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BUSINESS FINANCE (Important question answer)

Question 6:

What is the difference between GDR and ADR? Explain.

ANSWER:

The abbreviation 'GDRs' refers to 'Global Depository Receipts', which are issued by depository banks against the shares of a company—for instance, the shares issued by an Indian company abroad in order to raise foreign currency. Global Depository Receipts are usually denoted in US dollars and can easily be converted into shares at any time. They can be listed and traded on the stock exchange of any country other than the US. On the other hand, ADRs, or American Depository Receipts, are receipts of companies based in the US. They are traded like any other securities in the market. However, the trading of ADRs is restricted only to the US securities markets, and these instruments can be sold to US citizens only.

Question 7:

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

ANSWER:

Trade credit: It refers to the credit extended by the supplier to the purchaser of goods or services. It promotes the purchase of goods and services as the purchaser need not make immediate cash payments if trade credit is extended. Trade credits are granted only to customers or traders who are considered to be creditworthy by the supplier.

Merits of trade credit as a source of short-term finance:

(a) Trade credit helps a company to finance the accumulation of inventories for meeting future increase in sales.

(b) 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:

(a) Easy availability of trade credit can result in overtrading, which in turn increases the future liabilities of the buyer.

(b) 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: Bank credit is a loan advanced by a bank to a business firm. The interest charged by the bank on the loan usually depends on the interest rate prevailing in the economy. The borrower needs to mortgage assets with the bank to secure the loan.

Merits of bank credit as a source of short-term finance:

(a) Banks maintain secrecy over information related to their customers.

(b) 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:

(a) It is difficult to increase the loan.

(b) The terms imposed by banks are often very restrictive—for example, the bank that has granted a loan may restrict the sale of goods mortgaged to it by the borrower.

Question 8

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

ANSWER:

The following are some of the sources of long-term funds.

(a) ***Equity shares:*** These shares represent the ownership capital of a company. The holders of such shares are known as equity share holders and enjoy a say in the management and gain higher returns when the profits are higher. They are also called the owners of the company, or residual owners, since payments to them are made only after paying the external debts or claims.

(b) ***Retained earnings:*** Firms generally keep a certain fraction or part of their profits before distributing dividends to their shareholders. These undistributed profits are known as retained earnings because the funds are kept for future use.

(c) ***Preference shares:*** These types of shares provide the shareholders a preferential right regarding the repayment of capital and payment of earnings after a certain specified period of time. Such repayment to the preference share holders is made in accordance with the terms specified in Section 80 of the Companies Act, 1956.

(d) ***Debentures:*** Debentures are financial instruments used by companies to raise long-term debt capital. They imply that a company has borrowed a certain sum of money which it will repay later to the debenture holders. Just like loans, they carry a fixed rate of return and specify in advance the time for repayment of the debts.

(e) ***Loans from banks and other financial institutions:*** Business enterprises can borrow funds for a fixed period of time from banks and financial institutions in return for a fixed periodic payment called interest. The time for repayment of such a loan is fixed and is stated in advance at the time of granting the loan.

Question 9

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

ANSWER:

Debentures are financial instruments used by companies to raise long-term debt capital. They imply that the company has borrowed a certain sum of money which it will repay later to the debenture holders. They are considered as fixed income securities as they carry a fixed rate of return and are repayable on a certain pre-specified date in the future.

The following are the advantages of issuing debentures over issuing equity shares.

(a) The issue of equity shares denotes the dilution of ownership of a firm. This is because the equity share holders own specified shares of the company and have voting rights. In contrast, debenture holders do not have any rights in the company. That is, they do not enjoy voting rights or any kind of ownership in the firm. Rather, they are only entitled to a fixed amount as payment. Thus, debentures do not result in any kind of dilution of ownership of the firm. Thus, issuing debentures is more advantageous for a firm than issuing equity shares.

(b) In order to issue shares, a company has to incur huge costs. Besides, it has to pay dividends to its shareholders, which are not tax deductible. On the other hand, a company receives tax deductions on the interest paid to its debenture holders. Hence, issuing debentures is advantageous for a firm in terms of low costs.

(c) Debentures carry a fixed rate of return. This implies that irrespective of the profit earned, the company has to pay only a fixed interest to its debenture holders. On the other hand, 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. Thus, companies prefer to issue debentures if they expect to earn higher profits in a year.

Question 10

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

ANSWER:

Public deposits: Organisations raise public deposits directly from the public to finance their short-term as well as medium-term financial requirements. The rate of return on such deposits is generally higher than the return paid on bank deposits. In case a person is interested in investing in a business (by depositing money), then he or she can submit a prescribed form along with the deposit. In return for this sum borrowed, the organisation issues a deposit receipt as a token of acknowledgment of the debt.

Merits of Public Deposits

(a) Raising money by accepting public deposits is a very simple process with few regulations involved.

(b) The cost of raising funds by accepting public deposits is generally lower than the cost involved in borrowing loans from commercial banks.

(c) The depositors do not have any voting or management rights. Thus, acceptance of public deposits does not result in any dilution of ownership of the business.

Demerits of Public Deposits

(a) The amount of money that can be raised from public deposits is limited as it depends on the availability of funds and the willingness of people to invest in the company concerned.

(b) Generally, it is difficult for new companies to raise capital through public deposits as people lack faith in them.

(c) When a firm has huge capital requirements, it may face difficulty in borrowing funds through the issue of public deposits.

Retained Earnings: Firms usually keep a certain part of the profits earned before distributing dividends to their shareholders. These undistributed profits are retained in the business for future use and are known as retained earnings.

Merits of Retained Earnings

(a) As these funds are raised internally, they do not involve any kind of explicit costs, such as floatation cost and interest.

(b) High amounts of retained earnings can lead to an increase in the price of equity shares.

(c) Since these are surplus profits retained in the business, they help in reducing the burden of unexpected losses.

Demerits of Retained Earnings

(a) Retained earnings are an uncertain source of finance as the business profits keep fluctuating from time to time.

(b) In case a firm reinvests a large portion of profits in the business, then very little funds are left for payments to the shareholders, and this creates dissatisfaction among them.

(c) Firms often fail to recognise the opportunity cost of the earnings retained in the business. As a result, these funds are often misused or sub-optimally used.

Question 11

Discuss the financial instruments used in international financing.

ANSWER:

International financing mainly uses three types of financial instruments.

(a) ***Global Depository Receipts (GDRs):*** These are receipts issued by depository banks against the shares of a company—for instance, the shares issued by an Indian company abroad in order to raise foreign currency. Global Depository Receipts are usually denoted in US dollars and can easily be converted into shares at any time. They can be listed and traded on the stock exchange of any country other than the US.

(b) ***American Depository Receipts (ADRs):*** These are receipts of companies based in the US. They are usually traded like any other securities in the market. However, such trading is restricted to the US securities markets only. In addition, ADRs are sold only to US citizens.

(c) ***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.