CHAPTER - 8
SOURCES OF BUSINESS FINANCE

I. Multiple Choice Questions

Tick (✓) the correct answer out of the given alternatives:

Question 1. Equity shareholders are called:
(a) Owners of the company (b) Partners of the company
(c) Executives of the company (d) Guardian of the company

Question 2.The term 'redeemable' is used for
(a) Preference shares (b) Commercial paper
(c) Equity shares (d) Public deposits

Question 3. Funds required for purchasing current assets is an example of
(a) Fixed capital requirement (b) Ploughing back of profits
(c) Working capital requirement (d) Lease financing

Question 4. ADRs are issued in
(a) Canada (b) China
(c) India (d) USA

Question 5. Public deposits are the deposits that are raised directly from
(a) The public (b) The directors
(c) The auditors (d) The owners

Question 6. Under the lease agreement, the lessee gets the right to
(a) Share profits earned by the lessor
(b) Participate in the management of the organization
(c) Use the asset for a specified period
(d) Sell the assets

Question 7. Debentures represent
(a) Fixed capital of the company (b) Permanent capital of the company
(c) Fluctuating capital of the company (d) Loan capital of the company

Question 8. Under the factoring arrangement, the factor
(a) Produces and distributes the goods or services

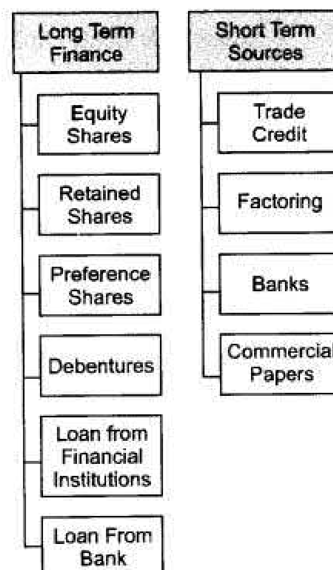
(b) Makes the payment on behalf of the client
(c) Collects the client's debt or account receivables
(d) Transfer the goods from one place to another
Question 9. The maturity period of a commercial paper usually ranges from
(a) 20 to 40 days (b) 60 to 90 days
(c) 120 to 365 days (d) 90 to 364 days
Question 10. Internal sources of capital are those that are
(a) Generated through outsiders such as suppliers
(b) Generated through loans from commercial banks
(c) Generated through issue of shares
(d) Generated within the business
Answers:
1. (a) 2. (a) 3. (c) 4.(d) 5.(a)
6. (c) 7. (d) 8. (c) 9. (d) 10. (d)

II. Short Answer Type Questions

Question 1. What is business finance? Why do businesses need funds? Explain.
Answer: Business is concerned with production and distribution of goods and services for the satisfaction of need of society. A business cannot function unless adequate funds are made available to it. The need of fund arises from the stage when an entrepreneur makes a decision to start a business. Some funds are needed immediately. The financial need of a business can be categorized in the following ways:

- **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 fixures. This is known as fixed capital requirement of an enterprise.
- **Working Capital Requirements:** The financial requirements of an enterprise do not end with the procurement of fixed assets. No matter how small or large business, it need funds for its day-to-day operations. This is known as working capital of an enterprise which is used for holding current assets like stock, bill receivable, current expenses etc. Therefore, a business needs funds to meet its fixed as well as working capital requirements.

Question 2. List sources of raising long-term and short term finance.
Answer: Sources of raising long term and short term finance are shown in the chart given below:



Question 3. What is the difference between internal and external sources of raising funds? Explain.
Answer: The differences between interned and external sources of raising funds are summarized in the table given as follows:

Basis	Internal Sources	External Sources
Meaning	Internal sources of capital are those sources that are generated within the business.	External sources of raising funds are those which are outside the business.
Example	Ploughing back of profits, equity shares	Financial institutions, loans from banks, preference shares, debentures, public deposits, lease financing, commercial papers, trade credit, factoring
Reliability	It is more reliable.	It is less reliable.

Question 4. What preferential rights are enjoyed by preference shareholders? Explain.
Answer: Following preferential rights are enjoyed by the preference shareholders:

- They get dividend at a fixed rate and dividend is given on these shares before any dividend on equity shares.
- When company winds up, preference shares are paid before equity shares.
- Preference shares also have a right to participate in excess profits left after payment being made to equity shares.
- They also have a right to participate in the premium at the time of redemption. In lieu of these preferential rights, their voting rights are taken i.e. they are not eligible for voting.

Question 5. Name any three special financial institutions and state their objectives.
Answer: Given below are three financial institutions along with their objectives:

1. **Industrial Credit and Investment Corporation of India (ICICI):** It came into existence in 1955 as a public limited company under the Companies Act, 1956. **Objective:** ICICI assists the expansion and modernisation of industrial enterprises exclusively in the private sector. The corporation has also encouraged the participation of foreign capital in the country.
2. **Industrial Development Bank of India (IDBI):** It came into existence in 1964 under the Industrial Development Bank of India Act, 1964.
   Objective: Its objective was to coordinate the activities of other financial institutions including commercial banks. The bank performed three types of functions namely, assistance to other financial institutions, direct assistance to industrial concerns and promotion and coordination of financial technique service.
3. **Life Insurance Corporation of India (LIC)**: It came into existence in 1956 under the LIC Act 1956 after nationalising 245 existing insurance companies.
   Objective: It mobilises the community saving in the form of insurance premia and makes it available to industrial concerns. Both public as well as private, in the form of direct loan and underwriting of an subscription to shares and debentures.

Question 6. What is the difference between GDR and ADR? Explain.
Answer: Global Depository Receipts (GDRs): GDR is an instrument issued by a company to raise funds in some foreign currency and is listed and traded on a foreign stock exchange. American Depository Receipts (ADRs): The depository receipts issued by the company in the USA are called American Depository Receipts.
GDR and ADR are similar to each other except:

- GDR can be issued to anyone but ADRs can be issued only to an American citizen.
- GDR can be listed and traded in stock exchange of any country but ADRs can be listed and traded only in the stock exchange of USA.

III. Long Answer Type Questions

Question 1. Explain trade credit and bank credit as sources of short term finance for business enterprises.

Answer: Trade Credit: Trade credit is the credit extended by the trader to another to purchase goods and services. It facilitates the purchase of supplies without immediate payment. In books of accounts they are shown as "creditors' or 'ills payable'.

Merits of Trade Credit

- It is a convenient and continuous source of finance.
- It is readily available.
- It helps in promoting sales of an organization.
- If an organization wants to expand its inventory level so as to meet expected rise in demand, it may use trade credit.
- It does not demand any security.

Demerits of Trade Credit

- When easy and flexible trade credit is available, it may induce the firm to indulge in over trading.
- Trade credit can meet only limited financial needs. Funds required for inventory can be met through it but not others like plant and machinery, land and building or salaries of employees etc.

Bank Credit: Borrowings from banks are an important source of finance to companies. Bank lending is still mainly short term, although medium-term lending is quite common these days.

Short term lending may be in the form of:

- An overdraft, which a company should keep within a limit set by the bank. Interest is charged (at a variable rate) on the amount by which the company is overdrawn from day to day.
- A short-term loan, for up to three years.
- Medium-term loans are loans for a period of three to ten years.

The rate of interest charged on medium-term bank lending to large companies will be a set margin, with the size of the margin depending on the credit standing and risk of the borrower. A loan may have a fixed rate of interest or a variable interest rate, so that the rate of interest charged will be adjusted every three, six, nine or twelve months in line with recent movements in the Base Lending Rate.

Merits of Bank Credit

- **Economical:** Rate of interest charged by banks is quite nominal and is therefore economical.
- **Maintains business secrecy:** Banks maintain secrecy of the business. They do not disclose the information shared to any third party.
- **Less formalities:** As compared to issue of shares, debentures or accepting public deposits, it has less legal formalities..

- **Flexible source:** It can be increased or decreased as per the requirements of the business. It is not so that once a loan is taken it can't be reduced.

Limitations of Bank Credit

- Short-term financing: It does not provide loans for long term as shares and debentures do.
- Difficult procedure: As compared to commercial papers and trade credit, it involves many legal and paper formalities. It makes its procedure difficult.
- Restrictive clauses: Bank credit has many restrictive clauses which includes mortgage on company's assets or ineligibility to raise funds from specific sources.

Question 2. Discuss the sources from which a large industrial enterprise can raise capital for financing modernisation and expansion.
Answer: A large industrial enterprise can raise capital from the following sources.

1. **Equity Shares:** Equity shares are the most important source of raising long term capital by a company. They represent the ownership of a company and therefore, the capital raised by issue of these shares is called owner's funds. These shareholders do not get a fixed dividend. They get according to the earnings of the company. They receive what is left after all other claims on the company's income and assets have been settled. They enjoy the reward and also bear the risk of ownership. They have voting rights. Using their voting rights, they get participation in management of the company.
2. **Preference Shares:** Preference shareholders are called so because they enjoy some preferential rights over equity shares. They get dividend at a fixed rate and dividend is given on these shares before any dividend on equity shares. When company winds up, preference shares are paid before equity shares. Preference shares also have a right to participate in excess profits left after payment being made to equity shares. They also have a right to participate in the premium at the time of redemption. In lieu of these preferential rights, their voting rights are taken i.e. they are not eligible for voting. Preference shares have some characteristics of equity shares as well as debentures. They are safer investment with stable return from investor's point of view and free from control from owner's point of view.
3. **Debentures:** Debenture is an acknowledgement by a company that the company has borrowed certain amount from the debenture holder which it promises to pay on a specific date. It is an important source for raising long term debt capital. Debentures bear a fixed rate of interest. In recent times, issue of zero interest debentures has also become popular which do not carry any explicit rate of interest. But they are issued at discount and redeemed at a premium or at par. It is the return on the debenture. Public issue of debentures requires that issue of debentures should be rated by a credit rating agency like CRISIL (Creditrating and Information Services of India Limited).
4. **Loans from Financial Institutions:** The government has established many financial institutions like LIC, IDBI, ICICI etc all over the country to provide finance to these organizations. These institutions are established by central and state government both. These institutions provide owned capital as well as borrowed capital for long term and short term requirements. They provide financial and technical advice and consultancy to business firms. Obtaining loan from a financial institution increases goodwill of a company. These sources are available even during depression. Loans can be repaid in easy instalments.
5. **Loans from Commercial Banks:** Borrowings from banks are an important source of finance to companies. Bank lending is still mainly short term, although medium- term lending is quite common these days. The rate of interest charged on medium- term bank

lending to large companies will be a set margin, with the size of the margin depending on the credit standing and risk of the borrower. A loan may have a fixed rate of interest or a variable interest rate, so that the rate of interest charged will be adjusted every three, six, nine or twelve months in line with recent movements in the Base Lending Rate. Short term lending may be in the form of:
(i) An overdraft, which a company should keep within a limit set by the bank. Interest is charged (at a variable rate) on the amount by which the company is overdrawn from day to day.
(ii) A short-term loan, for up to three years.
(iii) Medium-term loans are loans for a period of three to ten years.
6. **Retained Earnings:** For any company, the amount of earnings retained within the business has a direct impact on the amount of dividends. Profit re-invested as retained earnings is profit that could have been paid as a dividend. The management of many companies believes that retained earnings are funds which do not cost anything, although this is not true. However, it is true that the use of retained earnings as a source of funds does not lead to a payment of cash. In practice, the dividend policy of the company is determined by the directors. From their standpoint, retained earnings are an attractive source of finance because investment projects can be undertaken without involving either the shareholders or any outsiders. The use of retained earnings as opposed to new shares or debentures avoids issue costs. The use of retained earnings avoids the possibility of a change in control resulting from an issue of new shares. Another factor that may be of importance is the financial and taxation position of the company's shareholders. For example, because of taxation considerations, they would rather make a capital profit (which will only be taxed when shares are sold) than receive current income, then finance through retained earnings would be preferred to other methods.

Question 3. What advantage does issue of debentures provide over the issue of equity shares?
Answer: Debentures provide following advantages over issue of equity shares.

1. **Voting Rights:** Voting rights are not given to debentures while equity shareholders have voting rights.
2. **Dilution of Controlling Power:** Since voting power is not given, therefore, if funds are raised by issue of debentures then controlling power does not get diluted.
3. **Redeemable:** Debentures are redeemable. Therefore, funds become flexible. When funds are not required permanently but for 5 or 10 years, debentures are more suitable.
4. **Fixed Rate of Interest:** Debentures are to be paid at fixed rate of interest. However, we need to share profits with equity shareholders.
5. **Creditor versus Owner:** Debenture holder is a creditor of the company and cannot take part in the management of the company while a shareholder is the owner of the company. It is the basic distinction between a debenture and a share.
6. **Convertibility:** Shares cannot be converted into debentures whereas debentures can be converted into shares.

Question 4. State the merits and demerits of public deposits and retained earnings as methods of business finance.
Answer: Public Deposits: Deposits accepted from public directly by the companies are called public deposits. These deposits generally carry a rate of interest higher than the deposits in commercial banks.
Merits of Public Deposits

- The procedure of obtaining deposits is simple and does not contain restrictive conditions.
- Cost of public deposits is generally lower than the cost of borrowings from banks and financial institutions.
- Public company usually does not create a charge on the assets of the company.
- As the depositors do not have voting rights, it does not dilute control in the company.

Demerits of Public Deposits

- It is difficult for a newly established company to be able to get funds from public deposits.
- It is dependent on public response and can't be relied on if financial needs are urgent.
- It is difficult especially when size of deposits is large.

Retained Earnings: For any company, the amount of earnings retained within the business has a direct impact on the amount of dividends. Profit re-invested as retained earnings is profit that could have been paid as a dividend.

Merits of Retained Earnings:

- The management of many companies believes that retained earnings are funds which do not cost anything, although this is not true. However, it is true that the use of retained earnings as a source of funds does not lead to the payment of cash.
- The dividend policy of the company is in practice determined by the directors. From their standpoint, retained earnings are an attractive source of finance because investment projects can be undertaken without involving either the shareholders or any outsiders.
- The use of retained earnings as opposed to new shares or debentures avoids issue costs.
- The use of retained earnings avoids the possibility of a change in control resulting from an issue of new shares.
- Another factor that may be of importance is the financial and taxation position of the company's shareholders. For example, because of taxation considerations, they would rather make a capital profit (which will only be taxed when shares are sold) than receive current income, then finance through retained earnings would be preferred to other methods.

Demerits of Retained Earnings:

- A company must restrict its self-financing through retained profits because shareholders should be paid a reasonable dividend, in line with realistic expectations, even if the directors would rather keep the funds for re-investing.
- At the same time, a company that is looking for extra funds will not be expected by investors (such as banks) to pay generous dividends, nor over-generous salaries to owner-directors.
- Scope of retained earnings is limited by amount of profits. A loss incurring firm has no source called retained earnings.

Question 5. Discuss the financial instruments used in international financing.
Answer: Following financial instruments are used in international financing:

1. **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. When these depository receipts are denominated in US $, they are called GDR. It is a bank certificate issued in more than one country for shares in a foreign company. The shares are held by a foreign branch of an international bank. The shares trade as domestic shares, but are offered for sale globally through the various bank branches. A financial instrument used by private markets to raise capital denominated in either U.S. dollars or Euros. These instruments are called EDRs when private markets are attempting to obtain Euros. It is a negotiable instrument and can be traded freely like any other security. A holder of GDR can convert it into any other security at any time. Holders of GDR are eligible only for capital appreciation and dividend but no voting rights.

2. **American Depository Receipts (ADRs):** When a company in the USA issues depository receipts, they are termed as American Depository Receipts (ADRs). These are bought and sold in stock markets of the USA. They are similar to GDR except that these can be issued only to American citizens and these can be listed and traded on a stock exchange of USA.
3. **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. Foreign Currency Convertible Bonds are listed and traded in Foreign Stock Exchanges. A holder of Foreign Currency Convertible Bonds has the option of converting them into equity shares at a pre-determined price. Foreign Currency Convertible Bonds are issued in foreign currency. Their rate of interest is lower than rate of any other similar non convertible debt instrument.

Question 6. What is a commercial paper? What are its advantages and limitations?
Answer: Commercial Paper:

- Commercial paper is an unsecured, short-term debt instrument issued by a corporation, typically for the financing of accounts receivable, inventories and meeting short-term liabilities.
- Maturities on commercial paper can range up to 365 days. The debt is usually issued at a discount, reflecting prevailing market interest rates.
- Commercial paper is not usually backed by any form of collateral, so only firms with high-quality debt ratings will easily find buyers without having to offer a substantial discount (higher cost) for the debt issue.

Advantages and Limitations of Commercial Paper Advantages:

- For the most part, commercial paper is a very safe investment because the financial situation of a company can easily be predicted over a few months.
- Typically only companies with high credit ratings and credit worthiness issue commercial paper. Hence the companies issuing them enjoy (a) the prestige associated with such issuance and (b) the ability to issue large quantum without much hassles like other types of financing which requires restrictions from regulatory bodies.
- Interest rate is generally lower compared to others like bank loans and other types of short term financing

Disadvantage:

- It does not have any flexibility with regard to repayments.

MORE QUESTIONS SOLVED

I. Very Short Answer Type Questions

Question 1. Give the full form of GDR and ADR.
Answer: Global Depository Receipts and American Depository Receipts

Question 2. State various sources of long term funds.
Answer: Various sources of long term funds include: Equity shares, preference shares, debentures, retained earnings, loans from financial institutions, loans from commercial banks etc.

Question 3. State various sources of short and medium term funds.
Answer: Short term sources include trade credit, factoring, banks and commercial papers. Middle term credit sources include loans from banks, public deposits, loans from financial institutions and lease financing.

Question 4. What are the preferences given to preference shareholders?
Answer:

1. They get dividend at a fixed rate and dividend is given on these shares before any dividend on equity shares.
2. When company winds up, preference shares are paid before equity shares.
3. Preference shares also have a right to participate in excess profits left after payment being made to equity shares.
4. They also have a right to participate in the premium at the time of redemption.

Question 5. Name two sources of funds under owner's fund.
Answer: Equity shares and retained earnings

Question 6. Who are called the owners of a company?
Answer: Equity shareholders are called the owners of the company.

Question 7. Which deposits are directly raised from the public?
Answer: Public deposits.

Question 8. What are the two important functions of factors?
Answer: (a) Discounting of bills and collection of the client's receivables.
(b) Providing information to the client on credit worthiness of prospective client.

Question 9. What is the status of debenture holders?
Answer: Debenture holders are creditors of the company.

Question 10. In leasing agreement what right is given to lessee?
Answer: The right to use the asset in lieu of specific prepayment for a specific time period.

Question 11. Preference shares are not suitable for which kind of investors?
Answer: It is not suitable for those investors who want to get a fixed return without failure.

Question 12. What are Indian depository receipts (IDRs)?
Answer: IDR is an instrument in the form of a depository receipt created by the Indian depository in India against the underlying equity shares of the issuing company.

Question 13. Name the two Indian companies which have raised money through issue of GDRs.
Answer: WIPRO and ICICI

Question 14. Who regulates the acceptance of public deposits?
Answer: Reserve Bank of India

Question 15. What is factoring?
Answer: Factoring is a financial service under which the factor of discounting of the bills of exchange of the clients and collects his debts and also provides him information on credit worthiness of perspective client. He charges fees for the services rendered.

Question 16. What are retained earnings?
Answer: A company generally does not distribute all its earnings amongst shareholders in the form of dividend. A portion of the net earnings may be retained in the business of ruse in future. These are called retained earnings.

Question 17. What are public deposits?
Answer: Public deposits are the deposits raised by organizations directly from the public.

Question 18. Specify the objective of I.D.B.I.
Answer: Its objective was 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 technique service.

Question 19. What do you mean by discounting of bills of exchange?
Answer: Discounting of bills of exchange means that the bank pays the person beforehand at less than face value and receives the payment on maturity equivalent to maturity value. The difference between the amount paid and face value is the return for discounting bills of exchange.

Question 20. What is a trade credit?
Answer: Trade credit is the credit extended by one trader to another for the purchase of goods and services.

Question 21. What is debenture?
Answer: A debenture is a document or certificate, which is issued under the common seal of the company, acknowledging its debt to the holders at given terms and conditions.

Question 22. Why preferences are given to preferential shares?
Answer: They are given some preferences because they are not given the voting rights.

Question 23. State two factors affecting the fixed capital requirement of a firm.
Answer: Size of business and nature of business.

Question 24. Why is equity share capital called 'Risk Capital'?
Answer: Equity shareholders get return only when profits is left after paying interest on debentures and fixed return on preference shares. Therefore, it is called risk capital as it bears maximum risk.

Question 25. State two factors affecting the working capital requirement of a firm.
Answer: Nature of business and speed of sales turnover.

II. Short Answer Type Questions

Question 1. State the meaning of finance. What factors determine working capital and fixed

capital requirements of a business?
Answer: No business can be started, run or expanded without finance. There are many sources of finance. Each source has its own merits and demerits. Business needs to choose right source of finance to make the best use of it.
Business finance refers to the money required for carrying out business activities. Factors determining working capital requirements of a business:

- **Whether firm is selling goods on credit or cash:** If the firm is selling goods on credit or cash, then its working capital requirements will be more. On the other hand, if it is selling in cash, its working capital requirements will be less.
- **Speed of sales turnover:** A firm whose sales process gets converted into cash soon will have lesser working capital requirements and a firm whose sales process gets converted into cash in delay will have more working capital requirements.
- **Size and scale of business:** If business is operating at a larger scale then working capital requirements will be more. On the other hand, if size and scale of operations is small, its working capital requirements will be less.

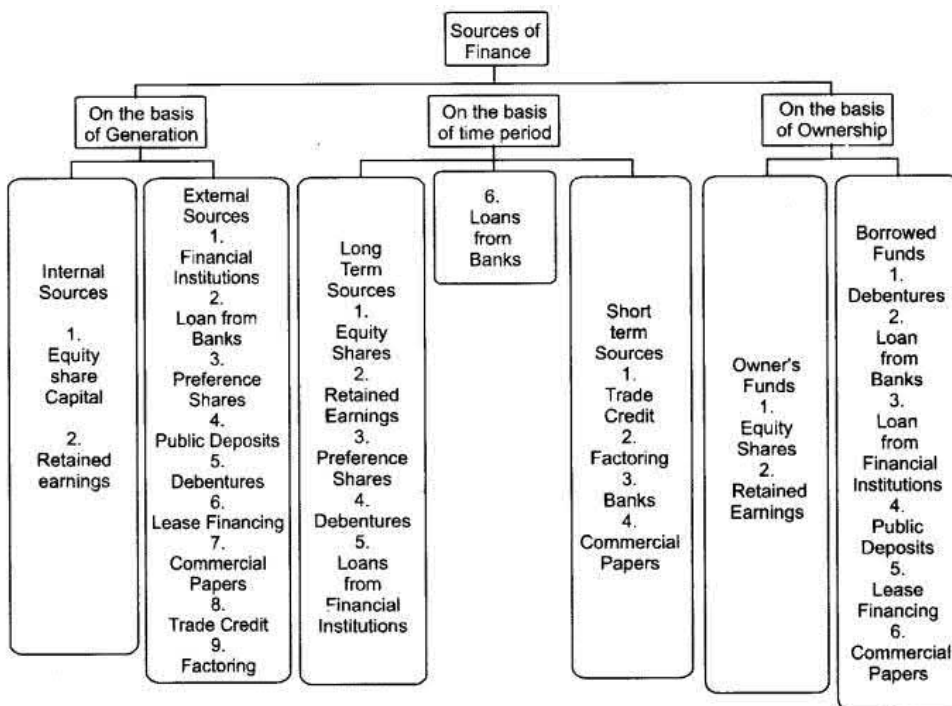
Factors determining Fixed Capital Requirements

- **Size and scale of business:** If business is operating at a larger scale then fixed capital requirements will be more. On the other hand, if size and scale of operations is small, its fixed capital requirements will be less.
- **Technology:** A firm using labour intensive method needs lesser fixed capital and a firm using capital intensive methods needs more fixed capital.

Question 2. Why does business enterprise need finance?
Answer: A business needs finance because:

1. Business is concerned with production and distribution of goods and services for the satisfaction of needs of society. There are four factors required for any production: land, labour, capital and entrepreneur. All these factors need to be paid for their services.
2. No business can be carried without availability of adequate funds.
3. As soon as a decision is taken to start a business, requirement of funds initiates.
4. Finance is called 'life blood of a business'.
5. It is very important to assess financial needs of the organization and the identification of various sources of finance.

Question 3. List different types of finance.
Answer:



Question 4. Differentiate between:

(a) Fixed Capital and Working Capital

(b) Short Term Finance and Long Term finance

(c) Owner's Funds and Borrowed Funds

(d) Internal Sources and External Sources

Answer: (a) Fixed Capital and Working Capital

Basis	Fixed Capital	Working Capital
Meaning	In order to start business, funds are required to purchase fixed assets like land and building, plant and machinery, furniture and fixtures etc. It is called fixed capital.	A business needs funds for its day to day operations. This is known as working capital of an enterprise.
Use	It is used to create basic and fundamental structure of business.	It is used for holding current assets such as stock of material, cash in hand, bills receivable and for meeting current expenses like salaries, electricity bill, rent etc.

(b) Short Term Finance and Long Term Finance

Basis	Long Term Finance	Short Term Finance
Meaning	Long term finance fulfils the financial requirements of an enterprise for a period exceeding 5 years.	Short term finance fulfils requirements of an enterprise for a period not exceeding one year.
Use	It is used of requiring fixed assets like equipment, plant and machinery etc.	It is used to meet working capital needs.
Example	Shares, debentures, Long term borrowing and Loans from Financial Institutions.	Trade credit, loans from commercial banks, commercial papers etc.

(c) Owner's Funds and Borrowed Funds

Basis	Owner's Funds	Borrowed Funds
Meaning	Owner's funds means funds that are provided by the owners of an enterprise.	Borrowed funds refer to the funds raised through loans and borrowings.
Duration	Owner's funds remain in business for a longer duration.	It is in business for shorter duration.
Refund	It is not required to be refunded.	It is required to be refunded.
Example	Equity shares, retained earnings.	Debentures, trade credit, loans, public deposits etc.

(d) Internal and External Sources

Basis	Internal Sources	External Sources
Meaning	Internal sources of funds are those that are generated within the business.	External sources of funds are those sources which lie outside an organization.
Duration	Internal sources remain in business for a longer duration.	It is in business for shorter duration.
Example	Equity shares, retained earnings	Debentures, Trade credit loans, public deposits etc.

Question 5. Preference shares are preferred by company but not by investors. Why?
Answer: Preference shares have a filed percentage dividend before any dividend is paid to the ordinary shareholders. As with ordinary shares a preference dividend can only be paid if sufficient distributable profits are available, although with 'cumulative' preference shares the right to an unpaid dividend is carried forward to later years. The arrears of dividend on cumulative preference shares must be paid before any dividend is paid to the ordinary shareholders.
From the company's point of view, preference shares are advantageous in the following ways:

1. Dividends do not have to be paid in a year in which profits are poor, while this is not the case with interest payments on long term debt (loans or debentures).
2. Since they do not carry voting rights, preference shares avoid diluting the control of existing shareholders while an issue of equity shares would not.
3. Unless they are redeemable, issuing preference shares will lower the company's gearing. Redeemable preference shares are normally treated as debt when gearing is calculated.
4. The issue of preference shares does not restrict the company's borrowing power, at least in the sense that preference share capital is not secured against assets in the business.
5. The non-payment of dividend does not give the preference shareholders the right to appoint a receiver, a right which is normally given to debenture holders.

However, dividend payments on preference shares are not tax deductible in the way that interest payments on debt are. Furthermore, for preference shares to be attractive to investors, the level of payment needs to be higher than for interest on debt to compensate for the additional risks.
For the investor, preference shares are less attractive than loan stock because:

1. They cannot be secured on the company's assets.
2. The dividend yield traditionally offered on preference dividends has been too low to provide an attractive investment compared with the interest yields on loan stock in view of the additional risk involved.

Question 6. What are the differences between Equity Shares and Preference Shares?
Answer: Differences between Equity shares and Preference shares are as follows:

Basis of Difference	Equity Shares	Preference Shares
1. Payment of dividend	Equity dividend is paid after paying the preference shares dividend.	Preference dividend are paid prior to equity shares dividend.
2. Refund of capital	Equity share is refunded only after refund of preference share capital.	Preference shareholder has prior right to refund the capital over equity capital.
3. Rate of dividend	Rate of dividend may over the year in equity shares.	Rate of dividend is fixed in preference shares.

4. Arrears of dividend	Dividend cannot be accumulated in equity share	Arrears of dividend may be accumulated in preference shares.
5. Convertibility	It is not convertible.	It is convertible.
6. Redeemability	It is not redeemable.	It is redeemable.
7. Voting Right	Every shareholder enjoys voting right on general meeting.	Preference shareholders have no such voting rights.

Question 7. Write a short note on the features of GDRs.
Answer: GDRs have following features:

- A bank certificate issued in more than one country for shares in a foreign company. The shares are held by a foreign branch of an international bank. The shares trade as domestic shares, but are offered for sale globally through the various bank branches. ‘
- A financial instrument used by private markets to raise capital denominated in either U.S. dollars or Euros.
- Holders of GDR are eligible only for capital appreciation and dividend but no voting rights.
- These instruments are called EDRs when private markets are attempting to obtain Euros.
- It is a negotiable instrument and can be traded freely like any other security.
- A holder of GDR can convert it into any other security at any time.

Question 8. Name zones of the Lessors and Lessees in India.
Answer: The Lessors

- Specialised Leasing Companies’
- Banks and Bank Subsidiaries
- Specialised Financial Institutions
- Manufacturer Lessors The Lessees
- Public Sector Undertakings
- Mid Market Companies
- Consumers
- Government Departments and Authorities

Question 9. Classify internal and external sources on the basis of time.
Answer:

	Short-Term	Medium-Term	Long-Term
Internal Sources	Retained Profits Selling Assets Working Capital	Retained Profits	Investing Extra Cash
External Sources	Overdrafts Trade Credit Government Grants Donations Sponsorships Debt Factoring Leasing Hire Purchase Venture Capitalists Preferred Shares	Government Grants Sponsorship Leasing Hire Purchase Bank Loans and Mortgages Venture Capitalists	Ordinary Shares Government Grants Leasing Hire Purchase Bank Loans and Mortgages Debentures

Question 10. What is factoring? Discuss its pros and cons.

Answer: Debtors are the people who owe money to a business. Debt factoring is a financial service that allows a business to raise funds based on the value owed to them by their debtors. Example: Receiving 80% of debtors outstanding debt on selling fabric abroad.
Advantages:

1. It reduces the probability of bad debt-debtors.
2. Non-recourse factoring allows for insurance against bad debts.
3. Companies don't have to chase up their own debtors.
4. Immediate sources of finance.

Disadvantages:

1. Without non-recourse factoring the company will still have to absorb losses.
2. It is expensive.

III. Long Answer Type Questions

Question 1. Explain different types of preference shares which can be issued by a company.
Answer: Different types of preference shares are discussed below:

1. **Cumulative and Non-cumulative:** The preference shares which enjoy the right to accumulate unpaid dividends in future years if it is not paid during a year are termed as cumulative preference shares. On the contrary, a non-cumulative preference share is one in which dividend is not accumulated if it is not paid in the particular year. .
2. **Participating and Non-participating Preference Shares:** Those preference shares which have a right to participate in further surplus of a company's shares which after dividend at certain rate has been paid on equity shares are called participating preference shares. Those preference shares which do not have a right to participate in further surplus of a company's shares which after dividend at certain rate has been paid on equity shares are called non-participating preference shares.
3. **Convertible and Non-convertible Preference Shares**: Those preference shares which can be converted into equity shares within a specified period of time are called convertible preference shares. On the contrary, preference shares which cannot be converted into equity shares within a specified period of time are called non-convertible preference shares.

Question 2. Describe in brief the features of equity shares.
Answer: Equity shares are the most important sources of raising long term capital by a company. They represent the ownership of a company and therefore, the capital raised by issue of these shares is called owner's funds. Features of equity shares:

- **Voting Rights:** They have voting rights and hence they are the owners of the business.
- **Participation in Management:** Using their voting rights, equity shares holders get a right to participate in company's management.
- **Return:** These shareholders do not get a fixed dividend. They get according to the earnings of the company. They receive what is left after all other claims on the company's income and assets have been settled.
- **Risk:** They enjoy the reward and also bear the risk of ownership. Therefore, it is also called risk capital.
- **Permanent Capital:** Equity capital serves as permanent capital as it is to be repaid only at the time of liquidation of a company.
- **No charge on assets of the company:** Funds can be raised though equity issue without creating any charge on the assets of a company. The assets of a company are therefore,

free to be mortgaged for the purpose of borrowings, if the need be.

- **More Costly:** The cost of equity shares is generally more as compared to the cost of raising funds through other sources.

Question 3. Differentiate between a share and a debenture.
Answer: Following are the main differences between a debenture and a share:

1. Debenture holder is a creditor of the company and cannot take part in the management of the company while a shareholder is the owner of the company. It is the basic distinction between a debenture and a share.
2. Debenture holders will get interest on debentures and will be paid in all circumstances, whether there is profit or loss will not affect the payment of interest on debentures. Shareholder will get a portion of the profits called dividend which is dependent on the profits of the company. It can be declared by the directors of the company out of profits only.
3. Shares cannot be converted into debentures whereas debentures can be converted into shares.
4. Debentures will get priority in getting the money back as compared to shareholder in case of liquidation of a company.
5. There are no restrictions on the issue of debentures at a discount, whereas shares at discount can be issued only after observing certain legal formalities.
6. Convertible debentures which can be converted into shares at the option of debenture holder can be issued whereas shares convertible into debentures cannot be issued.
7. There can be mortgage debentures i.e. assets of the company can be mortgaged in favor of debenture holders. But there can be no mortgage shares. Assets of the company cannot be mortgaged in favor of shareholders.

Question 4. What are retained profits? Discuss their advantages and disadvantages.
Answer: Retained Profits: For any company, the amount of earnings retained within the business has a direct impact on the amount of dividends. Profit re-invested as retained earnings is profit that could have been paid as a dividend. The management of many companies believes that retained earnings are funds which do not cost anything, although this is not true. However, it is true that the use of retained earnings as a source of funds does not lead to a payment of cash. The dividend policy of the company is in practice determined by the directors. From their standpoint, retained earnings are an attractive source of finance because investment projects can be undertaken without involving either the shareholders or any outsiders. The use of retained earnings as opposed to new shares or debentures avoids issue costs. The use of retained earnings avoids the possibility of a change in control resulting from an issue of new shares. Another factor that may be of importance is the financial and taxation position of the company's shareholders. For example, because of taxation considerations, they would rather make a capital profit (which will only be taxed when shares are sold) than receive current income, and then finance through retained earnings would be preferred to other methods.

Advantages of Retained Earnings

- The management of many companies believe that retained earnings are funds which do not cost anything, although this is not true. However, it is true that the use of retained earnings as a source of funds does not lead to a payment of cash.
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Disadvantages of Retained Earnings

- A company must restrict its self-financing through retained profits because shareholders should be paid a reasonable dividend, in line with realistic expectations, even if the directors would rather keep the funds for re-investing.
- At the same time, a company that is looking for extra funds will not be expected by investors (such as banks) to pay generous dividends, nor over-generous salaries to owner-directors.
- Scope of retained earnings is limited by amount of profits. A loss incurring firm has no source called retained earnings.

Question 5. Write a note on international sources of finance.
Answer:

- **Commercial banks:** Commercial banks all over the world extend foreign currency loans for business purposes. For e.g. Standard Chartered emerged as a major source of foreign currency loans to the Indian industry. The types of loans and services provided by banks vary from country to country.
- **International agencies and Development banks:** These bodies provide long and medium term loans and grants to promote the development of economically backward areas in the world. The more notable among them include International Finance Corporation(IFC), EXIM Bank and Asian Development Bank.
- **International Capital Markets:** Modern organizations including multinational companies depend upon sizeable borrowing in rupees as well as in foreign currency Prominent financial instruments used for this purpose are:
  1. Global Depository Receipts (GDR's)
  2. American Depository Receipts(ADR's)
  3. Foreign Currency Convertible Bonds(FCCB's)

Question 6. Explain in detail the types of debenture a company can issue.
Answer: Different types of debentures that a company can issue are described below:

1. **Convertible and Non-convertible Debenture:** 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.
2. **Registered and Bearer:** Registered debentures are those which are duly recorded in the register of debentures holders maintained by the company. These can be transferred only through a regular instrument of transfer. In contrast the debentures which are transferable by more delivery are called bearer debentures.
3. **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.

4. **First and Second:** Debentures that are rapid before other debentures are known as first debentures. The second debentures are those which are paid after the first debentures have been paid back.

Question 7. Describe briefly the factors responsible for selecting a source of finance.
Answer: Following factors responsible for selecting a source of finance:

- **Cost:** There are two types of cost viz., the cost of procurement of funds and cost of utilizing the funds. Both these costs should be taken into account while deciding about the source of funds that will be used by an organisation.
- **Form of organisation and legal status:** The form of business organisation and status influences the choice of a source for raising money. A partnership firm cannot raise money by issue of equity shares as these can be issued only by a joint stock company.
- **Risk Profile:** Business should evaluate each of the sources in terms of risk. For example, equity shares are to be repaid only at the time of liquidation of the company. While debentures need to be repaid on maturity date along with interest every six months or annually. Moreover, dividends are to be paid only if there are profits while interest is to be paid in case of loss as well.
- **Financial Strength and Operational Stability:** When the earnings of an organization are not stable, fixed charged funds like preference shares and debentures should be carefully chosen as they add to the fixed financial commitments of an organization.
- **Purpose and Time Period:** Business should select a source of finance according to time period for which funds are required. If funds are needed for short term, then we can make use of trade credit, commercial papers, bank loan, public deposits, etc but if funds are needed for long run then debentures, preference shares etc. are better.
- **Control:** A particular source of fund may affect the control and power of the owners of management of a firm. For example, equity shares dilute the control as they have voting power while other sources do not have voting power but loans from financial institutions, loans from commercial banks and issue of debentures get mortgaged on assets of the company. It dilutes power in different ways.
- **Effect on Credit Worthiness:** While choosing a source of finance, am organization also needs to consider its effect on credit worthiness. For example, if the company issues secured debentures then it affects the credit worthiness of company for unsecured debentures of the company. Their willingness to extend further loans as credit to the company gets adversely affected.
- **Tax Benefits:** Various sources of finance may also be evaluated in terms of their tax benefits. For example, interest on debentures is tax deductible while divided on preference shares is not tax deductible. Therefore those organizations which are seeking tax advantage may prefer debentures to preference shares.
- **Flexibility and Ease:** Another factor which determines the choice of a source of finance is how easily it is available i.e. how less the paper formalities are and how flexible it is i.e. how easily its amount and terms can be modified.

Question 8. What is lease financing? Discuss its merits and demerits.
Answer: A lease is a contractual agreement, in which the owner of the asset grants the other party the right to use the asset in return for a periodic payment, but retains the title over the property. The owner of the asset is called lessor and the party who uses the assets is called lessee.
Lessee pays a fixed periodic amount to the lessor. It is called lease rent. When period of lease expires, the asset is returned to the lessor. It is used more frequently with items like computers and electronic items which become obsolete soon. Leasing company (lessor)

owns the equipment and hires it out to the customers (lessee pays rental income to hire assets). It is a medium term fund. New companies need expensive equipments to run the business: office, equipment leasing from larger companies like Apple.
Merits of Lease financing

- It allows the lessee to acquire the asset with lesser investment.
- Simple documentations makes it easier to finance assets.
- Lease rentals get tax advantage as they are deductible for computing taxable profits.
- It reduces initial capital for (new) businesses.
- It provides added service: maintenance and upgrading.
- It makes funds available without diluting the ownership of business.
- The lease agreement does not bring any change in raising capacity of an organization.
- The risk of obsolesce is borne by the lessor.

Demerits of Lease Financing

- A lessee agreement imposes restrictions on usage of assets. For example, alternation and modification in assets may not be allowed.
- The normal business operations may be affected if lease is not renewed.
- It may result in higher payout obligations in case the equipment is not found useful and the lessee chooses for premature termination of the lease contact.
- It never makes lessee the owner of the asset.

IV. Higher Order Thinking Skills (HOTS)
Question 1. Mr. John has ? 1,00,000 for investment purposes. Should he invest in equity shares, preference shares, public deposits or debentures? Justify your answer.
Answer: John's investment depends on many factors:

- If he wants control in the company or participation in management of the company, he should invest in equity shares.
- If he wants some certainty in returns and also wants something extra in case of huge profits, he should invest in preference shares.
- If he wants perfect certainty, he should invest in public deposits or debentures as rate of return is pre fixed.
- He also needs to see if he wants to invest for short term or long term. If he is interested in short term investment, then he should choose public deposits.
- If he is interested in middle term investment, he should invest in preference shares or debentures.
- If he is interested in long term investment, he should invest in equity shares.

Question 2. As a source of finance retained profit is better than other sources. Do you agree with this view? Give reasons for your answer.
Answer: Yes, we agree. Retained earnings are better than other sources of finance because:

- Retained earnings is a permanent source of funds which an organization can avail of.
- It enhances capacity of the business to absorb unexpected losses.
- It does not involve any explicit cost in the form of interest, dividend or flotation cost.
- It may increase the process of equity shares of a company.
- There is a greater degree of operational freedom and flexibility as the funds are generated internally.

V. Value Based Questions

Question 1. Retained earnings are not a good source from the values point of view as it is the right of equity shareholders. Do you agree? Justify your answer.
Answer: Equity shareholders get a return only when profits are left after giving interest to debenture holders and preferential dividend to preference shareholders. In case, no profits are left after it, they do not get a return. Therefore, it is unreasonable to transfer funds to general reserves which are called retained profits if there are exceptionally good profits. They took the risk of uncertain returns. Then it is their right to get exceptional returns in good times. But in good times, it is being retained to plough back into the business. Therefore, it is right to say that retained earnings are not a good source from the values point of view as it is the right of equity shareholders.

Question 2. Debentures are good from debenture holders point of view but not for business. Do you agree? Explain.
Answer: Debentures are similar to shares, however, debenture holders do not have voting rights on how the business is run.
Debentures have certain merits and demerits from business as well as debenture holders point of view. **These are explained below:**
Advantages to Debenture Holders

- They receive annual interest/ benefits (VIP status or free passes) regardless of whether or not the business is making money.

Disadvantages to Debenture Holders

- No say in how the business will run.
- Greatly depends on the business' success to reuse it's value.

Advantages to Business

- Provides good long-term finance without losing control of the business.

Disadvantages to Business

- Firm increases the amount of long-term liabilities raising the amount of interest payments to the lenders.