Unit 7

Sources of Business Finance

REVISED CBSE SYLLABUS

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

BUSINESS QUOTE

Finance is the lifeblood of business.

Business Finance: Meaning, Nature and Importance

Business Finance – Meaning and Nature

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

Finance is called the life blood of any business

Nature/Features of Business Finance

1. A business cannot function unless adequate funds are made available to it. For carrying out various activities, business requires money.

2. The initial capital contributed by the entrepreneur is not always sufficient to take care of all financial requirements of the business. A business person, therefore, has to look for different other sources from where the need for funds can be met.
3. A clear assessment of the financial needs and the identification of various sources of finance, therefore, is a significant aspect of running a business organisation.
4. The need for funds arises from the stage when an entrepreneur makes a decision to start a business. Some funds are needed immediately say for the purchase of plant and machinery, furniture, and other fixed assets. Similarly, some funds are required for day – to – day operations, say to purchase raw

materials, pay salaries to employees, etc. Also when the business expands, it needs funds.

Note

Nature of Business Finance

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

Importance/Significance of Business Finance

Finance is needed for the following reasons:

1. Fixed capital requirements

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

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

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

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

2. Working Capital requirements

The financial requirements of an enterprise do not end with the procurement of fixed assets. A business needs funds for its day-to-day operations. This is known as working capital of an enterprise, which is used for holding current assets such as stock of material, bills receivables and for meeting current expenses like salaries, wages, taxes, and rent.

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

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

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

7.2

Classification of Sources of Funds on the Basis of Ownership

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

Differences between Owners' Funds and Borrowed Funds

Basis	Owners' Funds	Borrowed Funds
1. Meaning	Owner’s funds means funds that are provided by the owners of an enterprise, which may be a sole trader or partners or shareholders of a company. Apart from capital, it also includes profits reinvested in the business.	Borrowed funds refer to the funds raised through loans or borrowings.
2. Sources	• Equity shares • Preference shares • Retained earnings • GDR • ADR • IDR	• Debentures and Bonds • Loan from Financial Institutions • Loan from Commercial Banks • Public Deposits

		• Trade Credit • Inter Corporate Deposits (ICD)
3. Time Period	The owner's capital remains invested in the business for a longer duration and is not required to be refunded during the life period of the business.	Such sources provide funds for a specified period, on certain terms and conditions and have to be repaid after the expiry of that period.
4. Return	Return on Owner's funds (e.g. equity and preference shares) is called dividend, which is a part of profit after tax distributed among the shareholders. Dividend is payable only when there are profits available to the company.	A fixed rate of interest is paid by the borrowers on such funds. At times it puts a lot of burden on the business as payment of interest is to be made even when the earnings are low or when loss is incurred.
5. Security	It does not require any security.	Generally, borrowed funds are provided on the security of some fixed assets.
6. Control	Such capital forms the basis on which owners acquire their right of control of management.	It does not carry any right of control of management.

7.3

Various Sources of Owners' Funds – Concept

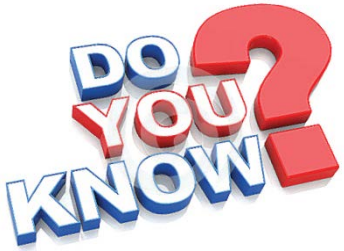
1. Equity Shares

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

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

- Equity share capital is a pre-requisite to the creation of a company.
- Equity shareholders do not get a fixed dividend but are paid on the basis of earnings by the company.
- They are referred to as 'residual owners' since they receive what is left after all other claims on the company's income and assets have been settled.

- They enjoy the reward as well as bear the risk of ownership.
- Their liability, is limited to the extent of capital contributed by them in the company.
- Through their right to vote, equity shareholders have a right to participate in the management of the company.



- The capital obtained by issue of shares is known as share capital.
- The capital of a company is divided into small units called shares.
- Each share has its nominal value/face value/par value. For example, if a company issues 1,00,000 shares of ₹10 each, then ₹10 is the face value/ nominal value/par value of each share.
- The person holding the share is known as shareholder.

- There are two types of shares normally issued by a company. These are equity shares and preference shares.
- The money raised by issue of equity shares is called equity share capital, while the money raised by issue of preference shares is called preference share capital.

Features/Merits

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

2. Preference Shares

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

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

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

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

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

Top Tips

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

Features/Merits

1. Preference shares provide reasonably steady income in the form of fixed rate of return. Thus, preference shares are useful for those investors who want fixed rate of return.

2. It does not affect the control of equity shareholders over the management as preference shareholders don't have voting rights.
3. Payment of fixed rate of dividend to preference shares may enable a company to declare higher rates of dividend for the equity shareholders in good times.
4. Preference shareholders have a preferential right of repayment over equity shareholders in the event of liquidation of a company.
5. Preference capital does not create any sort of charge against the assets of a company.

Extra Shots

Different types of preference shares

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

3. Retained Earnings

A company generally does not distribute all its earnings amongst the shareholders as dividends. A portion of the net earnings may be retained in the business for use in the future. This is known as retained earnings.

It is a source of internal financing or self-financing or 'ploughing back of profits'.

The profit available for ploughing back in an organisation depends on many factors like net profits, dividend policy and age of the organisation.

Features/Merits

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

Top Tip

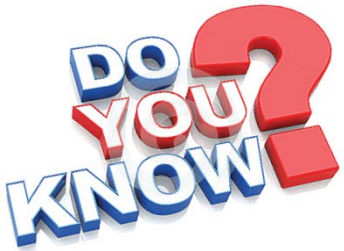
Excessive ploughing back may cause dissatisfaction amongst the shareholders as they would get lower dividends.

4. Global Depository Receipts (GDRs)

The local currency shares of a company are delivered to the depository bank. The depository bank issues depository receipts against these shares. Such depository receipts denominated in US dollars are known as Global Depository Receipts (GDR).

- GDR is a negotiable instrument and can be traded freely like any other security.
- In the Indian context, a GDR is an instrument issued abroad by an Indian company to raise funds in some foreign currency and is listed and traded on a foreign stock exchange.

- A holder of GDR can at any time convert it into the number of shares it represents.
- The holders of GDRs do not carry any voting rights but only dividends and capital appreciation.



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

5. American Depository Receipts (ADRs)

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

Note

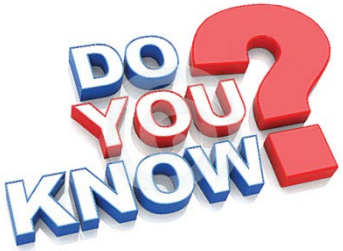
Features of ADRs - • US dollar denominated • Listed on any American stock exchanges • No right to vote in the company • Right to get dividend

6. Indian Depository Receipts (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.
- The IDR is a specific Indian version of the similar global depository receipts.
- The foreign company issuing IDR deposits shares to an Indian Depository *(custodian of securities registered with the Securities and Exchange Board of India)*. In turn, the depository issues receipts to investors in India against these shares.

- The benefits of the underlying shares (like bonus, dividends, etc.) accrue to the IDR holders in India.
- According to SEBI guidelines, IDRs are issued to Indian residents in the same way as domestic shares are issued. The issuer company makes a public offer in India, and residents can bid in exactly the same format and method as they bid for Indian shares.



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

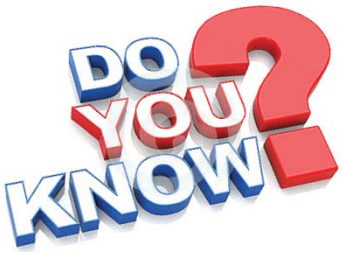
7.4

Various Sources of Borrowed Funds – Concept

1. Debentures and Bonds

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

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



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

Features/Merits

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

Bonds are also debt instrument that does not carry a specific rate of interest, but issued at a heavy discount. The difference between nominal valve and issue price is

treated as the amount of interest related to the duration of bonds.

Extra Shots

Types of Debentures

- **Secured and Unsecured:** Secured debentures are such which create a charge on the assets of the company, thereby mortgaging the assets of the company. Unsecured debentures on the other hand do not carry any charge or security on the assets of the company.
- **Registered and Bearer:** Registered debentures are those which are duly recorded in the register of debenture holders maintained by the company. These can be transferred only through a regular instrument of transfer. In contrast, the debentures which are transferable by mere delivery are called bearer debentures.do not enjoy such rights

- **Convertible and Non-Convertible:** Convertible debentures are those debentures that can be converted into equity shares after the expiry of a specified period. On the other hand, non-convertible debentures are those which cannot be converted into equity shares.
- **First and Second:** Debentures that are repaid before other debentures are repaid are known as first debentures. The second debentures are those which are paid after the first debentures have been paid back.

2. Loan From Financial Institutions

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

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

Note

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

Features/Merits

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

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

Extra Shots

Special Financial Institutions

- **Industrial Finance Corporation of India (IFCI):** It was established in July 1948 as a statutory corporation under the Industrial Finance Corporation Act, 1948. Its objectives include assistance towards balanced regional development and encouraging new entrepreneurs to enter into the priority sectors of the economy. IFCI has also contributed to the development of management education in the country.

- **State Financial Corporations (SFC):** The State Financial Corporations Act, 1951 empowered the State Governments to establish State Financial Corporations in their respective regions for providing medium and short term finance to industries which are outside the scope of the IFCI. Its scope is wider than IFCI, since the former covers not only public limited companies but also private limited companies, partnership firms and proprietary concerns.
- **Industrial Credit and Investment Corporation of India (ICICI):** This was established in 1955 as a public limited company under the Companies Act. ICICI assists the creation, expansion and modernisation of industrial enterprises exclusively in the private sector. The corporation has also encouraged the participation of foreign capital in the country.
- **Industrial Development Bank of India (IDBI):** It was established in 1964 under the Industrial Development Bank of India Act, 1964 with an objective to coordinate the activities of other financial institutions including commercial banks. The bank performs three types of functions, namely, assistance to other financial institutions, direct assistance to industrial concerns, and promotion and coordination of financial-technical services.

- **Life Insurance Corporation of India (LIC):** LIC was set up in 1956 under the LIC Act, 1956 after nationalising 245 existing insurance companies. It mobilises the community's savings in the form of insurance premia and makes it available to industrial concerns, both public as well as private, in the form of direct loans and underwriting of and subscription to shares and debentures.

3. Loan from Commercial Banks

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

- Banks extend loans to firms of all sizes and in many ways:

  (i) Cash credits (ii) Bank overdrafts

  (iii) Term loans

  (iv) Purchase/discounting of bills

  (v) Issue of letter of credit

- The rate of interest charged by banks depends on various factors such as the characteristics of the firm and the level of interest rates in the economy.

- The loan is repaid either in lump sum or in installments.
- Bank credit is not a permanent source of funds. Though banks have started extending loans for longer periods, generally such loans are used for medium to short periods.
- The borrower is required to provide some security or create a charge on the assets of the firm before a loan is sanctioned by a commercial bank.

Features/Merits

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

4. Trade Credit

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

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

- The volume and period of credit extended depends on factors such as reputation of the purchasing firm, financial position of the seller, volume of purchases, past record of payment and degree of competition in the market.

Features/Merits

1. Trade credit is a convenient and continuous source of funds.
2. Trade credit may be readily available in case the credit worthiness of the customers is known to the seller.
3. Trade credit needs to promote the sales of an organisation.

4. If an organisation wants to increase its inventory level in order to meet expected rise in the sales volume in the near future, it may use trade credit to, finance the same.
5. It does not create any charge on the assets of the firm while providing funds.

Note

Terms of trade credit may vary from one industry to another and from one person to another. A firm may also offer different credit terms to different customers.

5. Public Deposits

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

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

- Public deposits can take care of both medium and short-term financial requirements of a business.
- Public deposits are beneficial to both the depositor as well as to the organisation. While the depositors get higher interest rate than that offered by banks, the cost of deposits to the company is less than the cost of borrowings from banks.

Features/Merits

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

RECAP

Concept, Nature and Importance of Business Finance

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

Finance is needed for the following reasons:

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

Classification of Sources of Funds on the basis of Ownership

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

Sources of Owners' Funds

1. **Equity shares:** The money raised by issue of equity shares is known as 'equity share capital'. It represents owner's funds.
2. **Preference shares:** The money raised by issue of preference shares is called 'preference share capital'.
3. **Retained Earnings:** The portion of company's net profits after tax and preference dividend which is not distributed

as equity dividend, but are retained for reinvestment purposes is called 'retained earnings'.

4. **Global Depository Receipts (GDRs):** GDR is an instrument issued abroad by an Indian company to raise funds in some foreign currency.
5. **American Depository Receipts (ADRs):** The depository receipts issued by a company in the USA are known as ADRs.
6. **Indian Depository Receipts (IDRs):** An IDR is an instrument denominated in Indian Rupees in the form of a depository receipt created by an Indian Depository against the underlying equity of issuing company to enable foreign company to raise funds from the Indian securities market.

Sources of Borrowed Funds

1. **Debentures and Bonds:** Debentures are an important

debt instrument for raising long-term finance. They carry a fixed rate of interest. Bonds are also debt instrument that does not carry a specific rate of interest, but issued at a discount.

2. **Loan from Financial Institutions:** Examples: Industrial Finance Corporation of India (IFCI), Industrial Credit and Investment Corporation of India (ICICI), etc.
3. **Trade Credit:** Trade credit is the credit extended by one trade to another for the purchase of goods and services. Trade credit is commonly used by business organisations as a source of short-term financing. Trade credit appears in the records of the buyer of goods as 'sundry creditors' or 'accounts payable'.
4. **Loan from Commercial Banks:** Commercial banks extend loans to firms of all sizes and in many ways: Cash credits, Bank overdrafts, Term loans, Purchase/ discounting of bills and Issue of letter of credit.

5. **Public Deposits:** The deposits that are raised by organisations directly from the public are known as public deposits. Companies generally invite public deposits for a period up to three years. Rates of interest offered on public deposits are usually higher than that offered on bank deposits.

Key Terms

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

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

Working Capital – A business needs funds for its day – to - day operations. This is known as working capital of an enterprise, which is used for holding current assets such as stock of material,

bills receivables and for meeting current expenses like salaries, wages, taxes, and rent.

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

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

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

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

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

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

shares.

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

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

Retained Earnings – A company generally does not distribute all its earnings amongst the shareholders as dividends. A portion of the net earnings may be retained in the business for use in the future. This is known as retained earnings.

Global Depository Receipts (GDRs) – The local currency shares of a company are delivered to the depository bank. The depository bank issues depository receipts against these shares. Such depository receipts denominated in US dollars are known as Global Depository Receipts (GDR).

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

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

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

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

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

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

Objective Type Questions

Question 1

Equity shareholders are called

(Choose the correct alternative)

(a) Owners of the company

(b) Partners of the company

(c) Executives of the company

(d) Guardian of the company

Answer 1

(a) Owners of the company

Question 2

The term ‘redeemable’ is used for

(Choose the correct alternative)

(a) Preference shares

(b) Commercial paper

(c) Equity shares

(d) Public deposits

Answer 2

(a) Preference shares

Question 3

Funds required for purchasing current assets is an example of

(Choose the correct alternative)

(a) Fixed capital requirement

(b) Ploughing back of profits

(c) Working capital requirement

(d) Lease financing

Answer 3

(c) Working capital requirement

Question 4

ADRs are issued in

(Choose the correct alternative)

(a) Canada

(b) China

(c) India

(d) USA

Answer 4

(d) USA

Question 5

Debentures represent

(Choose the correct alternative)

(a) Fixed capital of the company

(b) Permanent capital of the company

(c) Fluctuating capital of the company

(d) Loan capital of the company

Answer 5

(d) Loan capital of the company

Question 6

_____ are debt instrument that does not carry a specific rate of interest, but issued at a heavy discount.

(Choose the correct alternative)

(a) Debentures

(b) Equity shares

(c) Bonds

(d) None of these

Answer 6

(c) Bonds

Question 7

_____ is commonly used by business organisations as a source of short-term financing.

(Choose the correct alternative)

(a) Lease financing

(b) ADRs

(c) Trade Credit

(d) None of these

Answer 7

(c) Trade Credit

Question 8

Match the columns:

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

Answer 8

(i) - (a), (ii) - (c), (iii) - (b)

Question 9

Finance invested in fixed assets is called working capital.

True/False? Give reason.

Answer 9

False: It is called fixed capital.

Question 10

Working capital is raised through short-term funds.

True/False? Give reason.

Answer 10

True: Working capital is required to meet day-to-day expenses. So, it is raised through short-term sources like trade credit, factoring, banks, commercial paper, etc.

Question 11

Preference shares carry preferential rights over the equity shares as regards payment of dividend and repayment of capital.

True/False? Give reason.

Answer 11

True: They get dividend before equity dividend is paid. On the winding up of the company, their capital is refunded first.

Question 12

A debenture is an acknowledgment of debt.

True/False? Give reason.

Answer 12

True: Debentures are a part of borrowed funds of a company. Debentures are an important debt instrument for raising long-term finance.

Question 13

Debentureholders are entitled to a fixed rate of interest.

True/False? Give reason.

Answer 13

True: Debentures carry a fixed rate of interest. Interest on debentures is a change against the profits of a company. It has to be paid even if the company suffers losses.

Question 14

Name the capital invested in permanent assets.

Answer 14

Fixed capital

Question 15

Name the funds needed for day-to-day operations of business.

Answer 15

Working capital

Question 16

Which concern—a trading concern or a manufacturing concern—will have large amount of fixed capital? Why?

Answer 16

Manufacturing concern, because it has to invest in plant and machinery.

Question 17

Neha Ltd. sells goods on credit while Pankhuri Ltd. sells goods on cash basis. Which company will require more working capital?

Answer 17

Neha Ltd

Question 18

Why is equity share capital called risk capital?

Answer 18

Because equity shareholders bear the risk of loss of the business. Moreover, they do not get dividend in the years of losses.

Question 19

Why are equity shareholders referred to as ‘residual owners’?

Answer 19

Equity shareholders do not get a fixed dividend, but are paid only when tax to the government, interest on loans and debentures and preference dividend have been paid. So, they are referred to as ‘residual owners’.

Question 20

Why is equity share capital called the permanent capital?

Answer 20

Because it is to be paid only at the time of liquidation of a company.

Question 21

Why are debentures known as borrowed funds?

Answer 21

Because debentures are an important debt-instrument for raising long-term finance. They carry a fixed rate of interest.

Question 22

Name the source of finance which is available in the normal course of purchase of goods.

Answer 22

Trade credit

Question 23

Why share capital is known as owned funds?

Answer 23

Shareholders are the real owners of the company.

Question 24

Why are retained profits called self-financing?

Answer 24

Because the business firm itself generates them.

Question 25

Name any two Indian companies which have raised money through issue of GDRs.

Answer 25

(i) Infosys (ii) Reliance

Question 26

A company wants to issue such shares which do not have the right of preference for payment of dividend and refund of capital at the time of liquidation.

Identify such shares.

Answer 26

Equity Shares

Question 27

A foreign company 'Zylo Ltd.' wants to collect money from the capital market of India. The finance manager of the company, Mr. Robert wants to issue a financial instrument which instead of being in dollars shall be denominated in rupees. One of the characteristics of this financial instrument is that it can be got listed in any Indian stock exchange.

Identify the financial instrument.

Answer 27

Indian Depository Receipts (IDR)

Question 28

Pranav Udyog Ltd. is a company manufacturing electric devices. The company's financial manager, Mr. Dhruv, in order to fulfill the long-term financial need, wants to raise the cheapest source of finance.

Identify the source of finance.

Answer 28

Debentures

Question 29

An Indian company ‘Vandana Ltd.‘, in order to cater to its financial needs, wants to issue such an international financial instrument which can be issued only to the American residents.

Identify the financial instrument.

Answer 29

American Depository Receipts (ADR)

Question 30

Fashion Hut, a reputed garments manufacturing unit needs to meet its day-to-day expenses like wages, rent, maintaining stock of raw material, etc. The owner approaches the supplier of the raw materials to give credit for two months, so that he can get cloth for making garments without making immediate payment. The supplier made an enquiry regarding the business organisation and found that its reputation was very good. So it extended two months credit to it.

Identify the source of finance discussed above.

Answer 30

Trade Credit

Question 31

C Ltd. is planning to modernise its plant with latest technology. The company is not having sufficient money. The finance manager plans to arrange money for 3 years since after that the company is expecting a good return on investment. The finance manager does not want to spend on floatation costs on issue of shares or debentures.

Identify the suitable source of finance for the company.

Answer 31

Public Deposits