# Sources of Business Finance

PART 1

## Objective Questions

### • Multiple Choice Questions

1. Requirement of funds by business to carry out its various activities is known as
(a) business management
(b) business finance
(c) business budgeting
(d) financial management

*Ans.* (b) A business requires funds for each and every activity from its commencement till it's winding up. This requirement of funds is known as business finance.

2. Primary goal of business finance is to
(a) increase corporate value
(b) increase brand value
(c) reduce debt burden
(d) avail opportunities

*Ans.* (a) Increase in brand value, reduction of debt burden and availing opportunities are the secondary goals of business finance, while primary goal is to increase corporate value.

3. Fixed capital requirements of a manufacturing concern are
(a) same as that of a trading concern
(b) more than that of a trading concern
(c) less than that of a trading concern
(d) None of the above

*Ans.* (b) Fixed capital requirements of a manufacturing concern are more since they require more machine and other factory tools as compared to trading concerns.

4. The working capital requirements of a business is high if ......
(a) sales turnover of business is high
(b) it sells goods on credit
(c) it has any expansion plans
(d) All of the above

*Ans.* (d) All the mentioned options lead to more requirement of working capital majorly in the form of high inventory levels, high outflow of cash and low inflow of cash.

5. Funds needed for the day-to-day operations is called .......... capital of the company.
(a) fixed (b) loan
(c) permanent (d) working

*Ans.* (d) working

6. In order to avoid failure in non-payment, fixed capital requirements should be met through which type of source of finance?
(a) Long-term sources
(b) Short-term sources
(c) Medium-term sources
(d) None of the above

*Ans.* (a) Long-term source of finance gives more opportunity to the borrower to repay the debt thereby helping in avoiding the failure of non-repayment.

7. Mary owns a small farm to grow fruits. She wants to purchase neighbouring land and convert it to farm for increasing the variety of fruits. She wishes to take tractor and some other machine for the same. She will also need money to purchase the land. Which source of finance is required by Mary?
(a) Short-term (b) Medium-term
(c) Long-term (d) Both (a) and (b)

*Ans.* (c) Mary will be able to pay only when her new farm starts giving high quantity of fruits which will require long time, therefore, she requires long-term finance.

8. **Statement I** Medium-term funds remain invested in a business for more than 1 year but less than 5 years.

**Statement II** Payment of dividend on equity shares is compulsory.

**Alternatives**
(a) Statement I is correct and statement II is wrong
(b) Statement II is correct and Statement I is wrong
(c) Both the statements are correct
(d) Both the statements are incorrect

*Ans.* (a) Equity shareholders are the residual owners of the company. So, dividend is only paid when amount is left after making payment to all other liabilities.

9. Directors of X Ltd wants to expand the company, for this they need land, new factory shed and machines.

Being the financial advisor of the company which source from the following you will recommend them?

(a) Debentures
(b) Inter-corporate deposits
(c) Loan from commercial banks
(d) Equity shares

*Ans.* (d) Acquisition of land and construction of factory shed on it takes time. This means that the factory will not generate any revenues for that time period. Therefore, funds required for the construction of the factory should be arranged from sources which are of long-term and do not require fixed interest payments. Debentures requires fixed interest payment while inter-corporate deposits and loans from commercial banks are short-term in nature. Therefore, equity is the best option among the given options.

**10.** Equity share capital represents

(a) fixed capital of the company
(b) loan capital of the company
(c) permanent capital of the company
(d) fluctuating capital of the company

*Ans.* (c) Equity shares are permanent source of capital which are redeemed only at the winding up of the company.

**11.** **Statement I** Participating preference shares participate in the management of the company.

**Statement II** The owner funds are a permanent source of finance.

**Alternatives**

(a) Statement I is correct and statement II is wrong
(b) Statement II is correct and Statement I is wrong
(c) Both the statements are correct
(d) Both the statements are incorrect

*Ans.* (b) Participating preference shares can participate for additional dividend of the company. They cannot take part in the management of the company.

**12.** Instead of distributing entire profits to the owners in the form of dividend, some profits are re-invested in business in order to finance the future earnings of the business. This is known as .......... .

(a) ploughing back (b) dividend
(c) working capital (d) dividend stripping

*Ans.* (a) ploughing back

**13.** **Statement I** Retained earnings involve any explicit cost in the form of interest, dividend or floatation cost.

**Statement II** Retained earnings are an uncertain source of fund.

**Alternatives**

(a) Statement I is correct and statement II is wrong
(b) Statement II is correct and Statement I is wrong
(c) Both the statements are correct
(d) Both the statements are incorrect

*Ans.* (d) Retained earnings do not involve any explicit cost as it does not involve any form of interest, dividend or floatation cost. As the profits of business are fluctuating, it is an uncertain source of fund.

**14.** Non-payment of debts on time results in

(a) higher interest costs (b) loss of goodwill
(c) fines and penalties (d) All of these

*Ans.* (d) Non-payment of debts on time results in imposition of fines or penalties by the lender. In normal course of business, money is borrowed at compound interest rates which means interest is charged on interest therefore, if there is any delay in repayment, interest costs would be higher. Extraordinary delay may also result in court cases leading to loss of goodwill.

**15.** Unsecured debentures are also known as …….. debentures.

(a) simple (b) naked
(c) collateralised (d) Both (a) and (b)

*Ans.* (d) Both (a) and (b)

**16.** The depository receipts issued by the company in the USA are known as ………. .

(a) GDR (b) ADR
(c) FDR (d) Both (b) and (c)

*Ans.* (b) ADR

**17.** One of the demerits of loan from financial institutions is that, financial institutions may put …… in the board of directors of the borrowing company which restricts their power.

(a) independent directors
(b) nominee directors
(c) experts
(d) auditors

*Ans.* (b) nominee directors

**18.** Companies generally invites public deposits for a period up to

(a) 5 years (b) 3 years
(c) 4 years (d) 10 years

*Ans.* (b) 3 years

**19.** **Statement I** In certain situations, collection of public deposits is difficult.

**Statement II** The dividends to be paid to the preference shareholders are fluctuating.

**Alternatives**

(a) Statement I is correct and statement II is wrong
(b) Statement II is correct and Statement I is wrong
(c) Both the statements are correct
(d) Both the statements are incorrect

*Ans.* (a) Collection of public deposits may prove difficult, when the size of deposits required is large. The dividends to be paid to the preference shareholders are fixed.

**20.** ……is the credit extended by one trader to another for the purchase of goods and services.
(a) Loan (b) Trade Credit
(c) Trade Loan (d) Both (a) and (b)

*Ans.* (b) Trade Credit

## • Assertion–Reasoning MCQs

**Directions** (Q. Nos. 1 to 7) *There are two statements marked as Assertion (A) and Reason (R). Read the statements and choose the appropriate option from the options given below*

(a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A)
(b) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A)
(c) Assertion (A) is true, but Reason (R) is false
(d) Assertion (A) is false, but Reason (R) is true

**1.** **Assertion** (A) The procedure of obtaining funds from commercial banks is complex.

**Reason** (R) Banks make detailed investigation of the company's affairs, financial structure, etc. Interest charged by banks depends upon a number of factors, such as nature of advance, period for which the loan is taken, etc.

*Ans.* (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).

**2.** **Assertion** (A) Financing through debentures is less costly.

**Reason** (R) Debentures do not carry voting rights. Therefore, financing through debentures does not dilute the control of equity shareholders on management.

*Ans.* (b) The interest paid on debentures is admissible as an expense according to the provisions of income tax. This helps a company to reduce its tax liability. Therefore, financing through debentures is less costly.

**3.** **Assertion** (A) Payment of dividend on equity shares is compulsory.

**Reason** (R) Voting rights are conferred upon equity shareholders and they participate in the affairs of the business.

*Ans.* (d) Equity shareholders are the residual owners of the company. So, dividend is only paid when amount is left after making the payment for all other liabilities.

**4.** **Assertion** (A) The control of the company is not diluted when they go for public deposits.

**Reason** (R) The depositors of company are given minor voting rights to keep their preference in consideration.

*Ans.* (c) In public deposit, the depositors of company are not given any voting rights.

**5.** **Assertion** (A) Borrowed funds are not considered as permanent source of capital.

**Reason** (R) Borrowed funds are raised from external source and are required to be paid back after a stipulated period.

*Ans.* (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A)

**6.** **Assertion** (A) To overcome problems during difficult times, a business needs finance.

**Reason** (R) During recession and depression, the sales of the business go down and the profitability is adversely affected.

*Ans.* (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A)

**7.** **Assertion** (A) Tax benefits are available on dividend paid on preference shares.

**Reason** (R) Dividend paid on preference shares is an appropriation of profits.

*Ans.* (d) Tax benefits are not available on dividend paid on preference shares because of the reason given.

## • Case Based MCQs

**1.** **Direction** *Read the following text and answer the question no. (i) to (vi) on the basis of the same.*

A company is searching options to raise ₹ 20,000 crore from the financial market for diversification and modernisation of existing projects. It hired the services of a renowned financial consultancy firm for suggesting options for the same. The financial consultancy firm suggested a list of options to the board of directors of the company.

It was decided that for the immediate requirement of ₹ 1,500 crore, the company will make a new issue of shares without diluting the right of existing shareholders according to the terms and conditions of the company and ₹ 4,500 crore, would be raised by taking loans from financial institutions.

It was further decided to raise capital to the term of ₹ 6,000 crore through debentures. All these options were accepted by the board of directors. The board further decided that trade credit can be used to finance short-term capital requirements. The company also decided that they will use their undistributed profits in case of shortfall of funds.

(i) It was decided that for the immediate requirement of ₹ 1,500 crore, the company will make a new issue of shares at a fixed rate of dividend without diluting the control of existing shareholders, according to the terms and conditions of the company. Name the type of financial securities issued by the company.

(a) Equity shares
(b) Debentures
(c) Commercial papers
(d) Preference shares

*Ans.* (d) Preference shares

(ii) Which of the following sources of finance used by company does not involve any cost?

(a) Shares
(b) Debentures
(c) Trade credit
(d) Loans from financial institutions

*Ans.* (c) Trade credit

(iii) Debentures are said to be the economical source of finance because of which of the merits?

(a) Low floatation cost (b) Tax benefits
(c) No loss of control (d) Fixed interest

*Ans.* (b) Tax benefits

(iv) ₹ 4,500 crore would be raised by taking loans from financial institutions. Loans from financial institutions are provided for

(a) short-term (b) medium-term
(c) long-term (d) Both (b) and (c)

*Ans.* (d) Both (b) and (c)

(v) The board of directors further decided that trade credit can be used to finance short-term capital requirements. Identify one of the sources of trade credit.

(a) Banks (b) Traders
(c) Suppliers (d) Customers

*Ans.* (b) Traders

(vi) The usage of undistributed profits indicates the usage of which source of capital?

(a) Bonds (b) Equity shares
(c) Preference shares (d) None of these

*Ans.* (d) The undistributed profit indicates retained earnings.

**2. Direction** *Read the following text and answer the question no. (i) to (vi) on the basis of the same.*

Vinita is the finance manager of Kipla pharma Co. As the company wants to import a piece of new machinery from Japan for its expansion, the capital requirements for the same are estimated to be ₹ 5 crore. Vinita reported that the company is not in a position to bear extra burden of paying interest so the company should use owned capital sources than borrowed capital.

The board of directors are confident about the sales turnover and cash flow position of the company in the coming years and supports the borrowed capital source of raising capital. The company is also considering using retained earnings for the same.

(i) Name the source of owned capital which is available free of cost.

(a) Equity shares (b) Preference shares
(c) Retained earnings (d) Bonds

*Ans.* (c) Retained earnings

(ii) Vinita is of the view to finance the fund requirements from owned capital sources rather than from borrowed capital sources as the risk of borrowed capital is .... and cost is ..... .

(a) high, low (b) low, high
(c) low, low (d) high, high

*Ans.* (a) high, low

(iii) If the cash flow position of the company is strong, the company can raise the required capital by issuing ......... to enjoy tax benefits.

(a) shares
(b) bonds
(c) debentures
(d) commercial papers

*Ans.* (c) debentures

(iv) The control of shareholders over management will get diluted if the company raises the capital by

(a) equity shares (b) debentures
(c) loans (d) preference shares

*Ans.* (a) equity shares

(v) Which of the owned source can be used by company without much of regulations?

(a) Raising share capital
(b) Retained earnings
(c) Using ADR/GDR
(d) Both (b) and (c)

*Ans.* (b) Retained Earnings

(vi) Which of the following is a merit of retained earnings?

(a) Retained earnings are permanent source of funds for an organisation.
(b) It enhances the capacity of business to absorb unexpected losses.
(c) This source offers a greater degree of operational freedom and flexibility.
(d) All of the above

*Ans.* (d) All of the above

**3. Direction** *Read the following text and answer the question no. (i) to (vi) on the basis of the same.*

Sahil Ltd. a firm manufacturing textile, wished to diversify their business. They were considering two options, either to diversify into manufacturing toothpaste or switches. They wanted to invest in the purchase of land, to set up a manufacturing unit in the backward areas of Gujarat. The finance manager of the company was asked by the management to do financial planning by identifying most suitable source of raising long-term funds for financing the investment decisions and short-term sources for working capital decisions.

The objective was to keep the financial risks as low as possible. Therefore, the company decided to source the raw materials using a source of finance which facilitates the purchase of supplies without immediate payment. Moreover, apart from the outside funds used, the company also decided to plough back the profits. The company also decided that after a certain point of time, they will release their IPO and get benefit of the bull run of the market.

(i) Identify which of the following is not the long-term source of finance?

(a) Equity shares (b) Retained Earnings
(c) ADR (d) Public deposits

**Ans.** (d) Public deposits

(ii) Name the source of finance having least financial risk on the business.

(a) Debentures (b) Trade credit
(c) Equity shares (d) Public deposits

**Ans** (c) Equity shares

(iii) "…. facilitates the purchase of supplies without immediate payment." Identify the source of finance stated above.

(a) Commercial paper (b) Retained earnings
(c) Subsidy (d) Trade credit

**Ans.** (d) Trade credit

(iv) Which of the following long-term source of finance is also known as ploughing back of profits?

(a) Preference shares (b) Lease financing
(c) Retained earnings (d) Equity shares

**Ans.** (c) Retained earnings

(v) Which of the following factor appears to be the primary factor taken into consideration by the management?

(a) Cost (b) Degree of risk
(c) Financial strength (d) Tax benefit

**Ans.** (b) Degree of risk

(vi) Which of these sources of finance would be raised through IPO as stated in the last line of the text?

(a) Preference shares (b) Lease financing
(c) Retained earnings (d) Equity shares

Ans. (d) Equity shares

# PART 2
# Subjective Questions

## • Short Answer (SA) Type Questions

**1.** Why is finance important for business?

**Ans.** Finance is the life blood of the business. Funds are required to commence and carry on business. All business activities such as planning, organising, managing, controlling, purchasing, selling, directing, marketing, etc cannot take place without finance. Business needs funds for purchasing fixed and current assets, for day-to-day operations, purchase of raw material, to pay salaries, etc.

**2.** For the successful running of a business, it is necessary to determine the amount of working capital. Do you agree? If yes, then give reasons in support of your answer.

**Ans.** Yes, I agree with the statement. Working capital is that portion of capital which is used to conduct day-to-day operations. It is very important for a business to determine the required amount of working capital.

The reasons for estimating required working capital are

(i) Prosperity and progress of the projects can be maintained by adequate working capital.

(ii) Adequate working capital enables a firm to improve the efficiency and profitability of its operations.

(iii) It is also required to channelise the day-to-day operations. That's why it is also called circulating or revolving capital.

**3.** Komalika wants to start her own business dealing in high end crockery items. She decides to arrange for initial finance from her savings. However, her savings are not enough to fulfil all the initial needs of the business. She seeks help of her husband, who works in government sector.

He advises her that to start her business with limited finance and then use the revenues earned by the business to fulfil other financial requirements. Is the view of Komalika's husband justified? Why or why not?

**Ans.** No, I don't think that the view of Komalika's husband is justified. Adequate finance is required in the business because of following reasons

(i) **Necessary to Start Business** Every new venture needs money to buy plant and machinery or to conduct certain activities. All financial needs will not be estimated in the absence of this concept.

(ii) **Necessary for Business Cycle** No matter how well the business is doing, a good finance manager has to prepare for rainy or even for stormy season. Business and economic cycles bring dark clouds that one can't predict. That's why financial plans are created for downturns.

(iii) **Necessary for Growth** Success can bring a business to a difficult crossroads. Sometimes in order to attain more or to achieve greater success, a company needs significant financial investment to acquire new capital, staff or inventory. This can only be possible after proper arrangements of business finance.

**4.** What are the different expenditures that any firm incurs in

(i) Short-term (ii) Medium-term

(iii) Long-term

**Ans.** (i) Short-term

(a) Purchase of raw material.

(b) Payment of telephone bill, electricity bill, etc.

(ii) Medium-term

(a) Expenditure made on renovation of office.

(b) Expenditure made on the promotion of company's product.

(iii) Long-term

(a) Purchase of building

(b) Purchase of machinery

**5.** Differentiate between owner's funds and borrowed funds on the basis of

(i) Reward

(ii) Security

(iii) Order of payment

**Ans.** Difference between owner's funds and borrowed funds.

| Basis | Owner's Funds | Borrowed Funds |
|---|---|---|
| Reward | Owner's funds earn rewards in the form of share in profit, as in the form of dividend. | Borrowed funds earn rewards in the form of interest. |
| Security | These funds are raised without providing for security of assets. | These funds are raised on security of assets. |
| Order of Payment | They rank last in the order of payment. | They have priority in the order of payment. |

**6.** Sun Rise company issues 10,000 shares of ₹ 10 each for a total value of ₹ 1,00,000. With reference to the given statement, explain the meaning of the term share, share capital and shareholders.

**Ans.** **Shares** The capital of a company is divided into small units and each such unit is referred to as a 'share'. Each share forms a unit of ownership and is offered for sale to raise the capital of the company. Shares are classified as equity shares and preference shares.

**Share Capital** Total amount raised by issue of shares constitute the share capital of the company.

**Shareholders** The persons who buy shares are referred to as 'shareholders'.

In the given example, number of shares issued are 10,000, share capital is of ₹ 1,00,000 and the persons who purchase these shares are the shareholders.

**7.** Discuss the features of equity shares as a source of finance.

**Ans.** Features of equity shares are

(i) The equity shareholders are the primary risk bearers as they provide fixed capital to the business.

(ii) The equity share capital is not redeemable during the lifetime of the company.

(iii) Returns are uncertain as the rate of dividend is not fixed.

(iv) Equity shareholders can participate in the company's decisions and management.

**8.** Preference shareholders have some preferential rights in the capital structure of any company. Comment.

**Ans.** The following preferential rights are enjoyed by preference shareholders

(i) Receiving a fixed rate of dividend, out of the net profits of the company, before any dividend is declared for equity shareholders.

(ii) Preference over equity shareholders in receiving their capital after the claims of the company's creditors have been settled but before any amount is paid to equity shareholders at the time of liquidation.

**9.** Preference shares are not suitable for those investors who are willing to take risk and are interested in higher returns. This highlights one of the demerits of preference shares. State any other four demerits of preference shares.

**Ans.** Demerits of preference shares are

(i) These shares dilute the claim of equity shareholders over the assets of the company.

(ii) The company has to pay higher rates of dividends to the preference shareholders as compared to interest on debentures.

(iii) The dividend on these shares is to be paid only when the company earns profit. Thus, the returns are not assured and they are unable to attract the investors.

(iv) The dividend paid on preference shares is not deductible from profits as expense. Thus, there is no tax savings, as in the case of interest on loans.

**10.** Shares are used to raise funds by the company. However, there is a distinction in shares. There are two types of shares – preference and equity. Differentiate between equity shares and preference shares on any three basis.

**Ans.** The differences between equity shares and preference shares are (any three)

| Basis | Equity Shares | Preference Shares |
|---|---|---|
| Participation in Management | Full right to participate. | No right to participate. |
| Sequence of Dividend | Dividend is paid last of all. | Preference is given in payment of dividend. |
| Sequence of Refund of Capital | On winding up of the company, capital is refunded after preference shares. | Preference is given in refunding the capital. |
| Refund of Capital During Lifetime | Not possible at all. | Capital can be refunded in case of redeemable preference shares. |
| Permanency of Dividend | Dividend is uncertain as it fluctuates with the amount of divisible profits decision of board of directors. | Dividend is certain and fixed. |

**11.** Amar owns a small farm in which he grows flowers. He is able to earn a small amount of profit, but being of an ambitious nature, he wants to take over a neighbouring farm and increase the range of flowers he is selling.

He is of the view that he will need long-term finance for this purpose and plans to take a bank loan to pay for the take-over. He has already borrowed money to buy a new tractor.

On the basis of above case, answer the following questions.

(i) What is meant by 'long-term sources of finance'?

(ii) Identify and explain a form of internal finance Amar could have used to buy the tractor.

(iii) What factors would the bank consider before granting loan to Amar?

**Ans.** (i) Long-term sources of finance means those sources which provide finance to business firms for a period exceeding five years.

(ii) A form of internal finance which Amar could have used to buy the tractor is 'retained earnings'. These earnings are a part of trading profits which are not withdrawn by the proprietor, but are reinvested by them in the business.

(iii) The bank would consider the following factors before granting loan to Amar

(a) Amount of loan required.

(b) Period for which the loan is required.

(c) Security offered.

(d) Profit earning capacity of the business

(e) Repayment schedule of any previous loan taken.

**12.** Though retained earnings are firm's own source of funding and they are free to use them but using retained earnings can sometimes prove to be disadvantageous. Do you agree? Explain.

**Ans.** Yes, I agree that using retained earnings can sometimes prove to be disadvantageous. Following points helps in explaining the demerits of retained earnings

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

(ii) As the profits of business are fluctuating, it is an uncertain source of fund.

(iii) Firms do not recognise the opportunity cost associated with this source, leading to sub-optimal use of funds.

**13.** What is the difference between GDR and ADR? **(NCERT)**

**Ans.**

| Basis | GDR | ADR |
|---|---|---|
| Location of Financial Markets | Global Depository Receipts (GDR) can be bought and sold in many international markets. | American Depository Receipts (ADR) can be bought and sold only in America. |
| Disclosure Requirements | Issue of GDRs do not require strict disclosure requirements. | Issue of ADRs require strict disclosure requirements. |
| Liquidity | GDRs are less liquid. | ADRs are more liquid. |
| Maintenance Costs | Maintenance costs of GDRs are less than that of ADRs. | Maintenance costs of ADRs are more than that of GDRs. |

**14.** A seminar was held in New York on the problems generally classified into owners fund and borrowed funds. ABC Ltd. can raise required funds by employing both the above mentioned sources to fulfill its needs of finance.

Its topic was "The difference 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 its was also large. One of the Indian representatives throw light on the special characteristics of this source. You are required to identify the source discussed by highlighting the relevant lines.

*Ans.* (i) Indian Depository Receipts (IDR)

**Line** "One of the sources of finance ......... securities in India."

(ii) Global Depository Receipts (GDR)

**Line** "Another source .... .... European countries".

(iii) American Depository Receipts (ADR)

**Line** "In the final session ... ... only in America."

**15.** Mahindra and Mahindra was the first company in India to issue convertible zero interest debentures in January 1990. Recently, the board of Titan Industries has approved the issue of partly convertible debentures on a right's basis to raise around ₹ 126.83 crore. The issue will comprise 21 lakh partly convertible debentures of ₹ 600 each in the ratio of one partly convertible debenture for every 20 equity shares held in the company to the shareholders.
On the basis of above case, answer the following questions

(i) Explain the meaning of convertible zero interest debentures issued by Mahindra and Mahindra.

(ii) Explain the meaning of partly convertible debentures on right's basis. **(NCERT)**

*Ans.* (i) Convertible zero interest debentures are debentures which carry no interest and are convertible into equity shares at the end of a specified period.

(ii) Partly convertible debentures on right's basis means that a part of these debentures will be converted into equity shares at the end of the stipulated period and that these debentures can be subscribed by only existing equity shareholders of the company.

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

*Ans.* Following are the advantages of issuing debentures instead of equity shares

(i) Debentures are fixed charge funds and do not participate in the profits of the company.

(ii) Financing through debentures does not dilute control of shareholders on management as debentures do not carry voting rights.

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

**17.** State the demerits of public deposits.

*Ans.* Demerits of public deposits are

(i) New companies generally find it difficult to raise funds through public deposits due to lack of goodwill.

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

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

**18.** The company getting finance through public deposits enjoys some benefits. Explain.

*Ans.* Following points illustrate the benefits of public deposits to the company

(i) The procedure of obtaining deposits is simple and does not contain restrictive conditions.

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

(iii) Public deposits do not usually create any charge on the assets of the company.

(iv) As the depositors do not have voting rights, the control of the company is not diluted.

**19.** Along with financial assistance, financial institutions also provide technical assistance and managerial services to business units. This reflects one of the merits of obtaining finance through financial institutions. Write any three more such merits.

*Ans.* Merits of obtaining finance from financial institutions are as follows

(i) Financial institutions provide long-term finance, which is not provided by the commercial banks.

(ii) A financial institution, before extending financial support to a business unit, conducts detailed study about its state of affairs. Only a promising and sound business is able to get a loan from these institutions. So, if a firm gets a loan from these institutes, then this will also help in raising the goodwill of the borrowing company in the capital market.

(iii) Repayment can be made in easy instalments therefore; it does not prove to be a burden on the business.

**20.** State the disadvantages of financial institutions as a source of finance.

*Ans.* Disadvantages of financial institutions as a source of finance are as follows

(i) Too many formalities are required by these institutes to grant a loan.

(ii) Restrictions are imposed by these institutes on companies such as restrictions on the payment of dividends or restrictions on the autonomy of management.

(iii) Generally, the financial institutions have their nominees in the Board of Directors of the borrowed company. This restricts their powers and the borrowed companies feel helpless in certain cases.

**21.** Mr. Anil Singh has been running a restaurant for the last two years. The excellent quality of food has made the restaurant popular in no time. Motivated by the success of his business, Mr. Singh is now contemplating the idea of opening a chain of similar restaurants at different places.

However, the money available with him from his personal sources is not sufficient to meet the expansion requirements of his business.

His father told him that he can enter into a partnership with the owner of another restaurant, who will bring in more funds, but it would also require sharing of profits and control of business.

He is also thinking of taking a bank loan. As a financial consultant, state the various sources of owned funds and debt funds that Anil Singh can use. **(NCERT)**

***Ans.*** The various sources of owned funds that Anil Singh can use are

(i) Selling a part of his business to other partners.
(ii) Issuing equity shares and preference shares (if he decides to form a joint stock company).

The various sources of debt funds are (any two)

(i) Loan from commercial banks.
(ii) Loan from specialised financial institutions.
(iii) Issue of debentures (if he decides to form a joint stock company).

## • Long Answer (LA) Type Questions

**1.** State any three merits and three limitations of equity shares.

***Ans.*** Merits of equity shares are (Any three)

(i) Equity shares are suitable for those investors who are willing to assume risk for higher returns.
(ii) Payment of dividend to the equity shareholders is not compulsory. Therefore, there is no burden on the company.
(iii) It is considered as a good source of long-term finance. A company is not required to pay back the equity capital during its lifetime. It is repaid only at the time of liquidation of company. Also, since it is paid in last, even on liquidation, therefore it provides a cushion for creditors. Thus, it is a permanent source of capital.
(iv) Funds can be raised through equity shares without creating any charge on the assets of the company. These assets can be mortgaged to raise finance from other sources.

Demerits of equity shares are as follows (Any three)

(i) Investors who want steady income may not prefer equity shares due to fluctuating returns.
(ii) The cost of equity shares is more as compared to other sources of funds.
(iii) Every successive issue of equity shares dilutes the voting power and earnings of existing equity shareholders.
(iv) Many formalities and procedural delays are involved while raising funds through equity.

**2.** Rohit Ltd. is a manufacturing firm which has been running in deep losses due to the onset of pandemic. The company wants to innovate the products to increase the sales and have therefore decided to purchase a new machinery for the same. The company decided to use its funds which it has saved over the years to fund this machinery. Which source of finance is highlighted here? Define. Also, give the merits of the same.

***Ans.*** The source of finance highlighted here is 'retained earnings'. It means that part of trading profits which are not distributed in the form of dividends, but retained by directors for future expansion of the company. This is also referred to as 'ploughing back of profits'.

Merits of retained earnings are

(i) Retained earnings are a permanent source of funds for an organisation.
(ii) Retained earnings do not involve any explicit cost in the form of interest, dividend or floatation cost.
(iii) This source offers a greater degree of operational freedom and flexibility.
(iv) It enhances the capacity of business to absorb unexpected losses.

**3.** 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. However, there are both merits and demerits of debentures. Explain those merits and demerits.

***Ans.*** Merits of debentures are (any three)

(i) It is preferred by investors who want fixed income at lesser risk.
(ii) Debentures are fixed charge funds and do not participate in profits of the company.
(iii) The issue of debentures is suitable in the situation when the sales and earnings are relatively stable.
(iv) Financing through debentures does not dilute control of equity shareholders on management.
(v) Financing through debentures is less costly as compared to cost of preference or equity capital.

Limitations of debentures are

(i) As fixed charge instruments, debentures put a permanent burden on the earnings of a company.
(ii) In case of redeemable debentures, the company has to make provisions for repayment on the specified date.
(iii) With the issue of debentures, the capacity of a company to further borrow funds reduces.

**4.** Differentiate between shares and debentures on the basis of

(i) Nature of finance (ii) Nature and rate of return

(iii) Status of holders (iv) Degree of control

(v) Security offered (vi) Level of risk

*Ans.* The differences between shares and debentures are

| Basis | Shares | Debentures |
|---|---|---|
| Nature of Finance | Shares are a part of owner's fund. | Debentures are a part of debt fund. |
| Nature and Rate of Return | Dividend is the return on shares. The rate of dividend is not fixed and is dependent on the profits of the company and the decision of the management. | Interest is the return on debentures. The rate of interest is fixed and is required to be paid even if the company incurs losses. |
| Status of Holders | Shareholders are deemed to be the owners of the company. | Debenture holders are deemed to be the creditors of the company. |
| Degree of Control | Shareholders can exercise reasonable degree of control on the affairs of the business by exercising their right to vote. | Debenture holders are in no position to control the affairs of the business as they do not have the right to vote. |
| Security Offered | No security is required to be offered at the time of issue of shares. | Security is required to be offered, either by creating a charge on assets or by mortgaging the assets, at the time of issue of debentures. |
| Level of Risk | Shareholders assume a high level of risk. | Risk is comparatively lower for debenture holders. |

**5.** Write a short note on the following three financial institutions

(i) Industrial Finance Corporation of India (IFCI)

(ii) State Financial Corporations (SFCs)

(iii) Life Insurance Corporation of India (LIC)

*Ans.* (i) **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.

(ii) **State Financial Corporations** (SFCs) They are established by the state governments under the State Financial Corporations Act, 1951 for providing medium and short-term finance to industries which are outside the scope of the IFCI. Its scope is wider than IFCI as it covers not only public limited companies, but also private limited companies, partnership firms and proprietary concerns.

(iii) **Life Insurance Corporation of India** (LIC) It was set up in 1956 under the LIC Act, 1956 after nationalising 245 existing insurance companies. It mobilises savings in the form of insurance premium and makes it available to industrial concerns in the form of direct loans and underwriting and subscribing to shares and debentures.

**6.** Commercial banks accept deposits from general public and extend loans to those who are in need. This also includes companies who are in need of capital for multiple business purposes. Getting finance from commercial banks has some merits and some limitations, explain.

*Ans.* Merits of loan from commercial banks are

(i) Banks provide timely assistance to business by providing funds as and when needed by it.

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

(iii) Formalities such as issue of prospectus and underwriting are not required for raising loans from a bank.

(iv) Loan from a bank is a flexible source of finance as the loan amount can be increased according to business needs

Limitations of loan from commercial banks are

(i) Funds are generally available for short periods.

(ii) Banks make detailed investigation of the company's affairs, financial structure etc., and may also ask for security of assets and personal sureties.

(iii) In some cases, difficult terms and conditions are imposed by banks for the grant of loan.

**7.** Sujeet is a proprietor of a stationery trading firm. The business of the firm is flourishing over last 18 months. Sujeet decided to expand the product line and include basic confectionery items as well. He negotiated deals with multiple suppliers and stroked contracts in such a way that he facilitated the purchase of supplies without immediate payments.

Which source of finance is highlighted here? Also, explain the concept of the same and write three merits and demerits each.

*Ans.* The source of finance highlighted here is 'trade credit'. Trade credit facilitates the purchase of supplies without immediate payment.

Such credit appears in the records of the buyer as sundry creditors or accounts payable. It is commonly used by business organisation as a source of short-term financing. It is granted to those customers who have reasonable amount of financial standing and goodwill.

Merits of trade credit are

(i) Trade credit is a convenient and continuous source of funds.

(ii) It may be readily available in case the credit worthiness of the customers is known to the seller.

(iii) It helps to promote the sale of an organisation.

Demerits of trade credit are

(i) This may motivate a firm to overtrade.

(ii) Only limited amount of funds can be raised through this source.

(iii) It is generally a costly source of fund as compared to others, as sellers charge more for goods sold on credit.

**8.** X-cellent company is well established domestically. It manufactures educative toys for children. The company has recently analysed the prospects of going global and founds them to be very promising. Now, it wants to choose suitable funds to finance the proposition.

State some of the factors which should be considered by X-cellent company, before making a choice for source of funds.

*Ans.* Following points should be considered to make a choice for source of funds

(i) **Cost** Two types of costs are there viz. the cost of procurement and the cost of utilising the funds. These two costs should be considered very carefully before making a choice.

(ii) **Financial Strength** The financial strength of an enterprise is also a key determinant in making the choice of funds. If the firm is financially strong with a steady flow of income, then it can raise finance by issuing debt instruments. Otherwise, owner's funds would be the logical choice.

(iii) **Form of Organisation** The form of organisation also influences the decision of a finance manager while deciding about the source of finance.

As we are aware that there are various forms of business organisations such as sole proprietorship, partnership, joint stock company, etc. A joint stock company can raise funds from various sources, but on the other side a sole proprietor has access to limited sources to raise funds.

(iv) **Control** It is also an important factor to be considered while raising finance. If the existing owners do not want to dilute their control on the business, then they should opt for debt funds, otherwise they can raise finance from owner's funds.

(v) **Degree of Risk** The risk associated with each of the source is different. Thus, a finance manager must evaluate the degree of risk involved in each source to make an appropriate choice.

(vi) **Tax Benefit** To avail tax benefits, companies consider every possible source very minutely. They should remember that interest paid on debt funds would be admissible as business expense and will generate tax benefits, but dividend paid will not give any such benefit to the firm.

# Chapter Test

## Multiple Choice Questions

**1.** Which of the following can be the negative implications of non-payment of debts?
(a) Higher interest costs
(b) Loss of goodwill
(c) Fines and penalties
(d) All of these

**2.** The return earned by ............. is known as interest.
(a) equity shareholders
(b) preference shareholders
(c) debenture holders
(d) Both (b) and (c)

**3.** Equity shareholders are also called ......... of company.
(a) borrowers
(b) partners
(c) owners
(d) Both (b) and (c)

**4.** **Statement I** Public deposits are not issued against security of assets of the company.
**Statement II** FCCBs are issued in foreign currency.
**Alternatives**
(a) Statement I is correct and statement II is wrong
(b) Statement II is correct and Statement I is wrong
(c) Both the statements are correct
(d) Both the statements are incorrect

**5.** **Statement I** Public deposits are issued in foreign currency.
**Statement II** Debentures create charge on assets of the company.
**Alternatives**
(a) Statement I is correct and statement II is wrong
(b) Statement II is correct and Statement I is wrong
(c) Both the statements are correct
(d) Both the statements are incorrect

## Short Answer (SA) Type Questions

**1.** What do you mean by fixed capital? What type of organisation need more fixed capital?

**2.** Mridul is an ambitious man. He wants to participate in the affairs of the company. What will he choose amongst the two— preference share or equity share? Also, give reason for the same.

**3.** Devika is considering taking loan from a commercial bank for her business. Advise her on the same by highlighting the cons of borrowing from commercial bank.

**4.** "Umya manufacturers" is a firm manufacturing cricket balls in India. The company had been fairly successful in last many years. The owners of the firm decided to raise finance from public and launched its IPO. The company received positive feedback from the market and used the IPO proceedings to expand its manufacturing to pink cricket balls as well. The company earned lot of profits in the following year. Instead of distributing entire profits to the owners in the form of dividend, some profits were re-invested in business in order to finance the future earnings of the business.
(i) Identify the source of finance discussed in the last part of the passage.
(ii) Highlight the demerits of the given method.

**5.** Name and explain any four reasons as to why businesses require finance.

## Long Answer (LA) Type Questions

**1.** Burman Ltd. is a medicines trading firm. The family owning the business has got some ancestral land vacant in the recent times. The company decides to make use of this land and expand its product line. Consequently, it started to trade the medical equipments as well. The company needed to purchase raw materials, payment of electricity bill, rent, etc.
(i) Identify and define the type of business finance needed by the company. Also, what type of source of finance is required for the same?
(ii) On what factors, these requirements are dependent upon?

**2.** Differentiate between owner's fund and borrower's fund on the basis of
(i) Meaning (ii) Nature (iii) Risk (iv) Control
(v) Nature of obligation (vi) Rate of return

## Answers

**Multiple Choice Questions**

*1. (d) 2. (c) 3. (c) 4. (c) 5. (b)*