or one year. For example, if X Ltd. has 8% Debentures of ₹ 1,00,000, then annual interest on debentures = 8% of ₹ 1,00,000 = ₹ 8,000 (or ₹ 4,000 half yearly)



- Public issue of debentures requires that the issue be rated by a credit rating agency like CRISIL (Credit Rating and Information Services of India Ltd.) on aspects like track record of the company, its profitability, debt servicing capacity, credit worthiness and the perceived risk of lending.
- Issue of Zero Interest Debentures (ZID) which do not carry any explicit rate of interest has also become popular in recent years. The difference between the face value of the debenture and its purchase price is the return to the investor.

Features/Merits

1. It is preferred by investors who want fixed income at lesser risk.
2. Debentures are fixed charge funds and do not participate in profits of the company.
3. As debentures do not carry voting rights, financing through debentures does not dilute control of equity shareholders on management.
4. Financing through debentures is less costly as compared to cost of preference or equity capital as the interest payment on debentures is tax deductible.

Bonds are also debt instrument that does not carry a specific rate of interest, but issued at a heavy discount. The difference between nominal value and issue price is treated as the amount of interest related to the duration of bonds.

Extra Shots

Types of Debentures

- **Secured and Unsecured:** Secured debentures are such which create a charge on the assets of the company, thereby mortgaging the assets of the company. Unsecured debentures on the other hand do not carry any charge or security on the assets of the company.
- **Registered and Bearer:** Registered debentures are those which are duly recorded in the register of debenture holders maintained by the company. These can be transferred only through a regular instrument of transfer. In contrast, the debentures which are transferable by mere delivery are called bearer debentures.
- **Convertible and Non-Convertible:** Convertible debentures are those debentures that can be converted into equity shares after the expiry of a specified period. On the other hand, non-convertible debentures are those which cannot be converted into equity shares.
- **First and Second:** Debentures that are repaid before other debentures are repaid are known as first debentures. The second debentures are those which are paid after the first debentures have been paid back.

2. Loan From Financial Institutions

The government has established a number of financial institutions all over the country to provide finance to business organisations.

- These institutions are established by the central as well as state governments.
- They provide loan capital for long and medium term requirements.
- This source of financing is considered suitable when large funds for longer duration are required for expansion, reorganisation and modernisation of an enterprise.



Note

As financial institutions aim at promoting the industrial development of a country, these are also called 'development banks'.

Features/Merits

1. Financial institutions provide long-term finance, which are not provided by commercial banks.
2. Obtaining loan from financial institutions increases the goodwill of the borrowing company in the capital market. Consequently, such a company can raise funds easily from other sources as well.

3. As repayment of loan can be made in easy instalments, it does not prove to be much of a burden on the business.
4. The funds are made available even during periods of depression, when other sources of finance are not available.

Extra Shots

Special Financial Institutions

- **Industrial Finance Corporation of India (IFCI):** It was established in July 1948 as a statutory corporation under the Industrial Finance Corporation Act, 1948. Its objectives include assistance towards balanced regional development and encouraging new entrepreneurs to enter into the priority sectors of the economy. IFCI has also contributed to the development of management education in the country.
- **State Financial Corporations (SFC):** The State Financial Corporations Act, 1951 empowered the State Governments to establish State Financial Corporations in their respective regions for providing medium and short term finance to industries which are outside the scope of the IFCI. Its scope is wider than IFCI, since the former covers not only public limited companies but also private limited companies, partnership firms and proprietary concerns.
- **Industrial Credit and Investment Corporation of India (ICICI):** This was established in 1955 as a public limited company under the Companies Act. ICICI assists the creation, expansion and modernisation of industrial enterprises exclusively in the private sector. The corporation has also encouraged the participation of foreign capital in the country.
- **Industrial Development Bank of India (IDBI):** It was established in 1964 under the Industrial Development Bank of India Act, 1964 with an objective to coordinate the activities of other financial institutions including commercial banks. The bank performs three types of functions, namely, assistance to other financial institutions, direct assistance to industrial concerns, and promotion and coordination of financial-technical services.
- **Life Insurance Corporation of India (LIC):** LIC was set up in 1956 under the LIC Act, 1956 after nationalising 245 existing insurance companies. It mobilises the community's savings in the form of insurance premia and makes it available to industrial concerns, both public as well as private, in the form of direct loans and underwriting of and subscription to shares and debentures.

3. Loan from Commercial Banks

Commercial banks occupy a vital position as they provide funds for different purposes as well as for different time periods.

- Banks extend loans to firms of all sizes and in many ways:
 - (i) Cash credits
 - (ii) Bank overdrafts
 - (iii) Term loans
 - (iv) Purchase/discounting of bills
 - (v) Issue of letter of credit
- The rate of interest charged by banks depends on various factors such as the characteristics of the firm and the level of interest rates in the economy.
- The loan is repaid either in lump sum or in installments.
- Bank credit is not a permanent source of funds. Though banks have started extending loans for long periods, generally such loans are used for medium to short periods.
- The borrower is required to provide some security or create a charge on the assets of the firm before loan is sanctioned by a commercial bank.

Features/Merits

1. Banks provide timely assistance to business by providing funds as and when needed by it.
2. Secrecy of business can be maintained as the information supplied to the bank by the borrowers is confidential.
3. Formalities such as issue of prospectus and underwriting are not required for raising loans from a bank. This, therefore, is an easier source of funds.
4. Loan from a bank is a flexible source of finance as the loan amount can be increased according to business needs and can be repaid in advance when funds are not needed.

4. Trade Credit

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

- Trade credit facilitates the purchase of supplies without immediate payment. The borrower does not receive any cash, but gets its supplies on credit.
- Such credit appears in the records of the buyer of goods as 'sundry creditors' or 'accounts payable'.
- Trade credit is commonly used by business organisations as a source of short-term financing.
- It is granted to those customers who have reasonable amount of financial standing and goodwill.
- Normally, trade credit is granted for a period ranging 30 to 90 days.
- The volume and period of credit extended depends on factors such as reputation of the purchasing firm, financial position of the seller, volume of purchases, past record of payment and degree of competition in the market.

Features/Merits

1. Trade credit is a convenient and continuous source of funds.
2. Trade credit may be readily available in case the credit worthiness of the customers is known to the seller.
3. Trade credit needs to promote the sales of an organisation.
4. If an organisation wants to increase its inventory level in order to meet expected rise in the sales volume in the near future, it may use trade credit to, finance the same.
5. It does not create any charge on the assets of the firm while providing funds.



Note

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.

5. Inter Corporate Deposits (ICD)

Inter Corporate Deposits are unsecured short-term deposits made by a company with another company.

- ICD market is used for short-term cash management of a large corporate. These deposits are usually considered by the borrower company to solve problems of short-term funds insufficiency.
- As per the RBI guidelines, the minimum period of ICDs is 7 days which can be extended to one year.
- The three types of Inter Corporate Deposits are:
 - (i) Three months deposits
 - (ii) Six months deposits
 - (iii) Call deposits.
- Interest rate on ICDs may remain fixed or may be floating. The rate of interest on these deposits is higher than that of banks.



Note

In case of Inter Corporate Deposits, the deal takes place between two companies through commission agents.

6. Public Deposits

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

- Companies generally invite public deposits for a period up to three years.
- Rates of interest offered on public deposits are usually higher than that offered on bank deposits.
- The acceptance of public deposits is regulated by the Reserve Bank of India.
- Any person who is interested in depositing money in an organisation can do so by filling up a prescribed form. The organisation in return issues a deposit receipt as acknowledgment of the debt.
- Public deposits can take care of both medium and short-term financial requirements of a business.

- Public deposits are beneficial to both the depositor as well as to the organisation. While the depositors get higher interest rate than that offered by banks, the cost of deposits to the company is less than the cost of borrowings from banks.

Features/Merits

1. The procedure of obtaining deposits is simple and does not contain restrictive conditions as are generally there in a loan agreement.
2. Cost of public deposits is generally lower than the cost of borrowings from banks and financial institutions.
3. Public deposits do not usually create any charge on the assets of the company. The assets can be used as security for raising loans from other sources.
4. As the depositors do not have voting rights, the control of the company is not diluted.

Objective Type Questions

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
(Choose the correct alternative)
2. The term 'redeemable' is used for
(a) Preference shares
(b) Commercial paper
(c) Equity shares
(d) Public deposits
(Choose the correct alternative)
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
(Choose the correct alternative)
4. ADRs are issued in
(a) Canada
(b) China
(c) India
(d) USA
(Choose the correct alternative)
5. 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
(Choose the correct alternative)
6. _____ are debt instrument that does not carry a specific rate of interest, but issued at a heavy discount.
(a) Debentures
(b) Equity shares
(c) Bonds
(d) None of these
(Choose the correct alternative)
7. _____ is commonly used by business organisations as a source of short-term financing.
(a) Lease financing
(b) ADRs
(c) Trade Credit
(d) None of these
(Choose the correct alternative)
8. _____ are the unsecured short-term deposits made by company with another company.
(a) Indian Depository Receipt
(b) American Depository Receipt
(c) Global Depository Receipt
(d) Inter Corporate Deposits
(Choose the correct alternative)
9. Match the columns:

(i) It facilitates the purchase of goods and services without making immediate payment.	(a) Trade Credit
(ii) It refers to that part of profits which is kept and reserve for use in the future.	(b) Preference Shares
(iii) This source of finance has characteristics of both equity shares and debentures.	(c) Retained Earnings

10. Finance invested in fixed assets is called working capital.
11. Working capital is raised through short-term funds.
12. Preference shares carry preferential rights over the equity shares as regards payment of dividend and repayment of capital.
13. A debenture is an acknowledgment of debt.
14. Debentureholders are entitled to a fixed rate of interest.
15. Name the capital invested in permanent assets.
16. Name the funds needed for day-to-day operations of business.
17. Which concern—a trading concern or a manufacturing concern—will have large amount of fixed capital? Why?
18. Neha Ltd. sells goods on credit while Pankhuri Ltd. sells goods on cash basis. Which company will require more working capital?
19. Why is equity share capital called risk capital?
20. Why are equity shareholders referred to as 'residual owners'?
21. Why is equity share capital called the permanent capital?
22. Why are debentures known as borrowed funds?
23. Name the source of finance which is available in the normal course of purchase of goods.
24. Why share capital is known as owned funds?
25. Why are retained profits called self-financing?
26. Name any two Indian companies which have raised money through issue of GDRs.
27. A company wants to issue such shares which do not have the right of preference for payment of dividend and refund of capital at the time of liquidation.
Identify such shares.
28. Narayan Traders Ltd. is a company that deals in the wholesale business of rice. The finance manager of the company, Mr. Radheshyam Das arranges unsecured short-term finance for the company. The rate of interest to be paid on this finance is more than the bank's rate of interest.
Identify the source of finance.
29. A foreign company 'Zylo Ltd.' wants to collect money from the capital market of India. The finance manager of the company, Mr. Robert wants to issue a financial instrument which instead of being in dollars shall be denominated in rupees. One of the characteristics of this financial instrument is that it can be got listed in any Indian stock exchange.
Identify the financial instrument.
30. Pranav Udyog Ltd. is a company manufacturing electric devices. The company's financial manager, Mr. Dhruv, in order to fulfill the long-term financial need, wants to raise the cheapest source of finance.
Identify the source of finance.
31. An Indian company 'Vandana Ltd.', in order to cater to its financial needs, wants to issue such an international financial instrument which can be issued only to the American residents.
Identify the financial instrument.
32. Fashion Hut, a reputed garments manufacturing unit needs to meet its day-to-day expenses like wages, rent, maintaining stock of raw material, etc. The owner approaches the supplier of the raw materials to give credit for two months, so that he can get cloth for making garments without making immediate payment. The supplier made an enquiry regarding the business organisation and found that its reputation was very good. So it extended two months credit to it.
Identify the source of finance discussed above.
33. C Ltd. is planning to modernise its plant with latest technology. The company is not having sufficient money. The finance manager plans to arrange money for 3 years since after that the company is expecting a good return on investment. The finance manager does not want to spend on floatation costs on issue of shares or debentures.
Identify the suitable source of finance for the company.

True/False? Give reason.
 True/False? Give reason.
 True/False? Give reason.
 True/False? Give reason.
 True/False? Give reason.

Q.1

Ans.
Q.2Ans.
Q.

A

Case Studies

Analysing, Evaluating & Creating Type Questions

- Q.1** Trinity Ltd. is a company which manufactures blankets. The company needs additional capital for expansion of the company decided that they would issue 50,000 shares of the face value of ₹ 100 each. Before issuing shares the management in the prospectus they mentioned that in the coming years, the company expected to earn a big profit and as a result, the investors would be able to earn extra dividends. The company collected money from the public and the company's business expanded.

Identify and explain the type of shares issued by Trinity Ltd.

(3 marks)

Ans. Equity Shares (explain its features)

- Q.2** Radhika Ltd. has good growth prospects. So it is planning to expand their business. For this the company needs additional funds. The finance manager reports that the company is not in a position to bear extra burden of paying any fixed financial charges like interest or dividend. They do not want to bear any floatation costs even. Also, the equity shareholders insist not to issue further shares as there is risk of dilution of control.

Suggest and explain the source of finance most suitable for Radhika Ltd.

(4 marks)

Ans. Retained Earnings (explain its features)

- Q.3** Krishna Pvt. Ltd. is facing the shortage of long-term finance as it is a period of depression in the economy. The experts were consulted to determine the source of finance the company should raise. One financial advisor, Mr. Ram, advised that the company should use such a security on which it has a tax advantage and there is no dilution of control of the shareholders. Another finance specialist, Mr. Shiv advised that the company should not issue any debt or equity security but raise such a source of long-term finance which can be redeemed in easy instalments.

Quoting the relevant lines from the above para, identify and explain the sources of finance suggested by the two specialists, Mr. Ram and Mr. Shiv.

(6 marks)

- Ans.** (a) Mr. Ram advised the company to issue 'Debentures'.
"...the company should use such a security on which it has a tax advantage and there is no dilution of control of the shareholders." (explain)
- (b) Mr. Shiv suggested to obtain 'Loan from Financial Institution'.
"... the company should not issue any debt or equity security but raise such a source long-term finance which can be redeemed in easy instalments." (explain)

- Q.4** A seminar was held in New York on the problems of finance. Its topic was 'The Different Finance Sources available at the Global Level in the Modern Context.' 200 representatives from different countries participated in this seminar. All the representatives expressed their respective opinions. One of the sources of finance discussed in the seminar was such through which the foreign companies could issue their securities in India. Looking at the great possibilities of obtaining capital from the investors in India, all of them showed a great interest in the discussion of the source. Another source of finance which created interest in everyone was the source through which money could be obtained from the investors in America and other European countries. Since this source was concerned with a very big area, the number of people who took interest in it was also large. One of the Indian representatives threw light on the special characteristics of this source. His presentation was appreciated by one and all. In the final session of the seminar, the discussion took place on such a source of finance which could be used only in America. In the end of the seminar, the organisers thanked all the guests, and the seminar came to a successful conclusion.

In the above paragraph, three international sources of finance were discussed. Quoting the relevant lines identify those sources and explain them.

(6 marks)

- Ans.** (i) Indian Depository Receipts (IDR)
"One of the sources of finance discussed in the seminar was such through which the foreign companies could issue their securities in India."
 An IDR is an instrument denominated in Indian Rupees in the form of a depository receipt created by an Indian Depository against the underlying equity of issuing company to enable foreign company to raise funds from the Indian securities market.

- (ii) Global Depository Receipts (GDR)

"Another source of finance which created interest in everyone was the source through which money could be obtained from the investors in America and other European countries."

The depository receipts denominated in US dollars are called GDRs. In the Indian context, a GDR is an instrument issued abroad by an Indian company to raise funds in some foreign currency. Many Indian companies such as Infosys, Reliance, Wipro and ICICI have raised money through issue of GDRs.

- (iii) American Depository Receipts (ADR)

"In the final session of the seminar, the discussion took place on such a source of finance which could be used only in America."

The depository receipts issued by a company in the USA are known as ADRs. These are bought and sold in American markets like regular stocks. It is similar to a GDR except that it can be issued only to American citizens and can be listed and traded on a stock exchange of USA only.

Q.5 Madhav Sales Pvt. Ltd. owns the agency of different food products, which sells goods of different brands to retailers after purchasing them from several companies. It purchases almost all goods for cash while its all sales are on credit of one month. So the company keeps struggling with the short term finance. To overcome this problem, the company's finance department held a meeting. The chairperson of the meeting asked the members to express their views on the solution of this problem. The first person said, "we should use a source of finance which does not involve any bureaucracy and legal problems and the market of which maintains secrecy." The second person's opinion was that the company often needs cash credit and overdraft. Therefore, the source of finance should be selected considering this fact. The view of the third person was that the company also should buy goods on credit. The chairperson of the meeting listened to the suggestions of all and, to take the final decision, asked them to be present in a meeting the next week.

Quoting the relevant lines from the above para, identify and explain the sources of finance as suggested by different persons. 6 marks

- Ans.** (a) The first person's opinion is to raise short-term finance through Inter-Corporate Deposits (ICD).
"... a source of finance which does not involve any bureaucracy and legal problems and the market of which maintains secrecy."

Inter corporate deposits are unsecured short-term deposits made by a company with another company. The rate of interest on these deposits is higher than that of banks. These deposits are usually considered by the borrower company to solve problems of short-term funds insufficiency.

- (b) The second person suggested to obtain Loan from Commercial Banks.

"... the company often needs cash credit and overdraft."

Commercial banks give loans and advances to business firms in the form of cash credit, overdrafts, term loans, etc. Borrowings from commercial banks are short-term or medium-term finance. 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. Rate of interest on loan is fixed.

- (c) The third person's view is to avail Trade Credit.

"... the company also should buy goods on credit."

Trade credit is the credit extended by one trade to another for the purchase of goods and services. Trade credit is commonly used by business organisations as a source of short-term financing. Trade credit appears in the records of the buyer of goods as 'sundry creditors' or 'accounts payable'.

Q.6 Shubham Ltd. has decided to expand its production capacity by modernising its plant and machinery at an estimated cost of ₹ 2 crore. It does not have adequate reserves to finance the expansion. Suggest any four sources of finance for the company. 3 marks

Ans. To expand its production capacity by modernising plant and machinery, the company has to depend on long-term sources of finance. If the company does not have adequate reserves (i.e., retained profits), it may rely on following sources:

- | | |
|---------------------|-----------------------------|
| (i) Debentures | (ii) Financial institutions |
| (iii) Equity shares | (iv) Preference shares. |

Q.7 Shobhit has ₹50,000 for investment purposes. Should he invest in equity shares, preference shares, public deposits or debentures? Justify your answer. 3 marks

Ans. Shobhit will invest ₹50,000 in debentures or public deposits if he cares more for the security of investment and stability of income (in the form of interest).

He will choose preference shares if he wants a fixed income (in the form of dividend) and also the safety of capital.

However, if he is an adventurous investor (who can take risk) and wants to participate in the affairs of the company and enjoy higher returns (in the years of high profits), he will certainly invest in equity shares.

Q.8 The Directors of Sheetal Ltd. have decided to expand the business activities by increasing the stock of raw materials and finished goods at an estimated cost of ₹50 lakh. As finance manager of the company, advise the directors about the various methods open to the company to raise necessary finance for this purpose. (3 marks)

Ans. To expand the business activities by increasing the stock of raw materials and finished goods at an estimated cost of ₹50 lakh, Sheetal Ltd. requires investment in current assets of permanent nature, i.e., permanent working capital, which requires long-term finance. Therefore, as a finance manager, I would suggest the following methods of long-term finance:

- (i) Issue of equity shares
- (ii) Issue of preference shares
- (iii) Issue of debentures
- (iv) retained earnings
- (v) Loans from banks and financial institutions.

Q.9 A company needs to increase its stock of raw material and finished goods, which will require funds of ₹40 lakh. What are the various options available with the company to finance this amount? Explain. 6 marks

Ans. The various options available with the company to finance the working capital needs of ₹ 40 lakh are:

- (i) Trade Credit
- (ii) Loans from Commercial Banks
- (iii) Public Deposits

(explain)

Q.10 'Enviro Solutions' constructs roof top rain water harvesting systems in Kerala. Company needs funds for making its day-to-day expenses like wages, electricity, generator etc. They decide to approach their supplier 'Reddy and Sons'. They requested 'Reddy and Sons' to grant them credit for purchase of goods and services. This would enable them to buy raw materials without making immediate payment.

'Enviro Solutions' financial position is not very strong and hence it has lost its goodwill. Their past record of payments to its lenders is also not convincing.

- (a) Identify the source of finance discussed in above case.
- (b) Source of finance identified in part (a) above is short-term or long term?
- (c) Will 'Enviro Solutions' be able to procure finance through this source? State with reason.
- (d) State any three characteristics of the source. 6 marks

Ans. (a) Trade credit
 (b) Short-Term
 (c) No; because of weak financial position
 (d) (i) Granted for a period ranging 30 to 90 days
 (ii) Granted to those customers who have reasonable amount of financial standing and goodwill.
 (iii) The borrower does not receive any cash, but gets its supplies on credit.

Q.11 'Correct' is a company manufacturing mobile phones. Its financial manager Ajay garg arranges unsecured short-term finance for the company through a commission agent. The rate of interest to be paid on this finance is more than bank's rate of interest. For Ajay Garg, one of the greatest advantages of this finance was that, this source was far away from bureaucratic and legal hassles.

- (a) Identify this source of finance and state its four features.
- (b) Source of finance identified in part (a) above is short term or long term? 6 marks

Ans. (a) Inter Corporate Deposits (Explain its features)

- (b) Short-term

RECAP



Concept, Nature and Importance of Business Finance

Money required for carrying out business activities is called business finance.

Finance is needed for the following reasons:

1. **Fixed capital requirement:** In order to start business, funds are needed to purchase fixed assets like land and building, plant and machinery, furniture, etc. This is called fixed capital requirements.
2. **Working Capital requirements:** A business needs funds for its day-to-day operations. This is known as working capital requirements. Working capital is required to purchase raw materials, to meet current expenses like salaries, wages, rent and taxes, etc.

Classification of Sources of Funds on the basis of Ownership

1. **Owner's funds**— funds that are provided by the owners of an enterprise, e.g. Equity shares, Preference shares, Retained earnings, etc.
2. **Borrowed funds**— funds raised through loans or borrowing, e.g. Debentures and Bonds, Loan from Financial Institutions and Banks, etc.

Sources of Owners' Funds

1. **Equity shares:** The money raised by issue of equity shares is known as 'equity share capital'. It represents owner's funds.
2. **Preference shares:** The money raised by issue of preference shares is called 'preference share capital'.
3. **Retained Earnings:** The portion of company's net profits after tax and preference dividend which is not distributed as equity dividend, but are retained for reinvestment purposes is called 'retained earnings'.
4. **Global Depository Receipts (GDRs):** GDR is an instrument issued abroad by an Indian company to raise funds in some foreign currency.
5. **American Depository Receipts (ADRs):** The depository receipts issued by a company in the USA are known as ADRs.
6. **Indian Depository Receipts (IDRs):** An IDR is an instrument denominated in Indian Rupees in the form of a depository receipt created by an Indian Depository against the underlying equity of issuing company to enable foreign company to raise funds from the Indian securities market.

Sources of Borrowed Funds

1. **Debentures and Bonds:** *Debentures* are an important debt instrument for raising long-term finance. They carry a fixed rate of interest. *Bonds* are also debt instrument that does not carry a specific rate of interest, but issued at a discount.
2. **Loan from Financial Institutions:** *Examples:* Industrial Finance Corporation of India (IFCI), Industrial Credit and Investment Corporation of India (ICICI), etc.
3. **Trade Credit:** Trade credit is the credit extended by one trade to another for the purchase of goods and services. Trade credit is commonly used by business organisations as a source of short-term financing. Trade credit appears in the records of the buyer of goods as 'sundry creditors' or 'accounts payable'.
4. **Inter Corporate Deposits (ICDs):** Inter corporate deposits are unsecured short-term deposits made by a company with another company. The rate of interest on these deposits is higher than that of banks. There are three types of Inter Corporate Deposits: (i) Three month deposits (ii) Six month deposits (iii) Call deposits
5. **Loan from Commercial Banks:** Commercial banks extend loans to firms of all sizes and in many ways: Cash credits, Bank overdrafts, Term loans, Purchase/discounting of bills and Issue of letter of credit.
6. **Public Deposits:** The deposits that are raised by organisations directly from the public are known as public deposits. Companies generally invite public deposits for a period up to three years. Rates of interest offered on public deposits are usually higher than that offered on bank deposits.

 Key Terms

Business Finance – The requirements of funds by business to carry out its various activities is called business finance.

Fixed capital – In order to start business, funds are required to purchase fixed assets like land and building, plant and machinery, and furniture and fixtures. This is known as fixed capital requirements of the enterprise.

Working Capital – A business needs funds for its day-to-day operations. This is known as working capital of an enterprise, which is used for holding current assets such as stock of material, bills receivables and for meeting current expenses like salaries, wages, taxes, and rent.

Owner's funds means funds that are provided by the owners of an enterprise, which may be a sole trader or partners or shareholders of a company. Apart from capital, it also includes profits reinvested in the business.

Borrowed funds refer to the funds raised through loans or borrowings.

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

Preference Shares – The capital raised by issue of preference shares is called preference share capital.

Share capital – The capital obtained by issue of shares is known as share capital. The money raised by issue of equity shares is called equity share capital, while the money raised by issue of preference shares is called preference share capital.

Shares – The capital of a company is divided into small units called shares.

Nominal value – Each share has its nominal value/face value/par value. For example, if a company issues 1,00,000 shares of ₹10 each, then ₹10 is the face value/nominal value/par value of each share.

Shareholder – The person holding the share is known as shareholder.

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.

Global Depository Receipts (GDRs) – 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).

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

Indian Depository Receipts (IDRs) – An Indian Depository Receipt is a financial instrument denominated in Indian Rupees in the form of a Depository Receipt.

Debentures are an important instrument for raising long term debt capital. A company can raise funds through issue of debentures, which bear a fixed rate of interest.

Bonds are also debt instrument that does not carry a specific rate of interest, but issued at a heavy discount. The difference between nominal value and issue price is treated as the amount of interest related to the duration of bonds.

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

Inter Corporate Deposits are unsecured short-term deposits made by a company with another company.

Public Deposits – The deposits that are raised by organisations directly from the public are known as public deposits.

Self Assessment Test 1

Sources of Business Finance

Time allowed : 1 hour

Maximum Marks : 25

(Choose the correct alternative) (1 mark)

Q.1 Equity shareholders are called

- (a) Owners of the company
- (c) Executives of the company

- (b) Partners of the company
- (d) Guardian of the company

(Choose the correct alternative) (1 mark)

Q.2 The term 'redeemable' is used for

- (a) Preference shares
- (c) Equity shares

- (b) Commercial paper
- (d) Public deposits

(Choose the correct alternative) (1 mark)

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

- (a) Fixed capital requirement
- (c) Working capital requirement

- (b) Ploughing back of profits
- (d) Lease financing

Q.4 What is a trade credit?

(1 mark)

Q.5 What is business finance? Why do businesses need funds? Explain any two reasons.

(3 marks)

Q.6 What preferential rights are enjoyed by preference shareholders. Explain.

(3 marks)

Q.7 Explain public deposits and loans from commercial banks as sources of finance.

(4 marks)

Q.8 Madhu Ltd. is a company manufacturing garments for children. It has been consistently earning good profits for many years. This year too, it has been able to generate enough profits. There is availability of enough cash in the company. It believes in quality of product, equal employment opportunities & good remuneration. It has many shareholders who prefer to receive a fixed & regular income. Mohan is one of such shareholders.

Which type of shares Mohan holds? Explain its four features.

(5 marks)

Q.9 Discuss the financial instruments used in international financing.

(6 marks)

Self Assessment Test 2

Sources of Business Finance

Time allowed : 1 hour

Maximum Marks : 25

Q.1 ADRs are issued in

- (a) Canada
- (c) India

- (b) China
- (d) USA

(Choose the correct alternative) (1 mark)

Q.2 Public deposits are the deposits that are raised directly from

- (a) The public
- (c) The auditors

- (b) The directors
- (d) The owners

(Choose the correct alternative) (1 mark)

Q.3 Debentures represent

- (a) Fixed capital of the company
- (c) Fluctuating capital of the company

- (b) Permanent capital of the company
- (d) Loan capital of the company

(Choose the correct alternative) (1 mark)

Q.4 What is meant by 'ploughing back of profit'?

(1 mark)

Q.5 Define preference shares. What preferential rights are enjoyed by preference shareholders?

(3 marks)

Q.6 "Equity capital is permanent source of capital." Explain.

(3 marks)

Q.7 Explain trade credit and bank credit as sources of short-term finance for business enterprises.

(4 marks)

Q.8 Abhimanyu Ltd. is manufacturing cotton shirts for men. It is planning to expand its business by opening one more unit in another city. It has been consistently earning good profits. So there are sufficient reserves. State the most appropriate source of finance for the company. Explain its features.

(5 marks)

Q.9 A foreign company wants to collect money from the capital market of India. The financial manager of the company. Mr. Trump wants to issue such a financial instrument, as instead of being in dollars, shall be denominated in rupees, as it can be listed in any Indian stock Exchange thereafter.

- (a) Identify the Financial Instrument indicated in above situation.

(6 marks)

- (b) Explain the features of this Financial instrument.

Self Assessment Test 3

Sources of Business Finance

Maximum Marks : 25

Time allowed : 1 hour

(Choose the correct alternative) (1 mark)

Q.1 Who is the owner of the company?

- (a) Equity share holder
(c) Debenture holder

(b) Preference share holder

(d) Director

(Choose the correct alternative) (1 mark)

Q.2 ICD's are issued by

- (a) Bank
(c) company to another

(b) RBI

(d) SIDBI

(Choose the correct alternative) (1 mark)

Q.3 Internal sources of capital are those that are

- (a) generated through outsiders
(c) generated through issue

(b) generated through loans such as suppliers from commercial banks

(d) generated within of shares the business

(1 mark)

Q.4 Why are preference shares called so?

Q.5 Mr. Pardeep owns a business of toys. At present he sells his product in North and West India, but now planning to sell his products in South India also. For this he applied to the bank for enhancement of his overdraft limit from ₹50 Lakhs to ₹75 Lakhs. Bank manager suggested him to take 'Term Loan' of ₹25 Lakh instead of increasing overdraft limit. Do you think he should consider Term Loan instead of overdraft limit? Give reasons. (3 marks)

Q.6 Name and explain the source of finance which is popularly known as self-financing or ploughing back of profit. (3 marks)

Q.7 "Ojas Auto Ltd." is a very well known auto company in the industry having more of equity share capital than long term debt in its capital structure. It is willing to expand and establish new unit in the backward region and want to train the tribal women in skill development to empower them. It has a huge amount of cash reserve of ₹1000 crores. Which source of finance should be used by the company in establishing new units? Give any three reasons in support of your answer. (4 marks)

Q.8 Define a share. What are two types of shares? Explain two features of each. (5 marks)

Q.9 What is the difference between GDR and ADR? Explain three features of each. (6 marks)

Check List to Objective Type Questions

1. (a)
2. (a)
3. (c)
4. (d)
5. (d)
6. (c)
7. (c)
8. (d)
9. (i) - (a), (ii) - (c), (iii) - (b)
10. False: It is called fixed capital.
11. True: Working capital is required to meet day-to-day expenses. So, it is raised through short-term sources like trade credit, factoring, banks, commercial paper, etc.
12. True: They get dividend before equity dividend is paid. On the winding up of the company, their capital is refunded first.
13. True: Debentures are a part of borrowed funds of a company. Debentures are an important debt instrument for raising long-term finance.
14. True: Debentures carry a fixed rate of interest. Interest on debentures is a charge against the profits of a company. It has to be paid even if the company suffers losses.
15. Fixed capital
16. Working capital
17. Manufacturing concern, because it has to invest in plant and machinery.
18. Neha Ltd
19. Because equity shareholders bear the risk of loss of the business. Moreover, they do not get dividend in the years of losses.
20. Equity shareholders do not get a fixed dividend, but are paid only when tax to the government, interest on loans and debentures and preference dividend have been paid. So, they are referred to as 'residual owners'.
21. Because it is to be paid only at the time of liquidation of a company.
22. Because debentures are an important debt-instrument for raising long-term finance. They carry a fixed rate of interest.
23. Trade credit
24. Shareholders are the real owners of the company.
25. Because the business firm itself generates them.
26. (i) Infosys (ii) Reliance
27. Equity Shares
28. Inter-Corporate Deposits (ICD)
29. Indian Depository Receipts (IDR)
30. Debentures
31. American Depository Receipts (ADR)
32. Trade Credit
33. Public Deposits