Gujarat Board Textbook Solutions Class 11 Organization of Commerce and Management Chapter 8 Sources of Business Finance

1. Select the correct alternative and write answers to the following questions :

Question 1. out of the following which is not a source of ownership capital?
(A) Ordinary equity share
(B) Sweat equity share
(C) Preferences share
(D) Debenture
Answer:
(D) Debenture

Question 2. Who are called the true owners of company?
(A) Equity share holder
(B) Preference share holder
(C) Debenture holder
(D) Bond holder
Answer:
(A) Equity share holder

Question 3. Which shares are offered to the managers at a discounted price or instead of cash?
(A) Ordinary equity share
(B) Sweat equity share
(C) Bonus share
(D) Rights share
Answer:
(B) Sweat equity share

Question 4. Who has the first right to receive dividend from profit of company?
(A) Preference share-holders
(B) Debentures holders
(C) Equity share-holders
(D) Creditors
Answer:
(A) Preference share-holders

Question 5. At time of liquidation who gets capital first?
(A) Preference share-holders
(B) Ordinary equity share-holders
(C) Promoters
(D) Debentures holders

Answer:
(D) Debentures holders

Question 6. The capital invested in the assets of capital is known as which capital?
(A) Working capital
(B) Short time capital
(C) Current capital
(D) Fixed capital
Answer:
(D) Fixed capital

Question 7. What are the debenture holders of the company called?
(A) Owners
(B) Debtors
(C) Creditors
(D) Promoters
Answer:
(C) Creditors

Question 8. _______ Is the internal source to satisfy the long term finance requirements for business unit.
(A) Ordinary Equity shares
(B) Preference share
(C) Public deposits
(D) Ploughing back of profits
Answer:
(D) Ploughing back of profits

Question 9. Which companies can plough back the profits?
(A) New establishing company
(B) Running company
(C) Financially sound company
(D) Loss making company
Answer:
(C) Financially sound company

Question 10. How does the government get finance to implement long term project?
(A) By ordinary share
(B) By bond
(C) By debentures
(D) By public deposits
Answer:
(B) By bond

Question 11. The proper source of getting short term working capital is
(A) Preference share
(B) Bond
(C) Financial institution
(D) Trade credit
Answer:
(D) Trade credit

2. Answer the following questions in one sentence each :

Question 1. Which shareholders are the true owners of business?
Answer:
Equity share holders.

Question 2. Who has the first right to receive dividend from company's profit?
Answer:
Preference share holders.

Question 3. State the sources of borrowed capital.
Answer:
Borrowed capital can be raised majorly through

- Debentures
- Bonds
- Public deposits
- Loans from financial institutions
- Commercial banks
- Trade credit and
- Internal deposits.

Question 4. What is a convertible debenture?
Answer:
If a company has announced that after specific time debentures will be converted fully or partly into equity shares then such debentures are known as convertible debentures.

Question 5. Explain the following terms :
(1) IFCI
(2) IDBI
(3) ICICI
(4) GSFC
(5) GIIC
Answer:
The full forms for the abbreviations are as follows:

(1) IFCI (Industrial Finance Corporation of India)
(2) IDBI (Industrial Development Bank of India)
(3) ICICI (Industrial Credit and Investment Corporation of India)
(4) GSFC (Gujarat Slate Finance Corporation)
(5) GIIC (Gujarat Industrial Investment Corporation)

Question 6. State the main lending polices of commercial banks.
Answer:
Banks thoroughly analyses the financial requirement of a business, its ability to repay, income tax returns, old and current accounts, profit, etc. If the bank gets satisfied it can lend money in the form of loans, cash credit and overdraft.

3. Answer the following questions in short :

Question 1. Give meaning of capital from the view of commerce.
Answer:
Business finance:

- The word 'capital' has a limited scope when one talks in terms of accountancy. As per principle of accountancy, money invested, goods and assets when clubbed together is called capital.
- Commerce has a broader meaning for capital. As per commerce, capital includes owner's invested money and money borrowed from different financial sources. Thus, capital means 'funds raised to satisfy the various financial requirements of the business.

Question 2. What is called sweat equity share?
Answer:
Equity shares issued by a company to its directors or employees at a discounted price or for consideration other than cash for their specialized knowledge and skills that they provide to the company are known as sweat equity shares.

Question 3. Why preference shares are called the share of preference?
Answer:
The shares that get the first preference to obtain dividend and during liquidation the first right to get the capital back are called preference shares. Since these shares get the first preference to obtain dividend and claim the capital they are called preference shares.

Question 4. State types of preference share.
Answer:

- Preference shares redeemable before 20 years and
- Preference shares redeemable after 20 years.

Question 5. Why ordinary equity share is called risky share?
Answer:

- The buyers of equity shares take a lot of risk on their heads by buying the shares.
- They know that the price of shares may go down in the market. They also know that they may or may not get dividends and also that the amount of dividends will never be fixed.
- In case of liquidation when company pays off all its debts and then if it has some money left only then it will give the capital back to equity share-holders.
- Owing to several risks that equity share-holders take and still remain stuck to the company as investors they are known as true owners of the company.

Question 6. What is the main difference between bond and public deposits?
Answer:

Question 7. What is a floating charge?
Answer:
Floating charge:

- Floating charge is used by a company to borrow capital against debentures. It is a charge on the assets of the company. The charge keeps on floating as per the property which is to be covered.
- A specific characteristic of the floating charge is that the company can continue to use the assets even when the assets are mortgaged for debentures.

4. Answer the following questions in brief :

Question 1. Explain advantages and limitations of ordinary equity share.
Answer:
Advantages of ordinary shares:

- Share-holders/investors buying these shares are considered the true owners of the company.
- Share-holders can earn good dividends.
- Share-holders have right to attend general meetings and right to vote and elect directors.
- Prices of these shares fluctuate frequently and so one can make good money by trading them in the share market.
- Share-holders may also get bonus shares from the company.

Disadvantages of ordinary shares:

- Owners of ordinary shares are under high risk of price fluctuations of share in the market.

- In case of liquidation of the company they are the last to receive their capital invested in the shares.
- They may not get or may get very less dividend.
- Though they have voting rights but small investors may not be able to put their words in company's management due to domination of directors and big investors. Share-holders may become victims of speculation.

Question 2. Distinguish between equity share capital a preference share capital.
Answer:

Points of difference	Equity share capital	Preference share capital
Compulsion	A company needs to compulsorily issue these shares	A company may or may not issue these shares.
Rate of divided	Rate of dividend varies	Rate of dividend is fix
Rights	Equity share holders have the right to attend meetings and to vote and elect directors	Generally, preference share-holders do not have voting rights except matters related to their interests
Risk	Risk is more	Risk is less
Investors interest	Investors interested in taking high risk and speculation prefer equity shares	Investors interested in fixed income and safety of capital prefer preference shares.
Market price	Market price of these shares increase and decrease	Market price generally remains steady
Addition of capital	Capital can be raised by rights shares and bonus shares	Capital cannot be raised

Question 3. Explain the lending policy of commerical bank.
Answer:
Banks thoroughly analyses the financial requirement of a business, its ability to repay, income tax returns, old and current accounts, profit, etc. If the bank gets satisfied it can lend money in the form of loans, cash credit and overdraft.

Question 4. Distinguish between ownership capital a burrowed capital.
Answer:

Points of difference	Ownership capital	Borrowed capital
Meaning	A fund invested by shareholder is called owner's funds.	Funds borrowed from sources other than owner's fund are called borrowed funds.
Source	Can be obtained through equity and preference shares, retained earnings, depreciation fund and reserves.	Can be obtained through debentures, commercial banks, financial institutions, etc.
Mode of returning	As dividends	As interest at a fix rate.
Rate of return	Rate of return is not fixed	Rate of return is fixed
Repayment of capital	Owner's fund is repaid at the end i.e. after all the debts are paid.	Borrowed funds are debts and so they are to be returned before owner's funds.

Question 5. Write short notes on.
(A) Bond
Answer:

- Bonds are issued just like debentures to obtain capital.
- Bonds are borrowed capital and hence the debt of the company. The bond holders are creditors of the company. Bond holders get interest at specific rate and time. At the end of pre-fixed duration the company returns the borrdwpd capital to the bond holders.
- Generally, bonds are costlier than debenture. They are a good source of finance for long-term large-sized projects.
- Bonds can be issued by companies, municipality or even government and are called corporate bonds, municipal bonds and government bonds respectively.
- Bonds are known by the project for which they are issued. For example, bonds issued by government for Sardar Sarovar project were known as Sardar Sarovar Bond.

(B) Trade credit
Answer:

- When a businessman buys raw material, finished goods, etc. from procedures or traders and pays after a pre-decided time he is said to have obtained trade credit.
- The businessman is said to have purchased on credit from other businessmen for some time. This helps the purchasing businessman save his working capital and use it elsewhere.
- The businessman than pays the money after a decided time. Here, the creditor does not give the money directly but gives goods on credit and satisfies the short-term capital need.

(C) Inter-corporate deposits.
Answer:

- When a company having surplus funds deposits a part or whole of it in another company it is called inter-corporate deposit.
- Usually these kinds of transactions take place between major and minor companies. Such transactions may also take place between various companies owned by one group. For example, Tata group owns Tata Teleservices and Timex watches. In need Tata Teleservices may provide inter-corporate deposit to Timex.
- The rate of interest and duration of deposit is decided by an agreement. Compared to borrowing from other sources this form of borrowing is an easier option.

Question 6. "Public Deposit is known as Fair Weather friends'-Explain statement.
Answer:

- Fair weather friend is a friend who is friendly or available only when it is advantageous to him.
- People invest money as public deposit in the companies when they get assured returns.
- Interest of these depositors is purely to earn by lending money to the company When the company is under financial crisis and if such news or rumors gets spread in the market then depositors rush to company to withdraw their money even before the maturity date. This creates financial problems for the company and so public deposits are considered fair weather friends.

Question 7. "Ploughing back of profit is not possible for every company'-Explain statement.
Answer:

- A company retains profits in the good times of business.
- A company can only retain profits if it does not have liability more than its assets. For a new company, a small company or a financially weak company making profits and

maintaining its position against strong and established companies itself is a challenge.

- Moreover, such companies also need to invest more in modernization, expansion and innovation of their business so that they can have a strong foot in market.
- They also need to provide dividends to maintain the faith of investors and encourage them investing in their company. Hence, retaining profits is not possible for every company.

5. Answer the following questions in detail :

Question 1. Explain the factors deciding the need of capital.

Answer:

Need of business finance:

A businessman needs capital to conduct all the business activities effectively and on time.

Following points clarify the need of business finance:

1. For establishing business:

- Several activities need to be done and documents to be prepared and submitted for starting a business.
  Expenses are incurred on conducting primary and detailed research, preparing documents like certificate of registration and incorporation, etc.
- The businessman also needs to hire experts of legal procedures, registration procedures, etc. Businessman need to pay fees and charges at several stages of the establishment and also pay fees to these industry experts.

2. For purchasing fixed assets:

- Assets such as land, building, furniture, machinery, etc. which are purchased for long-term business use and are not likely to be converted quickly into cash are called fixed assets.
- One may need huge long term finance in terms of loans to buy these assets.

3. For current assets:

- Once a business is set up it requires working capital i.e. capital to manage daily expenses. These expenses include salaries and wages, various utility bills, purchasing raw material, production and transportation charges, etc.
- Working capital can be either raised by oneself or even borrowed as loan from banks or other sources.

4. For modernization and expansion of business:

Scientific inventions and technology upgradations take place constantly across the world. This leads to faster production of newer products and quality enhancement. A businessman needs to keep pace with these changes so that he can maintain and expand his business. For this, he may have to invest in modern equipment and machineries and production methods.

5. For unforseen situations:
A business may witness many unforseen internal and external factors which may lead to financial crisis. For example, strikes, changes in government policies, changes in trade cycle, natural calamities, etc. are unforseen events that demands capital reserve.

Question 2. Define share and explain the charactristics of equity share.
Answer:
Equity shares:
An equity share, commonly known as ordinary share represents the fractional or part ownership of the person i.e. share-holder in the company. Equity shares have ' the right to obtain dividend (i.e. earn income) as per company's laws and right to claim repayment of share value after the company has made all its payments. After paying all the business expenses, taxes, etc. the company may earn profit. The equity share-holders have a right to claim a share in this profit. The company based on its policy may distribute a part of residual income in the form of dividends to the share-holders. The equity share-holders have a right to claim this dividend.

A company can invite people to buy its shares. The share-holders become part owners and the company gets its capital.

Characteristics of equity shares:
1. True owners:
Owners of equity shares i.e. equity share-holders are considered as true owners of the company or faithful companions because they take much higher risk on their head by investing in equity shares as compared to preference share-holders.

2. Kight to vote:
Equity share holders have right to vote for electing directors of the company. One share is equal to one vote. Thus, higher the number of shares held, higher the votes one can cast.

3. Dividend:
Whether to distribute the dividend or not and how much to distribute depends upon the company.

4. Dividend is based on profit:

- The dividend a share-holder gets depends on the profit a company makes.
- A company earning higher profit may distribute higher dividend and that making lesser profit or loss may distribute lesser dividend or may not distribute at all.

5. General meeting:
Share-holders have the right to attend general meetings and also have right to vote and elect the directors.

6. Repayment of capital:
Share capital is not repaid to the share-holders as long as the company exists. If the company winds up it returns the share capital after paying off all its business debts.

7. Dissolution (Liquidation):
At the time of liquidation the company first pays off capital of preference share¬holders and all other business debts and then if it has money, it pays to equity share-holders.

8. Share qualification:
If there is a provision in the memorandum and directors have given consent that if a particular person holds a specific number of shares decided by the company then he can become the director of the company then the shares are considered as share qualification.

9. Capital benefits:
Share-holders get various capital benefits by owning the shares. They earn dividend, company may also give them bonus shares, they earn by selling the shares whose prices have increased, etc.

10. Registration of shares:
Equity shares are registered in recognized share markets or say stock exchange. Investors can buy/sell the shares in these markets freely.

Question 3. Give the meaning of preference share and explain its characteristics.
Answer:
Preference shares:
The shares that get the first preference to obtain dividend and during liquidation the first right to get the capital back are called preference shares.
Types:
(A) Preference shares redeemable before 20 years
(B) Preference shares redeemable after 20 years

Characteristics of preference shares:
1. Dividend:
Preference share-holders possess the right to obtain dividend that too at a fixed rate irrespective of the volume of profit.

2. Right to vote:
Generally, preference share-holders do not have voting rights except for matters related to their interests.

3. Preference:
Investors prefer to buy these shares because they get a fixed income and security for their capital.

4. Market price:
The price of these shares generally remains steady i.e. it neither increase nor decrease. Their prices may change only when the rate of interest changes in the market.

5. Proportion of risk:
The risk is quite less in preference shares because holders of these shares are first paid their capital back during liquidation of company.

6. Repayment of capital:
In case the company is wound up and its assets are sold, the money that comes n this sale is first given to the preference share-holders.

Question 4. Give the meaning of debenture and explain its types.
Answer:
Debentures:

- A debenture is a certificate issued by a company to public in order to obtain public money as loan.
- The way a company invites public to buy shares it can ask public to buy debentures.
- The basic difference between a share and a debenture is that a share-holder becomes the part owner of the company whereas a debenture holder becomes creditor of the company from whom the company has taken the money as loan.
- Debentures are issued when company is in need of additional capital but does not want to issue shares. The total capital needed is divided into small parts i.e. debentures and then public is invited to subscribe for them.
- Debenture is a liability to the company. Buyers of debentures become creditors of the company. The company needs to pay them interest at pre-decided rates and period. At the end of the pre-decided time frame the company as per conditions returns the entire money to the debenture holders or convert the money equal to the share value and gives shares to the debenture holders.
- Issuing debentures is a good medium-term as well as long-term nnance option for the company.
- When a company issues debentures it appoints trustees who work for protecting the interests of debenture holders as per the Trust Deed.

Characteristics:
1. Creditors of company:
Since the amount of debenture is considered as loan debenture is a debt of the company and the debenture holders are the creditors of the company.

2. Fixed rate of interest:
Debenture holders are paid interest at fixed-rate at a pre-decided time.

3. Fixed burden and charge on asset:
A Company mortgages assets as security to obtain capital through debentures. -» The company needs to pay interest on debentures to the debenture holders. This interest is considered as a 'fixed charge on the assets' or say on the profits. This means that the company has to pay this charge even if it makes no profit. Moreover, company cannot raise loan on such assets unless it fully pays up capital borrowed from debentures. However, it can use the assets.

4. Satisfy need:
Debenture is a useful tool to satisfy the needs of medium term and long-term finance.

5. Registration at stock-exchange:
If the debentures are listed at stock-exchange, one can trade them just like shares.

6. Repayment:
At the end of the duration, the company returns the debenture money to debenture holders either all at once or in installments as per the pre-decided conditions.

7. First preference for payment:
Since debentures are debt of the company the debenture holders get the preference to receive the money before the share-holders at the time of dissolution of the company.

Types of debentures:
1. Secured debentures:
Debentures that are secured against company's assets are called secured debentures. This means that at the time of dissolution if the company does not . have sufficient funds to repay the debentures than it will sell the mortgaged assets to repay. These assets carry floating charge when mortgaged.

2. Convertible debentures:

- If a company has announced that after a specific time debentures will be converted fully or partly into equity shares then such debentures are known as convertible debentures.
- If the company has made a provision of converting debentures in its Memorandum of Association then the company would give equity shares against the debentures in a pre-decide ratio.

3. Non-convertible debentures:
Debentures that are not converted into shares and whose money is returned to the

debenture holders as per specific conditions and time frame are called non-convertible debentures.

Question 5. What is the ploughing back of profit? Explain its advantages and limitations.
Answer:
Retained profits OR PloughIng back of profits:

- In good times of business a company makes quite good profit. In such times instead of distributing the entire profit as divtdend company saves Le. retains some part of profit for future business needs.
- The company may use such reserved profit or say retained earnings for expansion, investing in new products, etc. This re-invested money in the business is known as ploughing back of profit.

Advantages of retained profit:
1. Useful in times of recession :
Retained (saved) profit can be very useful in times of recession, changed market trends, etc.

2. Useful ¡n Implementing future plans

- The saved earnings can be used to successfully rnplement future plans of expanding business, modernizing equipment and infrastructure, raising capital for buying assets, additional raw material, etc.
- By wisely retaining the profits the company will not have to depend on external sources for raising capital for these activities.

3. Useful for purchasing new assets:
The retained earnings can be used to replace old or worn out assets like machinery, furniture, etc. with new and modern assets.

4. Fixed dividend policy:
By retaining profits a company can prepare a stable policy to distribute dividends. This will keep the share-holders happy and motivated to re-invest in the company.

5. Burden on assets:
If the businessman borrows money from financial institutions like banks it has to mortgage its assets. If the business can retain its earnings it can keep its assets free of burden of mortgage.

6. Borrowed capital can be repaid:
Retained earnings can be used to repay capital borrowed from banks or other financial institutions.

7. Decrease in cost of capital:

- When money is borrowed from banks or other financial institutions one needs to pay interest on it. The interest paid can be termed as the 'cost of capital'.
- If the company has sufficient retained earnings it can use it as capital and thus save itself from additional cost of capital

8. Owner's funds:
Earnings retained are infact owner's fund and so the businessman can plough them back in the business and save himself from borrowing capital from outside and paying interest.

Limitation of retained earnings:
1. Encourages monopoly:
When a company retains its profit too much it becomes economically quite strong. If can then dominate the market by over stocking very large amount of raw material, forcing vendors and suppliers to follow company's policies, ask them to create artificial scarcity etc. and hence create monopoly.

2. Promotes speculation:

- At times the directors of the company may distribute very less dividends and put the excess profits in company's reserve.
- This would led people believe that company is not doing well and so price of company's share would decrease.
- The directors would then buy lots of shares in low prices and later announce high dividends.
- Higher dividends would again lure investors and they will start buying the shares. At that time the directors would sell their shares and make huge personal profits out of difference they get in the share trading.

3. Difficult for financially weak and new companies:

- Retaining earnings is not possible or possible at a very small scale for financially weak and new companies.
- No benefit to small investors:
- Small investors invest in company's shares with an aim of earning high dividends. When directors retain more earnings than necessary or speculates, small investors cannot earn dividends or earn very less dividends and hence they are in loss.

Question 6. What is public deposits? Explain advantages and limitations of public deposit.
Answer:
Public deposits:
When a company accepts deposits of about 6 months to 36 months from public to satisfy its short-term financial need such as working capital, the amount it receives is called public deposits.

The deposit is borrowed capital and so a debt of the company. The investors who invest their money as public deposits are called creditors of the company. The company pays them a specific interest quarterly half yearly or on maturity i.e. at the end of duration along with the principle amount as per decided terms. According to the provisions of companies Act, 2013 private companies excluding ' banking companies and non-banking finance companies cannot accept deposit from public.

Advantages of public deposits:

- Easy to obtain: It is quite easy for a well-established and profit making company to obtain finance.
- Less expensive finance option: Compared to other sources of finance, a company can easily obtain public deposits that too quickly and) with lesser expenses.
- Assets do not have a charge i.e. no need to mortgage assets: A company need not mortgage its assets to obtain public deposits. Hence, it can mortgage the assets to obtain finance from other sources in future.
- Interest is an expense: A company needs to pay interest on the public deposits. The interest paid is considered as an expenses and it is to be subtracted from profit while preparing accounts for income tax. Thus, a company needs to pay lesser income tax.
- Useful as working capital: A company can satisfy its short-term need of working capital through public deposits.

Limitations:

- Uncertainly: It is quite uncertain to obtain public deposits. The investors may not be interested in investing due to their personal preferences, behaviour, lack of spare money etc.
- Insecurity to investors: Company does not give under-writing like in case of shares and debentures and so investor consider it as risk and feels insecured. Hence, public deposits are also called unsecured debts.
- Fair weather friends: When the company is under financial crisis and if such news or rumors gets spread in the market then, depositors rush to company to withdraw their money even before the maturity date. This creates financial problems for the company and so public deposits are considered fair-weather friends.
- Difficult for new and weak companies: Investors do not have much faith in new and financially weak companies. Hence, they do not wish to risk their capital in such companies. So, such companies face difficulties in raising public deposits.

Question 7. Explain the functions of financial institutions.
Answer:
Functions of financial institutions:
1. Provide finance by buying shares:

- When the company is in the phase of incorporation, modernization or expansion it associates with financial institutions and asks them to buy its shares.
- This helps the companies to obtain necessary capital from these institutions. Companies may also ask such institutions to become their underwriter i.e. guarantors.

2. Provide finance by loan:
A company can mortgage its assets to take loan from these institutions. To further satisfy its financial needs companies can even mortgage personal properties and avail loan.

3. Help through direct payment for technological services:
At times a company may have to spend heavily in raising technological infrastructure or obtaining technological services. For example, developing and maintaining intranet of the company. Under such situations the financial institutions makes payment on behalf of the companies to the companies providing technology services.

4. Provide guarantee:
A financial institution may agree to become a guarantor of the company i.e. the institution will be liable to pay the company's debts in case the company is unable to pay. This helps the company in gaining faith of investors and other financial institutions for obtaining finance.

5. Other services:
Financial institutions offer help in establishing a company, conducting market research, providing information about foreign markets, etc.