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Exercises

Multiple Choice Questions:

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

1. Equity shareholder are called
(a) Owners of the company
(b) Partners of the company
(c) Executives of the company
(d) Guardian of the company
► (a) Owners of the company

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

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
► (c) Working capital requirement

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

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

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 organisation
(c) Use the asset for a specific period
(d) Sell the assets
► (c) Use the asset for a specific period

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
► (d) Loan capital of the company

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
► (c) Collects the client's debt or account receivables

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
► (d) 90 to 364 days

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10. Internal sources of capital are those that are
(a) generated through outsiders such as suppliers
(b) generated through loans from commercial papers
(c) generated through issue of shares
(d) generated within the business
► (d) generated within the business

Short Answer Questions

1. What is business finance? Why do businesses need funds? Explain.

Answer

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

The business need funds for:

→ Fixed capital requirements: In order to start business, funds are required to purchase fixed assets like land and building, plant and machinery, and furniture and fixtures. The funds required in fixed assets remain invested in the business for a long period of time.

→ Working Capital requirements: Firms require funds for financing their day-to-day operations such as purchase of raw materials and payment of wages to workers. The requirement of funds for such operations is known as the working capital requirement.

2. List sources of raising long-term and short-term finance.

Answer

Sources of long-term-finance are:

- Equity shares
- Retained earnings

- Preference shares
- Debentures
- Loans from financial institutions
- Loan from Banks

Sources of short-term-finance

- Trade credit
- Factoring
- Banks
- Commercial paper

3. What is the difference between the internal and external sources of raising funds? Explain.

Answer

Internal Sources	External Sources
Internal sources of funds are those that are generated within a business.	External sources of funds includes those source that lie outside the organisation such as the suppliers, creditors, investors, banks and financial institutions.
Accelerating collection of receivables, disposing of surplus inventories and ploughing back of profit are examples of these funds.	Issue of debentures, borrowing from commercial banks and financial institutions and accepting public deposits are examples of these funds.
The internal sources of funds can only fulfill limited needs of the business.	Large amount of money can be raised through external sources.

4. What preferential rights are enjoyed by preference shareholders? Explain.

Answer

The preference shareholders enjoy a preferential position over equity shareholders by:

→ They receive a fixed rate of dividend, out of the net profits of the company, before any dividend is declared for equity shareholders;

→ They receive their capital after the claims of the company's creditors have been settled, at the time of liquidation.

5. Name any three special financial institutions and state their objectives.

Answer

Financial institutions and their objectives:

→ Industrial Finance Corporation of India (IFCI): Its objectives include assistance towards balanced regional development and encouraging new entrepreneurs to enter into the priority sectors of the economy. IFCI has also contributed to the development of management education in the country.

→ Unit Trust of India (UTI): The basic objective of UTI is to mobilise the community's savings and channelise them into productive ventures. Therefore, it sanctions direct assistance to industrial concerns, invests in their shares and debentures, and participates with other financial institutions.

→ Industrial Credit and Investment Corporation of India (ICICI): It assists the creation, expansion and modernisation of industrial enterprises exclusively in the private sector. The corporation has also encouraged the participation of foreign capital in the country.

6. What is the difference between GDR and ADR? Explain.

Answer

Global Depository Receipts (GDR) are the depository receipts denominated in US dollars issued by depository bank to which the local currency shares of a company are delivered. GDR is a negotiable instrument and can be traded freely like any other security. In the Indian context, a GDR is an instrument issued abroad by an Indian company to raise funds in some foreign currency and is listed and traded on a foreign stock exchange.
American Depository Receipts (ADR) are depository receipts issued by a

company in the USA. ADRs are bought and sold in American markets like regular stocks. ADR is similar to a GDR except that it can be issued only to American citizens and can be listed and traded on a stock exchange of USA.

Long Answer Questions

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

Answer

Trade credit is the credit extended by one trader to another for the purchase of goods and services. Trade credit facilitates the purchase of supplies without immediate payment. Trade credit is commonly used by business organisations as a source of short-term financing. It is granted to those customers who have reasonable amount of financial standing and goodwill.

• Merits of trade credit as a source of short-term finance:
→ Trade credit helps a company to finance the accumulation of inventories for meeting future increase in sales.
→ As the trade creditors do not have any rights over the assets of the company, it can mortgage its assets to raise money from other sources.

• Demerits of trade credit as a source of short-term finance:
→ Easy availability of trade credit can result in overtrading, which in turn increases the future liabilities of the buyer.
→ The amount of funds that can be generated through trade credit is limited to the financial capacity of the supplier or the creditor.

Bank credit: Banks all over the world extend foreign currency loans for business purposes. They are an important source of financing non-trade international operations. The types of loans and services provided by banks vary from country to country.

• Merits of bank credit as a source of short-term finance:
→ Banks maintain secrecy over information related to their customers.
→ Bank credit provides flexibility to the borrower as the borrower can increase or decrease the amount of loan according to the business needs.

• Demerits of bank credit as a source of short-term finance:
→ It is difficult to increase the loan.
→ The terms imposed by banks are often very restrictive as example, the bank that has granted a loan may restrict the sale of goods mortgaged to it by the borrower.

2. Discuss the sources from which a large industrial enterprise can raise capital for financing modernisation and expansion.

Answer

Many financial institutions are created both by central and state governments for financing is when
large funds are required for expansion, reorganisation and modernisation of the enterprise. These are:

→ Industrial Finance Corporation of India (IFCI): It was established in July 1948 as a statutory corporation under the Industrial Finance

Corporation Act, 1948. Its objectives include assistance towards balanced regional development and encouraging new entrepreneurs to enter into the priority sectors of the economy. IFCI has also contributed to the development of management education in the country.

→ State Financial Corporations (SFC): The State Financial Corporations Act, 1951 empowered the State Governments to establish State Financial Corporations in their respective regions for providing medium and short term finance to industries which are outside the scope of the IFCI. Its scope is wider than IFCI, since the former covers not only public limited companies but also private limited companies, partnership firms and proprietary concerns.

→ Industrial Credit and Investment Corporation of India (ICICI): This was established in 1955 as a public limited company under the Companies Act. ICICI assists the creation, expansion and modernisation of industrial enterprises exclusively in the private sector. The corporation has also encouraged the participation of foreign capital in the country.

→ Industrial Development Bank of India (IDBI): It was established in 1964 under the Industrial Development Bank of India Act, 1964 with an objective to coordinate the activities of other financial institutions including commercial banks. The bank performs three types of functions, namely, assistance to other financial institutions, direct assistance to industrial concerns, and promotion and coordination of financial-technical services.

→ State Industrial Development Corporations (SIDC): Many state governments have set up State Industrial Development Corporations for the purpose of promoting industrial development in their respective states. The objectives of the SIDCs differ from one state to another.

→ Unit Trust of India (UTI): It was established by the Government of India in 1964 under the Unit Trust of India Act, 1963. The basic objective of UTI is to mobilise the community's savings and channelise them into productive ventures. For this purpose, it sanctions direct assistance to industrial concerns, invests in their shares and debentures, and participates with other financial institutions.

→ Industrial Investment Bank of India Ltd.: It was initially set up as a primary agency for rehabilitation of sick units and was known as Industrial Reconstruction Corporation of India. It was reconstituted and renamed as the Industrial Reconstruction Bank of India in 1985 and again in 1997 its name was changed to Industrial Investment Bank of India. The Bank assists sick units in the reorganisation of their share capital, improvement in management system, and provision of finance at liberal terms.

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

3. What advantages does issue of debentures provide over the issue of equity shares?

Answer

Debentures are long term debts by which a company can raise funds 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.

The advantage of issue of debentures over the issue of equity shares are:

→ The issue of equity shares means dilution of ownership of a firm while debentures holders do not have any rights in the company. They do not enjoy voting rights or any kind of ownership in the firm. They are only entitled to a fixed amount as payment.

→ For issuing shares a company has to incur huge costs. Also, it has to pay dividends to its shareholders, which are not tax deductible while a company receives tax deductions on the interest paid to its debenture holders. Therefore, issuing debentures is advantageous for a firm in terms of low costs.

→ Debentures carry a fixed rate of return which means that irrespective of the profit earned, the company has to pay only a fixed interest to its debenture holders while a company that issues shares has to pay dividends to the shareholders, which varies with the profit i.e., the higher the profit, the higher will be the dividends.

4. State the merits and demerits of public deposits and retained earnings as methods of business finance.

Answer

Public Deposits
The deposits that are raised by organisations directly from the public are known as public deposits. Rates of interest offered on public deposits are usually higher than that offered on bank deposits. Any person who is interested in depositing money in an organisation can do so by filling up a prescribed form. The organisation in return issues a deposit receipt as acknowledgment of the debt.

• Merits of Public deposits are:

→ The procedure of obtaining deposits is simple and does not contain restrictive conditions as are
generally there in a loan agreement
→ Cost of public deposits is generally lower than the cost of borrowings from banks and financial
institutions
→ 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
→ As the depositors do not have voting rights, the control of the company is not diluted.

• Demerits of Public deposits are:
→ New companies generally find it difficult to raise funds through public deposits
→ It is an unreliable source of finance as the public may not respond when the company needs money
→ Collection of public deposits may prove difficult, particularly when the size of deposits required is large.

Retained earnings
Business enterprise keep a portion of the net earnings may be retained in the business for use in the future. This is known as retained earnings. It is a source of internal financing or self- financing or ‘ploughing back of profits’.

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

• Demerits of Retained earnings are:
→ Excessive ploughing back may cause dissatisfaction amongst the shareholders as they would get lower dividends;
→ It is an uncertain source of funds as the profits of business are fluctuating;
→ The opportunity cost associated with these funds is not recognised by many firms. This may lead to sub-optimal use of the funds.

5. Discuss the financial instruments used in international financing.

Answer

The financial instruments used in international financing are:

→ Global Depository Receipts (GDRs): These are receipts issued by depository banks against the shares of a company. Such depository receipts denominated in US dollars are known as Global Depository Receipts (GDR). GDR is a negotiable instrument and can be traded freely like any other security. In the Indian context, a GDR is an instrument issued abroad by an Indian company to raise funds in some foreign currency and is listed and traded on a foreign stock exchange.

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

→ Foreign Currency Convertible Bonds (FCCBs): These bonds are debt securities that are convertible into equity shares or depository receipts after a specific period of time. The terms and prices of such conversions are generally specified in advance. The return on such securities is pre-fixed and lower than the return on non-convertible securities.

6. What is a commercial paper? What are its advantages and limitations.

Answer

Commercial paper is an unsecured promissory note issued by a firm to raise funds for a short period, varying from 90 days to 364 days. It is issued by one firm to other business firms, insurance companies, pension funds and banks. The amount raised by CP is generally very large. As the debt is totally unsecured, the firms having good credit rating can issue the CP. Its regulation comes under the purview of the

Reserve Bank of India.

• Advantages of Commercial paper are:
→ A commercial paper is sold on an unsecured basis and does not contain any restrictive conditions;
→ As it is a freely transferable instrument, it has high liquidity;
→ 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;
→ 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;
→ Companies can park their excess funds in commercial paper thereby earning some good return on the same.

• Limitations of Commercial paper are:
→ 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.
→ 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;
→ 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