Class XI BUSINESS STUDIES

CHAPTER -8 Sources of Business Finance

IMPORTANT QUESTIONS

MULTIPLE CHOICE QUESTIONS (1 MARKS)

Question 1

What do you mean by ploughing back of profits?

Answer

A portion of the net earnings may be retained in the business for use in the future is known as retained earnings. It is a source of internal financing or selffinancing or 'ploughing back of profits

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Question 2

Differ between ADR & GDR.

Answer

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

Question 3

State the difference between lessor and lessee with the help of an example

Answer

The owner of the assets is called the 'lessor' while the party that uses the assets is known as the 'lessee'. For example: Amul Diary Ltd purchased machinery from Jindal and Co. on hire purchase basis for which he paid lease rentals of Rs 200000. Here Amul Diary Ltd is lessee and Jindal and Co. is Lesor

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Question 4

What type of share capital is also called ''Risk Capital"

Answer

Equity share capital is also called as Risk Capital

Question 5

Name the return given to debenture holders for using their funds?

Answer

Fixed rate of Interest is given to debenture holders for using their funds.

Question 6

Name the one unique feature of ''Retained Earnings'' which is not available in any other source of finance?

Answer

It is a source of self-financing and does not involve any explicit cost. A portion of the net earnings may be retained in the business for use in the future is known as retained earnings

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Question 7

What is the similarity between ADR and Public Deposits?

Answer

In both ADR and Public deposit, Depositor do not have voting rights, the control of the company is not diluted.

Question 8

Which term is concerned with the acquisition and conservation of capital funds in meeting the financial needs of a business enterprise

Answer

Retained earnnings is concerned with acquisition and conservation of capital funds in meeting the financial needs

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Question 9

Name the organization which have been set up by the central as well as State governments to provide medium term and long term loans to business sector

Answer

Developmental Banks provides medium term and long term loans to business sector

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Question 10

Write any one similarity between Equity share capital and Preference share capital.

Answer

They are part of owner's fund

Question 11

Write the names of 2 Indian companies that offer Factoring services.

Answer

Two names of Indian Companies offering factoring services are SBI Factors and Commercial Services Ltd., Canbank Factors Ltd.,

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VERY SHORT AND SHORT ANSWER QUESTIONS (2 OR 3 MARKS)

Question 1

What prefential rights are enjoyed by preference shareholders?

Answer

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

1. receiving a fixed rate of dividend, out of the net profits of the company, before any dividend is declared for equity shareholders;

2. receiving their capital after the claims of the company's creditors have been settled, at the time of liquidation

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Question 2

What factors influence the working capital need in a business? write any three

Answer

1. **Cost:**
   There are two types of cost viz., the cost of procurement of funds and cost of utilising the funds. Both these costs should be taken into account while deciding about the source of funds.

2. **Financial strength and stability of operations:**
   In the choice of source of funds business should be in a sound financial position so as to be able to repay the principal amount and interest on the borrowed amount. When the earnings of the organisation are not stable, fixed charged funds should be carefully selected as these add to the financial burden

3. **Form of organisation and legal status:**
   A partnership firm, for example, cannot raise money by issue of equity shares as these can be issued only by a joint stock company

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Question 3

Define Share and write any two advantages of it.

Answer

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. They are referred to as 'residual owners'. They enjoy the reward as well as bear the risk of ownership. Their liability is limited to capital contributed. They have right to participate in the management

Advantages:

- Equity capital serves as permanent capital as it is to be repaid only at the time of liquidation of a company
- Equity capital provides credit worthiness to the company and confidence to prospective loan providers

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Question 4

Write any two differences between share and debentures.

Answer

1. Shares are referred to as owner's fund whereas Debentures are borrowed fund

2. Shares carry return on the investments whereas in case of debentures a fixed rate of interest is paid by the company

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Question 5

Write any three limitations of equity share capital.

Answer

- Investors who want steady income may not prefer equity shares as equity shares get fluctuating returns
- The cost of equity shares is generally more as compared to the cost of raising funds through other sources
- Issue of additional equity shares dilutes the voting power, and earnings of existing equity shareholders

Question 6

Write any three advantages of Retained Earnings

Answer

- It does not involve any explicit cost in the form of interest, dividend or floatation cost
- It has greater degree of operational freedom and flexibility
- It enhances the capacity of the business to absorb unexpected losses

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LONG ANSWER QUESTIONS (5 OR 6 MARKS)

Question 1

Explain trade credit and Factoring as a source of finance for a business enterprise.

Answer

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. It is short-term financing source. It is granted to those customers who have reasonable amount of financial standing and goodwill. 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

Advantages

- It is a convenient and continuous source of funds
- It is readily available in case the credit worthiness of the customers is known to the seller
- It helps in promoting the sales of an organisation
- It does not create any charge on the assets of the firm while providing funds.

Disadvantages

- It may induce a firm to indulge in overtrading, which may add to the risks of the firm
- Only limited amount of funds can be generated through it
- It is a costly source of funds as compared to most other sources

Factoring: Factoring is a financial service under which the 'factor' renders various services which includes: Discounting of bills (with or without recourse) and collection of the client's debts. Under this, the receivables on account of sale of goods or services are sold to the factor at a certain discount. There are two methods of factoring—recourse and non-recourse. Under recourse factoring, the client is not protected against the risk of bad debts. On the other hand, the factor assumes the entire credit risk under non-recourse factoring Providing information about credit worthiness of prospective client's etc., Factors hold large amounts of information about the trading histories of the firms

Advantages

- Cheaper than financing through other means such as bank credit
- Factoring as a source of funds is flexible and ensures a definite pattern of cash inflows from credit sales. It provides security for a debt
- It does not create any charge on the assets of the firm
- The client can concentrate on other functional areas of business as the responsibility of credit control is shouldered by the factor

Disadvantages

- This source is expensive when the invoices are numerous and smaller in amount
- The advance finance provided by the factor firm is generally available at a higher interest cost
- The factor is a third party to the customer who may not feel comfortable while dealing with it

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Question 2

Discuss the various international sources from where the funds can be generated.

Answer

There are various avenues for organisations to raise funds internationally. Various international sources from where funds may be generated include

- **Commercial Banks:**
  Commercial banks all over the world extend foreign currency loans for business purposes. The types of loans and services provided by banks vary from country to country.
- **International Agencies and Development Banks:**
  A number of international agencies and development banks have emerged over the years to finance international trade and business. These bodies provide long and medium-term loans and grants to promote the development of economically backward areas in the world.
- **International Capital Markets:**
  - **Global Depository Receipts (GDR's):**
    The local currency shares of a company are delivered to the depository bank. The depository bank issues depository receipts against these shares. Such depository receipts denominated in US dollars are known as Global Depository Receipts (GDR). The holders of GDRs do not carry any voting rights but only dividends and capital appreciation.
  - **American Depository Receipts (ADRs):**
    The depository receipts issued by a company in the USA are known as American Depository Receipts. 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.
  - **Indian Depository Receipt (IDRs):**

An Indian Depository Receipt is a financial instrument denominated in Indian Rupees in the form of a Depository Receipt. It is created by an Indian Depository to enable a foreign company to raise funds from the Indian securities market. 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.

- **Foreign Currency Convertible Bonds (FCCBs):**
  Foreign currency convertible bonds are equity linked debt securities that are to be converted into equity or depository receipts after a specific period. Thus, a holder of FCCB has the option of either converting them into equity shares at a predetermined price or exchange rate, or retaining the bonds. They carry a fixed interest rate which is lower than the rate of any other similar nonconvertible debt instrument. FCCB's are listed and traded in foreign stock exchanges

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Question 3

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

Answer

The government has established a number of financial institutions all over the country to provide finance to business organisations. They provide both owned capital and loan capital for long and medium term requirements and supplement the traditional financial agencies like commercial banks These are also called 'development banks

Merits are listed as below:

- Financial institutions provide longterm finance, which are not provided by commercial banks
- Many of these institutions provide financial, managerial and technical advice and consultancy to business firms
- Obtaining loan from financial institutions increases the goodwill of the borrowing company in the capital market
- As repayment of loan can be made in easy instalments, it does not prove to be much of a burden on the business
- The funds are made available even during periods of depression, when other sources of finance are not available

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Question 4

What do you mean by owners fund? When it is not suitable?

Answer

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. Issue of equity shares and retained earnings are the two important sources from where owner's funds can be obtained.

When it is not suitable depends on the following factors:

1. **Cost:**
   There are two types of cost viz., the cost of procurement of funds and cost of utilising the funds. Both these costs should be taken into account while deciding about the source of funds.

2. **Financial strength and stability of operations:**
   In the choice of source of funds business should be in a sound financial position so as to be able to repay the principal amount and interest on the borrowed amount. When the earnings of the organisation are not stable, fixed charged funds should be carefully selected as these add to the financial burden

3. **Form of organisation and legal status:**
   A partnership firm, for example, cannot raise money by issue of equity shares as these can be issued only by a joint stock company

4. **Purpose and time period:**
   Business should plan according to the time period for which the funds are required. A short-term need for example can be met through borrowing funds at low rate of interest through trade credit, commercial paper, etc. For long term finance, sources such as issue of shares and debentures are more appropriate. Similarly, the purpose for which funds are required need to be considered so that the source is matched with the use

5. **Risk profile:**
   Business should evaluate each of the source of finance in terms of the risk involved For example, there is a least risk in equity as the share capital has to be repaid only at the time of winding up A loan on the other hand, has a repayment schedule for both the principal and the interest which is to be paid irrespective of the firm earning a profit or incurring a loss.

6. **Control:**
   Issue of equity shares may mean dilution of the control. Thus, business firm should choose a source keeping in mind the extent to which they are willing to share their control over business.

7. **Effect on credit worthiness:**
   Issue of secured debentures may affect the interest of unsecured creditors of the company and may adversely affect their willingness to extend further loans as credit to the company.

8. **Flexibility and ease:**
   Restrictive provisions, detailed investigation and documentation may be the reason that a business organisations may not prefer it, if other options are readily available.

9. **Tax benefits:**

   Non taxable instrument will be preferred over tax deductible. For example, while the dividend on preference shares is not tax deductible interest paid on debentures and loan is tax deductible and may, therefore, be preferred by organisations seeking tax advantage

So, it is not suitable in case of partnership form of organization, short term need , business wants to take challenge risk, no dilution of control etc.

Question 5

Write main advantages and disadvantages of Public Deposits.

Answer

Advantages

- The procedure of obtaining deposits is simple and does not contain restrictive conditions as are generally there in a loan agreement
- Cost of public deposits is generally lower than the cost of borrowings
- Public deposits do not usually create any charge on the assets of the company
- As the depositors do not have voting rights, the control of the company is not diluted

Disadvantages

- New companies generally find it difficult to raise funds through public deposits;
- It is an unreliable source of finance as the public may not respond when the company needs money;
- Collection of public deposits may prove difficult, particularly when the size of deposits required is large

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Question 6

Comment on the following sources of International finance

(i) I.D.R.

(ii) F.C.C.B

Answer

(i) IDR: **Indian Depository Receipt (IDRs):**

An Indian Depository Receipt is a financial instrument denominated in Indian Rupees in the form of a Depository Receipt. It is created by an Indian Depository to enable a foreign company to raise funds from the Indian securities market. 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.

(ii)FCCB: **Foreign Currency Convertible Bonds (FCCBs):**

Foreign currency convertible bonds are equity linked debt securities that are to be converted into equity or depository receipts after a specific period. Thus, a holder of FCCB has the option of either converting them into equity shares at a predetermined price or exchange rate, or retaining the bonds. They carry a fixed interest rate which is lower than the rate of any other similar nonconvertible debt instrument. FCCB's are listed and traded in foreign stock exchanges

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Question 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 Rs. 1000 crores.

(a) what is the status of capital structure of the above company.

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

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

Answer

(a) The capital structure of the compny is sound as it is having more of equity share capital than long term debt in its capital structure and huge amount of cash reserve

(b) I think Retained earnings i.e. the self financing method should be used in establishing new unit. A portion of the net earnings may be retained in the business for use in the future is known as retained earnings. It is a source of internal financing or selffinancing or 'ploughing back of profits. Reason for supporting Retained earnings are as follows:

- It is a permanent source of funds
- It does not involve any explicit cost in the form of interest, dividend or floatation cost
- It has greater degree of operational freedom and flexibility as there is no dilution of control
- It enhances the capacity of the business to absorb unexpected losses by optimum utilization of resources
- It may lead to increase in the market price of the equity shares of a company

(c)Company exhibit the following value:

- Balanced Regional Development: The company is willing to expand and establish new unit in the backward region and contributes in regional development

- Women Enpowerment: The company wants to train the tribal women in skill Development to empower them

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Question 8

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

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

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

[Hints- ADR and Public Deposits, Employment Generation, Concern for environment]

Answer

(a)The company can meet its requirement through ADR and Public Deposits.

- Public Deposits: The deposits that are raised by organisations directly from the public are known as public deposits. 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. It is Regulated by RBI. Companies generally invite public deposits for a period upto three years
- ADR: The local currency shares of a company are delivered to the depository bank. The depository bank issues depository receipts against these shares. The depository receipts issued by a company in the USA are known as American Depository Receipts. The holders of ADRs do not carry any voting rights

(b) The company exhibits the following values:

- Social Responsibility towards the environment: The company is generating 50% of its office electricity through solar power. Hereby conserving resources.

- Generation of Employment: The company is following the practice of educating and giving employment to under privileged youth and thereby generating employment opportunities for youth

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