BUSINESS STUDIES

Chapter 8: SOURCES OF BUSINESS FINANCE

SOURCES OF BUSINESS FINANCE

Concept Of Business Finance

The term finance means money or fund. The requirements of funds by business to carry out its various activities is called business finance. Finance is needed at every stage in the life of a business. A business cannot function unless adequate funds are made available to it.

Need Of Business Finance

1. **Fixed Capital Requirement:** In order to start a business, funds are needed to purchase fixed assets like land and building, plant and machinery. The funds required in fixed assets remain invested in the business for a long period of time.
2. **Working Capital Requirement:** A business needs funds for its day to day operation. This is known as working Capital requirements. Working capital is required for purchase of raw materials, to pay salaries, wages, rent and taxes.
3. **Diversification:** A company needs more funds to diversify its operation to become a multi-product company e.g. ITC.
4. **Technology upgradation:** Finance is needed to adopt modern technology for example uses of computers in business.
5. **Growth and expansion:** Higher growth of a business enterprise requires higher investment in fixed assets. So finance is needed for growth and expansion.

Classification of Sources of Fund:

On the basis of period, the different sources of funds can be categorised into three parts. These are long-term sources, medium-term sources and short-term sources.

1. The long-term sources fulfil the financial requirements of an enterprise for a period exceeding 5 years and include sources such as shares and debentures, long-term borrowings and loans from financial institutions. Such financing is generally required for the acquisition of fixed assets such as equipment, plant, etc.
2. Where the funds are required for a period of more than one year but less than five years, medium-term sources of finance are used. These sources include borrowings from commercial banks, public deposits, lease financing and loans from financial institutions.
3. Short-term funds are those which are required for a period not exceeding one year. Trade credit, loans from commercial banks and commercial papers are some of the examples of the sources that provide funds for short duration.

Ownership Basis of Business Finance:

Depending upon the types of fund a business gets, the funds can be classified into two sets- ‘owner’s funds’ and ‘borrowed funds’.

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1) **Owner Funds:** If the funds are provided by the business or shareholders or partners creator, then it is the Owner's funds. Profits used to invest again in the business also fall under this. Owner funds usually do not need to be refunded and remain invested in the business's life period. Two important sources of owner funds include Equity shares and Retained earnings. This type of investment grants controls over the enterprise. It carries risk with the investment as the principal amount and returns are not guaranteed.

2) **Borrowed Funds:** If the investment source comes from outside the business, it is called Borrowed funds. It cannot be a permanent source of capital because it has to be returned. Even though it carries less risk because the principal and returns are guaranteed, it does not grant control. A fixed interest rate is also levied on borrowed funds, and it can put a lot of burden to payback when the company/business is not raising enough funds.

On the basis of source of generation:

1) **Internal Sources:** Funds generated from within the organization are known as internal sources. Though only short term or limited needs could be fulfilled by this source. For example: Ploughing back profit, Disposing surplus inventory, etc.

2) **External Sources:** Large amounts of money requirements are fulfilled through external sources. These are more expensive sources than internal sources of financing. These are done through: Borrowings from commercial banks Acceptance of Public deposits, Raising debentures etc.

Sources of Finance

Retained Earnings

Out of the company's total earnings, a certain section of the total profits can be saved for the future. This part is not divided among shareholders and is a source of self-financing. It depends heavily on the net profits and age of the organization.

Merits

(i) Retained earnings is a permanent source of funds available to an organisation.

(ii) It does not involve any explicit cost in the form of interest, dividend or floatation cost.

(iii) As the funds are generated internally, there is a greater degree of operational freedom and flexibility.

(iv) It enhances the capacity of the business to absorb unexpected losses. It may lead to increase in the market price of the equity shares of a company.

Limitations

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

(ii) It is an uncertain source of funds as the profits of business are fluctuating.

(iii) The opportunity cost associated with these funds is not recognised by many firms. This may lead to sub-optimal use of the funds.

Trade Credits

Trade credits refer to sources of short term finances where a business extends credit for purchasing goods and services to the other. According to class 11 sources of business finance chapter, it appears as a record for an account payable and isn't taken immediately. It is based on goodwill and a decent financial situation.

Merits

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

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

(iii) Trade credit needs to promote the sales of an organisation.

(iv) 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

(v) It does not create any charge on the assets of the firm while providing funds.

Limitations

(i) Availability of easy and flexible trade credit facilities may induce a firm to indulge in overtrading, which may add to the risks of the firm.

(ii) Only limited amount of funds can be generated through trade credit

(iii) It is generally a costly source of funds as compared to most other sources of raising money.

Factoring

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It is referred as a financial service within which the ' factor' provides various services like-

1) Discounting the bill as well as collecting clients' debt through which the receivables on the account of sales of goods or services will be sold to the factor at a variable discount.

2) It also provides information about the creditworthiness of the prospective clients, etc. along with very factors that possess information regarding the trading history of the firm.

Merits

(1) Obtaining funds through factoring is cheaper than financing through other means such as bank credit.

(2) With cash flow accelerated by factoring, the client is able to meet his/her liabilities

promptly as and when these arise.

(3) Factoring as a source of funds is flexible and ensures a definite pattern of cash inflows from credit sales. It provides security for a debt that a firm might otherwise be unable to obtain.

(4) It does not create any charge on the assets of the firm.

(5) The client can concentrate on other functional areas of business as the responsibility of credit control is shouldered by the factor.

Limitations

(1) This source is expensive when the invoices are numerous and smaller in amount.

(2) The advance finance provided by the factor firm is generally available at a higher interest cost than the usual rate of interest.

(3) The factor is a third party to the customer who may not feel comfortable while dealing with it.

Lease Financing

A periodic payment is set up between two parties allowing the temporary use of an asset owned by another company. This also allows the renting of assets. A fixed periodic amount is called lease rental. The asset is returned after the contract time.

Merits

1) It enables the lessee to acquire the asset with a lower investment.
2) Simple documentation makes it easier to finance assets.
3) Lease rentals paid by the lessee are deductible for computing taxable profits.
4) It provides finance without diluting the ownership or control of business.
5) The lease agreement does not affect the debt raising capacity of an enterprise.
6) The risk of obsolescence is borne by the lesser. This allows greater flexibility to the lessee to replace the asset.

Limitations

1. A lease arrangement may impose certain restrictions on the use of assets. For example, it may not allow the lessee to make any alteration or modification in the asset.
2. The normal business operations may be affected in case the lease is not renewed,
3. It may result in higher payout obligation in case the equipment is not found useful and the lessee opts for premature termination of the lease agreement.
4. The lessee never becomes the owner of the asset. It deprives him of the residual value of the asset.

Public Deposits

When an organisation raises certain deposits directly from the public, it is known as public deposits. Usually, the rate of interest offered on public deposits is higher than that offered on the bank deposits. Those who are interested in investing in an organisation, they can do so by filling the designated form.

Merits The merits of public deposits are:

(i) The procedure of obtaining deposits is simple and does not contain restrictive conditions as are generally there in a loan agreement;

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

(iii) 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;

(iv) As the depositors do not have voting rights, the control of the company is not diluted. Limitations The major limitation of public deposits are as follows: (i) New companies generally find it difficult to raise funds through public deposits; (ii) It is an unreliable source of finance as the public may not respond when the company needs money; (iii) Collection of public deposits may prove difficult, particularly when the size of deposits required is large.

Issue of Share

Also known as share capital, where capital is divided into small marketable units known as shares. Each share gets a variant value fixed at one point. According to sources of business finance chapter class 11, there are two types of share, i.e., Equity Share and Preference Shares. Let us take a detailed look at the key features of Equity Shares and Preference Shares.

(a)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 prerequisite 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, however, is limited to the extent of capital contributed by them in the company. Further, through their right to vote, these shareholders have a right to participate in the management of the company.

Merits

(1) Equity shares are suitable for investors who are willing to assume risk for higher returns.

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(2) Payment of dividend to the equity shareholders is not compulsory. Therefore, there is no burden on the company in this respect.

(3) 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.

(4) Equity capital provides credit worthiness to the company and confidence to prospective loan providers.

(5) 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.

(6) Democratic control over management of the company is assured due to voting rights of equity shareholders.

Limitations

1) Investors who want steady income may not prefer equity shares as equity shares get fluctuating returns.
2) The cost of equity shares is generally more as compared to the cost of raising funds through other sources.
3) Issue of additional equity shares dilutes the voting power, and earnings of existing equity shareholders.
4) More formalities and procedural delays are involved while raising funds through issue of equity share.

b. **Preference Share:** Preferential Position receives a fixed cut in dividends out of the profit. At the time of liquidation, they enjoy a later claim to capital. They get the first preference in repayment and dividend. They have a fixed rate of return, like debentures

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Merits

(1) Preference shares provide reasonably steady income in the form of fixed rate of return and safety of investment.

(2) Preference shares are useful for those investors who want fixed rate of return with comparatively low risk.

(3) It does not affect the control of equity shareholders over the management as preference shareholders don't have voting rights.

(4) 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.

(5) Preference shareholders have a preferential right of repayment over equity shareholders in the event of liquidation of a company.

(6) Preference capital does not create any sort of charge against the assets of a

company.

Limitations

1) Preference shares are not suitable for those investors who are willing to take risk and are interested in higher returns.
2) Preference capital dilutes the claims of equity shareholders over assets of the company.
3) The rate of dividend on preference shares is generally higher than the rate of interest on debentures.
4) As the dividend on these shares is to be paid only when the company earns profit, there is no assured return for the investors. Thus, these shares may not be very attractive to the investors.
5) The dividend paid is not deductible from profits as expense. Thus, there is no tax saving as in the case of interest on loans.

Debentures

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.

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) The issue of debentures is suitable in the situation when the sales and earnings are relatively stable.
4) As debentures do not carry voting rights, financing through debentures does not dilute control of equity shareholders on management.
5) Financing through debentures is less costly as compared to cost of preference or equity capital as the interest payment on debentures is tax deductible.

Limitations

1) As fixed charge instruments, debentures put a permanent burden on the earnings of a company. There is a greater risk when earnings of the company fluctuate.
2) In case of redeemable debentures, the company has to make provisions for

repayment on the specified date, even during periods of financial difficulty.

3) Each company has certain borrowing capacity. With the issue of debentures, the capacity of a company to further borrow funds reduces.

Commercial Paper

Commercial paper is an unsecured, short period debt tool issued by a company, usually for the finance and inventories and temporary liabilities. The maturities in this paper do not last longer than 270 days. These papers are like a promissory note allotted at a huge cost and exchangeable between the All-India Financial Institutions (FIs) and Primary Dealers (PDs).

Most of the commercial paper investors are from the banking sector, individuals, corporate and incorporated companies, Non-Resident Indians (NRIs) and Foreign Institutional Investors (FIIs), etc. However, FII can only invest according to the limit outlined by the Securities and Exchange Board of India (SEBI)

In India, commercial paper is a short-term unsecured promissory note issued by the Primary Dealers (PDs) and the All-India Financial Institutions (FIs) for a short period of 90 days to 364 days.

Merits

1) A commercial paper is sold on an unsecured basis and does not contain any restrictive conditions
2) As it is a freely transferable instrument, it has high liquidity
3) It provides more funds compared to other sources. Generally, the cost of CP to the issuing firm is lower than the cost of commercial bank loans
4) A commercial paper provides a continuous source of funds. This is because their maturity can be tailored to suit the requirements of the issuing firm. Further, maturing commercial paper can be repaid by selling new commercial paper
5) Companies can park their excess funds in commercial paper thereby earning some good return on the same.

Limitations

1) Only financially sound and highly rated firms can raise money through commercial papers. New and moderately rated firms are not in a position to raise funds by this method
2) The size of money that can be raised through commercial paper is limited to the excess liquidity available with the suppliers of funds at a particular time
3) Commercial paper is an impersonal method of financing. As such if a firm is not in a position to redeem its paper due to financial difficulties, extending the maturity of a CP is not possible.

Commercial Bank

A commercial bank is a kind of financial institution that carries all the operations related to deposit and withdrawal of money for the general public, providing loans for investment, and other such activities. These banks are profit-making institutions and do business only to make a profit.

The two primary characteristics of a commercial bank are lending and borrowing. The bank receives the deposits and gives money to various projects to earn interest (profit). The rate of interest that a bank offers to the depositors is known as the borrowing rate, while the rate at which a bank lends money is known as the lending rate.

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.

Limitations

1) Funds are generally available for short periods and its extension or renewal is uncertain and difficult
2) Banks make detailed investigation of the company's affairs, financial structure etc., and may also ask for security of assets and personal sureties. Thismakes the procedure of obtaining funds slightly difficult
3) In some cases, difficult terms and conditions are imposed by banks. for the grant of loan. For example, restrictions may be imposed on the sale of mortgaged goods, thus making normal business working difficult.

Factors Affecting the Choice of the Source of Funds

1) **Cost:** It refers to the cost incurred in obtaining the fund and the cost of using the funds. So, while deciding about the source of funds both the costs should be taken into consideration.
2) **Flexibility and ease:** Borrowings from banks and financial institutions involve many restrictions, detailed investigation and documentation. Therefore, business firms may not prefer them in case other sources are easily available.

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3) **Effect on creditworthiness:** The creditworthiness of business is affected by the use of certain sources. For example, the issue of secured debentures by a company may lead to the withdrawal of loans by unsecured creditors. It might become difficult for the company to raise further unsecured loans.

4) **The form of organisation and legal status:** The form of the legal status of business firms also affect the choice of the source of finance. For example, a sole proprietor or a partnership firm cannot obtain funds by issue of equity shares as these can be issued only by joint stock companies.

5) **Purpose and time period:** The time period for which the funds are required also affects the selection of the source of funds. For example, if the funds are required for a short period, sources such as trade credit, commercial papers, etc. can be used. For the long term, sources such as the issue of shares, debentures, etc. are preferred. Therefore, the purpose of the business should also be considered while choosing the source of finance.

6) **Tax benefits:** Certain sources of funds like debentures and loans provide tax benefits. The interest payable on them is tax deductible. Hence, the organisations seeking tax advantage prefer to raise funds through debentures or loans.

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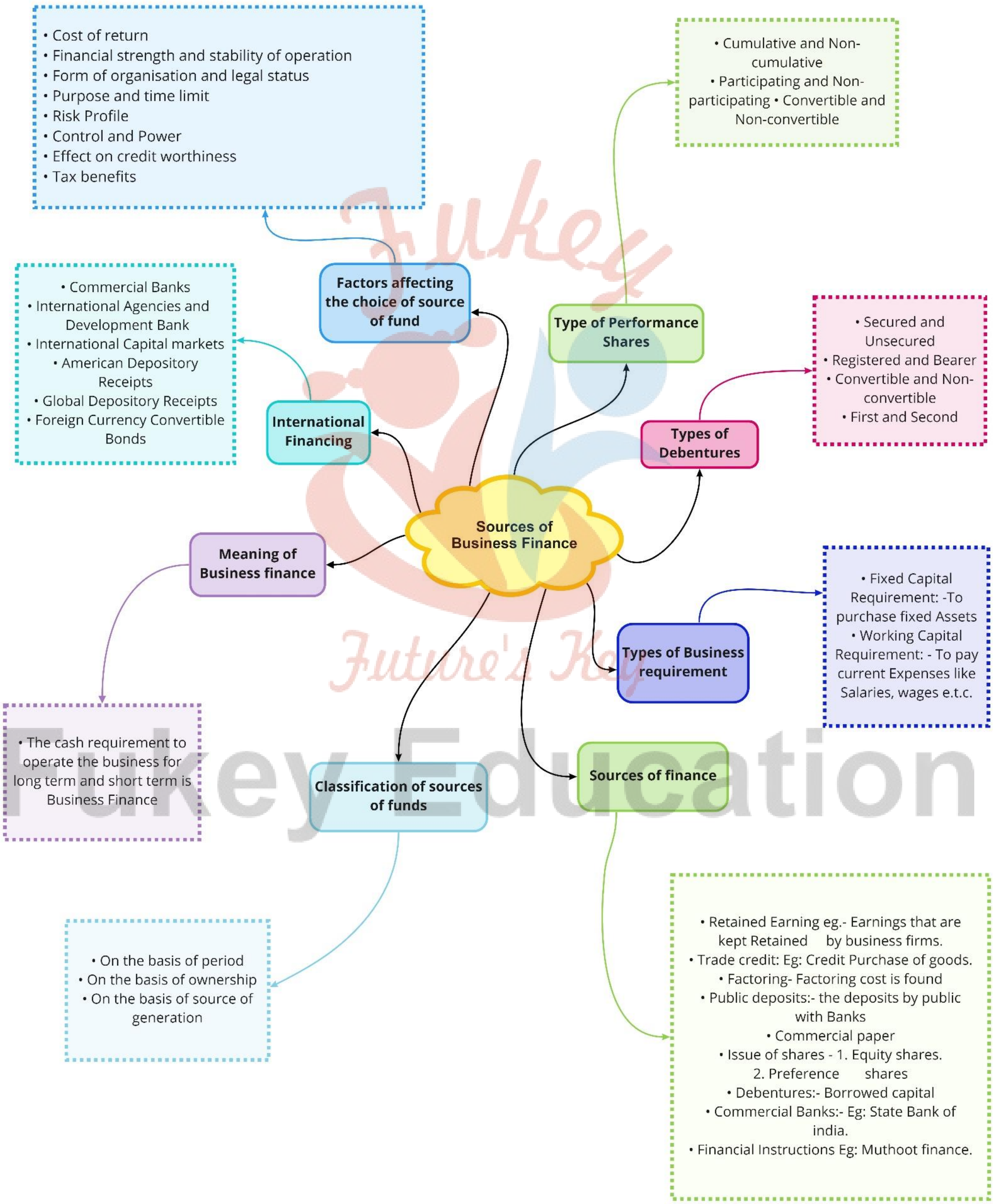

Important Questions

Multiple Choice Questions -

Question 1.Sources of finance can be categorised as ______________

(a) Source of Generation Basis

(b) Period Basis

(c) Ownership

(d) All of the above

Question 2.Expand ADR

(a) American Depository Receipts

(b) American Direct Receipts

(c) American Domestic Receipts

(d) None of the above

Question 3. Industrial Finance Corporation of India (IFCI) was established in _______

(a) July 1948

(b) July 2001

(c) July 1956

(d) July 1991

Question 4.__________ is an example of short term finance

(a) Trade Credit

(b) Debenture

(c) Share

(d) None of the above

Question 5.___________ was the first company in India to issue convertible zero interest debentures in January 1990

(a) Reliance Limited

(b) Adani Enterprise

(c) Tata Motors

(d) Mahindra and Mahindra

Question 6.Expand GDR

(a) Global Depository Receipts

(b) Gross Domestic Receipts

(c) Government Direct Receipts

(d) None of the above

Question 7.Money obtained by issue of shares is known as ____________

(a) Debts

(b) Loans

(c) Reserve Funds

(d) Share Capital

Question 8.A person who purchases the common stock of a corporation is known as:

(a) Preferred stockholder

(b) Creditor

(c) Bondholder

(d) Common stockholder

Question 9.ICICI was established in ___________________

(a) 1985

(b) 1975

(c) 1965

(d) 1955

Question 10.Commercial papers can be issued only by large and creditworthy companies because

(a) It is protected by the Government

(b) It is an Unsecured Debt

(c) It is Fully Secured Debt

(d) None of the above

Question 11.Which of the following is a commercial bank?

(a) Punjab National Bank

(b) Canara bank

(c) State Bank of India

(d) All of the above

Question 12.State Industrial Development Corporations were established by ________

(a) Ministry of Finance

(b) the Different States

(c) Central Government

(d) None of the above

Question 13.Under the lease agreement, the lessee gets the right to

(a) Use the asset for a specified period

(b) Share profits earned by the lessor

(c) Sell the assets

(d) Participate in the management of the organisation

Question 14.When one party grants the other party the right to use the asset in return for a periodic payment, it is known as __________

(a) Lease Financing

(b) Public Deposits

(c) Debts

(d) Factoring

Question 15.The term 'redeemable' is used for

(a) Public deposits

(b) Commercial paper

(c) Equity shares

(d) Preference shares

Very Short Questions –

QUESTION 1 Define ploughing back of profits.

QUESION 2 Risk capital is defined as which type of capital?

QUESTION 3 State the return given to debenture holders for using their funds.

QUESTION 4 Give one feature of retained earnings that the other source of finance does not have.

QUESTION 5 Mention one similar function of Public deposits and ADR.

QUESTION 6 Mention one similar function between preference share capital and equity share capital.

QUESTION 7 Which term is concerned with the redemption and conservation of capital funds in matching the financial need of a company?

QUESTION 8 In the business sector which organization provides both medium and long term loans and has been set up by both the state and central government.

QUESTION 9 Name the two companies in India offer factoring services.

QUESTION 10 Mention two rights of preference shareholder.

Short Questions –

1. What preferential rights are enjoyed by preference shareholders?
2. What factors influence the working capital need in a business? write any three
3. Define Share and write any two advantages of it.
4. Write any two differences between share and debentures.

5. Write any three limitations of equity share capital.

6. Write any three advantages of Retained Earnings

Long Questions –

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

2. What do you mean by owner's fund? When it is not suitable?

3. Write the main advantages and disadvantages of Public Deposits.

4. Comment on the following sources of International finance

(i) I.D.R.

(ii) F.C.C.B

5. ''Ojas Auto Ltd. '' is a very well-known auto company in the industry having more equity share capital than long term debt in its capital structure. It is willing to expand and establish a new unit in the backward region and wants to train the tribal women in skill Development to empower them. It has a huge amount of cash reserve of Rs. 1000 crores.

(a) What is the status of the capital structure of the above company?

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

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

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

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

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

(Hints- ADR and Public Deposits, Employment Generation, Concern for the environment)

Case Study Questions –

1. Read the following text and answer the questions on the basis of the same:

Faulad Steel Ltd. is a multi-product company, manufacturing steel pipes in wide range for wide spectrum of application. Recently the company received a big order from an MNC for which it requires additional funds. The finance manager reported that the company is not in a position to bear extra burden of explicit cost and equity shareholders insisted not to issue more shares as it can affect their control consideration. Now, the company has only one option, i.e., ploughing back of profit.

(i) 'Company is not in a position to bear extra burden of explicit cost.' Identify the meaning of explicit cost in the context of equity shares.

a) Dividend

b) Interest

c) Market value of shares

d) Operating expenses

(ii) Right to control is enjoyed by which of the following sources of finance?

a) Debentures

b) Equity shares

c) Retained earnings

d) Preference shares

(iii) '............. can affect their control consideration.' What is the meaning of control consideration in this context?

a) Control over funds

b) Control over management

c) Control over risks

d) Control over the activities of the company

(iv) In the above case, which of the following sources of finance is most suitable?

a) Shares

b) Debentures

c) Retained earnings

d) Bank loans

2. Read the following text and answer the questions that follow:

Saksham Ltd., a firm manufacturing textiles, needs to finance its day-to-day expenses, like, wages, rent, maintain stock of raw material, etc. Other than this, the company also decides to set up a new plant at an estimated cost of ` 5 crores. The finance manager of the company, Mr. Ramakant was asked by the management to do the financial planning by identifying most suitable source of raising long-term funds for financing the investment decision and short-term sources for working capital decision. As per the suggestions of Mr. Ramakant, the company approached their raw material supplier to give them credit for three months, so that the company can get cloth for making garments without making immediate payment. For long-term investment, the company had issued equity and preference shares to meet its requirement. This decision resulted in payment of large amount of taxes to government as dividend on shares is not deducted from total income of the company before calculating income tax. But this situation could be avoided if company had chosen borrowed funds as a source of finance.

(i) State the source of finance, suggested by Mr. Ramakant to finance working capital decision.

a) Trade credit

b) Public deposits

c) Equity and Preference shares

d) Retained earnings

(ii) State the factors which have not been kept in mind for selecting source of long-term finance.

a) Risk involved

b) Financial capacity of the firm

c) Time period

d) Tax benefits

(iii) State the source of finance which can give the benefit of tax saving.

a) Equity Shares

b) Debentures

c) Both (a) and (b)

d) Neither (a) nor (b)

(iv) Identify the fund needed for the day-to-day operations of business.

a) Working capital

b) Trading capital

c) Equity capital

d) Debt capital

MCQ Answers –

1. Answer: (d) All of the above
2. Answer: (a) American Depository Receipts
3. Answer: (a) July 1948
4. Answer: (a) Trade Credit
5. Answer: (d) Mahindra and Mahindra
6. Answer: (a) Global Depository Receipts
7. Answer: (d) Share Capital
8. Answer: (d) Common stockholder
9. Answer: (d) 1955
10. Answer: (b) It is an Unsecured Debt
11. Answer: (d) All of the above
12. Answer: (b) the Different States

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13.Answer: (a) Use the asset for a specified period

14.Answer: (a) Lease Financing

15.Answer: (b) Commercial paper

Very Short Answers –

1. Answer: In a company, a part of the net incomes is retrained for future use is known as retained earnings. It is used as a source of internal financing, self-financing, or ploughing back of profits.

2. Answer: Risk capital is defined as equity share capital.

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3. Answer: Fixed rate of interest is given to debenture holders for using their funds.

4. Answer: Retained earnings save a portion of the net incomes for future use is retained earnings. The retained earnings have the ability to self-finance and it doesn't involve any explicit cost.

5. Answer: In both public deposits and ADR, the depositors doesn't have a voting right.

6. Answer: The one similar function between preference share capital and equity share capital is that both capitals are a part of the owner's share.

7. Answer: The retained earning is concerned with the redemption and conservation of capital funds in matching the financial need of a company.

8. Answer: The organization which provides both medium and long term loans and has been set up by both the state and central government is the development bank.

9. Answer: The two companies in India offer factoring services are SBI Factors and Commercial Service Ltd.

10. Answer: The two rights of preference shareholder are

- Getting a fixed rate of dividend from the net profit of an organization, before declaring any dividends for equity stockholder.
- At the time of liquidation, receiving funds after the organization creditor's claim has been resolved.

Short Answers –

1. Ans: Preference shareholders have the following preferred rights:

- Preference in Dividend: They receive dividends at a fixed rate, and dividends on these shares are paid before dividends on equity shares.
- Preference in Repayment: When a corporation closes, preference shares are paid out first, followed by equity shares.
- Excess Profits: Preference shares have the right to partake in any excess profits that remain after equity shares have been paid.
- Preference in case of dissolution: They have the preference over equity shareholders

in the share capital refund in the event of company dissolution.

2. Ans: The factors influencing the working capital need in a business are:

- Nature of Business: Manufacturing business requires more working capital as compared to trading business or service provider.
- Business Cycle: During boom period firms require a large amount of working capital to manage the increased sales and production.
- Seasonal Factors: Seasonal businesses require more working capital during their season time.
- Scale of Operations: Businesses operating on a large scale require larger amounts of working capital as compared to small business firms.
- Credit Allowed: A business extending a longer credit period to its buyers will need more working capital as compared to a business doing cash business or offering a lesser credit period.
- Production Cycle: Businesses with longer production cycles require more working capital as compared to businesses with short-term production cycles.
- Credit Availed: A business organisation receiving longer credit period from their supplier will require lesser working capital as compared to business purchases goods for cash or receive short credit period.

3. Ans: A company needs huge investments to start a business, this amount is known as capital. Since, it is impossible for one individual to bring in such a huge amount of capital, the entire capital is divided into small units known as shares, where each person holding shares is referred to as a shareholder.

Advantages

- It serves as permanent capital as it has to be repaid at the time of liquidation.
- Democratic control over the management of the company is given to shareholders through voting rights.
- Equity capital establishes a company's creditworthiness and gives prospective loan providers trust.

4. Ans: The difference between shares and debentures are:

Basis	Shares	Debentures
Meaning	Owners' funds are referred to as shares	Borrowed funds are referred to as debentures

Returns	In the case of shares, the dividend payment is not fixed, and is based on the profits of the company	In the case of debentures, the corporation pays a fixed rate of interest.

5. Ans: The three limitations of equity share capital are:

- The returns are fluctuating in nature so investors who need steady income may not prefer equity shares.
- Cost of raising funds from equity shares is quite high as compared to other sources.
- It is more of a complicated process and may take longer time to raise funds.
- The issuance of additional equity shares dilutes current equity shareholders' voting power and earnings.

6. Ans: The Merits of Retained Earnings are:

- No initial fees: These funds are not subject to any explicit fees, such as floatation costs or interest, because they are raised internally.
- Positive share price: A large quantity of retained earnings can cause the price of equity shares to rise.
- Loss Absorption: Because these are surplus profits retained in the business, they serve to mitigate the impact of unanticipated losses.

Long Answers -

1. Ans: Financial Institutions

There are numerous financial institutions established by the government of India across the country. These institutions finance the businesses and are set up by both state and central governments. There are development banks especially established to promote industrial development in the country.

Merits

- Provide long term funds which are not provided by the commercial banks
- Provide various services such as managerial advice, financial and technical advice to the companies.
- Increases the goodwill of the borrowing company in the capital markets.
- Funds can be made available even at the time of contingency and can be paid in easy installment without being a burden to the company.

2. Ans: Funds provided by the owners of the organization are known as Owners' funds. It includes profits that are reinvested into the business. The important sources of owners' funds are

- Retained earnings
- Issue of equity shares.

Fukey Education

The non-suitability of using owner's funds is based on the following factors:

- Dilution of Control: The choice of what source from which financing has to be procured also depends upon the extent to which firm is ready for the dilution of control. Such as if existing equity shareholders aren't willing to dilute the control they enjoy, in such a case the company may issue finance from sources other than equity share capital.
- Tax Advantages: Some sources of finance are tax deductible, and hence firms can enjoy tax advantage using those sources. For example interest on debentures is a tax deductible expense, hence firms wanting to enjoy tax benefits may go for these sources. In such a situation, using the owners' fund is not suitable.
- Cost: There are two types of costs: the cost of obtaining funds and the cost of putting these funds to use. Both of these costs should be considered when deciding on a funding source. If the cost of the owner's fund exceeds the prospective returns, it should not be issued.
- Cash Flow Position: Before raising finance business must consider the projected flow to ensure that it has sufficient cash to pay fixed cash obligations. A company with high liquidity and a good cash flow position can issue debt capital, as the company will have less chances of facing financial risk than the company with a low cash position.
- Purpose and time frame: The business should plan for the time frame in which the finances are needed. A short-term requirement, for example, can be addressed by borrowing cash at a low-interest rate via trade credit, commercial paper, or other means. Long-term financing is best accomplished through the issuance of shares and debentures.
- Stock Market Conditions: If the stock market is flourishing, and there is a condition of boom then the companies may prefer more equity over debt in the capital structure. However, in the case of a bear market, to avoid any more risks, the companies will prefer more debt over equity in the capital structure.
- Ease of issuance of finance: The flexibility and ease with which the firm is able to procure finance also affects the choice of source of finance. Excessive documents, legal restrictions, heavy investigation and other reasons may discourage the company from using a particular source of finance. Hence, if the issue of such a source is difficult, the firm should not go for it.

Ans: Public deposits:

Organizations raise public deposits from the general public to fund their short- term and medium-term financial needs. The interest rate on these deposits is usually higher than the interest rate on bank deposits. If a person wishes to invest in a business (by making a deposit), he or she must complete and submit a required form together with the deposit. The organization issues a deposit receipt as a mark of debt acknowledgment in exchange for the money borrowed.

Merits of Public Deposits:

Fukey Education

- Minimal Restrictions: Accepting public deposits as a means of raising funds is a straightforward process with minimal restrictions.
- Low cost: The cost of raising funds through public deposits is generally lower than the cost of borrowing money from a commercial bank.
- No dilution of control: There are no voting or management rights for depositors. As a result, accepting public deposits does not affect the business's ownership structure.

Demerits of Public Deposits:

- Restricted financing: The quantity of money that may be raised from public deposits is restricted because it is dependent on the availability of capital and people's desire to invest in the company in question.
- Not suitable for new firms: Because people have little faith in new businesses, it is difficult for them to raise capital through public deposits.

4. Ans: (i) An Indian Depository Receipt (IDR) is a financial instrument in the form of a Depository Receipt that is denominated in Indian Rupees. An Indian Depository creates it for a foreign firm to raise capital from the Indian securities market. IDRs are issued to Indian residents in the same way that domestic shares are issued, according to SEBI norms. Residents can bid in the same style and technique as they can for Indian shares when the issuer company makes a public offering in India.

(ii) FCCB (Foreign Currency Convertible Bonds) are debt securities with an equity component that can be converted into equity or depository receipts after a set length of time. FCCB holders can choose to convert their bonds into equity shares at a predetermined price or exchange rate or keep the bonds. They have a fixed interest rate that is lower than any other non-convertible debt instrument with a similar interest rate. FCCBs are listed on overseas stock exchanges and traded there.

5. Ans: (a) The company's financial structure is robust, with more equity share capital than long-term debt in its capital structure and a large cash reserve.

(b) As the company has huge cash reserves with itself, it should use retained earnings, or the self-financing technique for the establishment of new unit

When a company earns profit, a certain amount or percentage of those profits is retained within the business for future use and this is known as retained earnings. When the business is financed through this source it is known as ploughing back of profit or internal financing. Retained earnings is a percentage of net earnings that is kept in the business for future usage.

Reasons

- No initial fees: These funds are not subject to any explicit fees, such as floatation costs or interest, because they are raised internally.
- Positive share price: A large quantity of retained earnings can cause the price of equity shares to rise.
- Loss Absorption: Because these are surplus profits retained in the business, they serve

to mitigate the impact of unanticipated losses.

(c) The following values are displayed by the company:

- Balanced Regional Development: The company is willing to expand and open new units in underdeveloped areas, and it contributes to regional development.
- Women Empowerment: The company intends to empower indigenous women by training them in skill development.

6. Ans: (a) ADR and Public Deposits can be used to satisfy the company's needs.

- Public Deposits: Public deposits are deposits that are raised directly from the public by organizations. While depositors receive a greater interest rate than banks, the cost of deposits to the company is lower than the cost of bank borrowings. RBI is in charge of regulating it. Companies typically solicit public contributions over a three-year term.
- ADR (American Depository Receipt): This instrument is issued by the American companies and can be traded in American markets. It can be issued to only citizens of America and can only be traded in US stock exchanges. This instrument is like a regular stock which is purchased and sold in American markets.

(b) The following values are demonstrated by the company:

Environmental stewardship: The company uses solar power to generate 50% of its office electricity. As a result, resources are conserved.

Employment Generation: The company is committed to teaching and employing underprivileged youngsters, hence creating job possibilities for them.

Case Study Answers –

1.

(i) d) Operating expenses

Solution: Explicit costs are typical business costs which appear in the general ledger and have a direct impact on the profitability of a company. Examples of explicit costs include salaries, raw materials, utilities, lease payments, and other direct costs.

(ii) b) Equity shares

Solution: Equity shares are long-term financing sources for any company. These shares are issued to the general public and are non-redeemable in nature. Investors in such shares hold the right to vote, share profits and claim assets of a company.

(iii) a) Control over funds

Solution: Control Consideration means the amount per Company Share to be received by Company Shareholders in connection with a Change of Control Transaction, with any non-cash consideration valued as determined by the value ascribed to such consideration by the parties to such transaction.

(iv) c) Retained earnings

Solution: Retained earnings (RE) is the amount of net income left over for the business after it has paid out dividends to its shareholders. The decision to retain the earnings or distribute them among the shareholders is usually left to the company management.

2.

(i) a) Trade credit

Solution:

• Trade credit is the loan extended by one trader to another when the goods and services are bought on credit.

• Trade credit facilitates the purchase of supplies without immediate payment.

• Trade credit is commonly used by business organizations as a source of short-term financing.

(ii) d) Tax benefits

Solution:

• Long-term finance can be defined as any financial instrument with maturity exceeding one year (such as bank loans, bonds, leasing and other forms of debt finance), and public and private equity instruments.

• Equity, which has no final repayment date of a principal, can be seen as an instrument with non finite maturity.

(iii) b) Debentures

Solution:

• Debentures are a debt instrument used by companies and government to issue the loan.

• Debentures are also known as a bond which serves as an IOU between issuers and purchaser.

• Companies use debentures when they need to borrow the money at a fixed rate of interest for its expansion.

(iv) a) Working capital

Solution:

Working capital is the money used to cover all of a company's short-term expenses, which are due within one year. Working capital is the difference between a company's current assets and current liabilities. Working capital is used to purchase inventory, pay short-term debt, and day-to-day operating expenses.