# 5 Types of Financing

**BASIC CONCEPTS**

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| **1. Sources of Funds** | There are several sources of finance/funds available to any company. Some of the parameters that need to be considered while choosing a source of fund are:<br>• Cost of source of fund<br>• Tenure<br>• Leverage planned by the company<br>• Financial conditions prevalent in the economy<br>• Risk profile of both the company as well as the industry in which the company operates. |
| **2. Categories of Sources of Funds** | **(i) Long term**<br>Refer to those requirements of funds which are for a period exceeding 5 -10 years. All investments in plant, machinery, land, buildings, etc., are considered as long term financial needs.<br>▪ Share capital or Equity share<br>▪ Preference shares<br>▪ Retained earnings<br>▪ Debentures/Bonds of different types<br>▪ Loans from financial institutions<br>▪ Loans from State Financial Corporation<br>▪ Loans from commercial banks<br>▪ Venture capital funding<br>▪ Asset securitisation<br>▪ International financing like Euro-issues, Foreign currency loans<br>**(ii) Medium term**<br>Refer to those funds which are required for a period exceeding one year but not exceeding 5 years.<br>▪ Preference shares |

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| | ▪ Debentures/Bonds<br>▪ Public deposits/fixed deposits for duration of three years<br>▪ Commercial banks<br>▪ Financial institutions<br>▪ State financial corporations<br>▪ Lease financing/Hire-Purchase financing<br>▪ External commercial borrowings<br>▪ Euro-issues<br>▪ Foreign Currency bonds<br>**(iii) Short term**<br>Investment in these current assets such as stock, debtors, cash, etc. assets is known as meeting of working capital requirements of the concern. The main characteristic of short term financial needs is that they arise for a short period of time not exceeding the accounting period. i.e., one year.<br>▪ Trade credit<br>▪ Accrued expenses and deferred income<br>▪ Commercial banks<br>▪ Fixed deposits for a period of 1 year or less<br>▪ Advances received from customers<br>▪ Various short-term provisions |
| **3. Some Important Sources of Finance Defined** | • **Venture Capital Financing:** It refers to financing of new high risky venture promoted by qualified entrepreneurs who lack experience and funds to give shape to their ideas.<br>• **Securitisation**: It is a process in which illiquid assets are pooled into marketable securities that can be sold to investors.<br>• **Leasing:** It is a very popular source to finance equipments. It is a contract between the owner and user of the asset over a specified period of time in which the asset is purchased initially by the lessor (leasing company) and thereafter leased to the user (Lessee Company) who pays a specified rent at periodical intervals.<br>• **Trade Credit:** It represents credit granted by suppliers of goods, etc., as an incident of sale.<br>• **Commercial Paper:** A Commercial Paper is an unsecured money market instrument issued in the form of a |

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| | promissory note.<br>• **Export Finance:** To support export, the commercial banks provide short term export finance mainly by way of pre and post-shipment credit.<br>• **Certificate of Deposit (CD):** The certificate of deposit is a document of title similar to a time deposit receipt issued by a bank except that there is no prescribed interest rate on such funds.<br>• **Seed Capital Assistance:** The Seed capital assistance scheme is designed by IDBI for professionally or technically qualified entrepreneurs and/or persons possessing relevant experience, skills and entrepreneurial traits.<br>• **Deep Discount Bonds:** Deep Discount Bonds is a form of zero-interest bonds. These bonds are sold at a discounted value and on maturity face value is paid to the investors. In such bonds, there is no interest payout during lock in period.<br>• **Secured Premium Notes*:*** Secured Premium Notes is issued along with a detachable warrant and is redeemable after a notified period of say 4 to 7 years.<br>• **Zero Coupon Bonds:** A Zero Coupon Bonds does not carry any interest but it is sold by the issuing company at a discount.<br>• **External Commercial Borrowings(ECB) :** ECBs refer to commercial loans (in the form of bank loans, buyers credit, suppliers credit, securitised instruments (e.g. floating rate notes and fixed rate bonds) availed from non resident lenders with minimum average maturity of 3 years.<br>• **Euro Bonds:** Euro bonds are debt instruments which are not denominated in the currency of the country in which they are issued.<br>• **Foreign Bonds:** These are debt instruments issued by foreign corporations or foreign governments.<br>• **American Depository Deposits (ADR) :** These are securities offered by non-US companies who want to list on any of the US exchange. Each ADR represents a certain number of a company's regular shares. ADRs allow US investors to buy shares of these companies without the costs of investing directly in a foreign stock exchange. |

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| | • **Global Depository Receipt (GDRs):** These are negotiable certificate held in the bank of one country representing a specific number of shares of a stock traded on the exchange of another country. These financial instruments are used by companies to raise capital in either dollars or Euros.<br>• **Indian Depository Receipts (IDRs):** IDRs are similar to ADRs/GDRs in the sense that foreign companies can issue IDRs to raise funds from the Indian Capital Market in the same lines as an Indian company uses ADRs/GDRs to raise foreign capital. |

Question 1

*Explain the importance of trade credit and accruals as source of working capital. What is the cost of these sources?*

Answer

Trade credit and accruals as source of working capital refers to credit facility given by suppliers of goods during the normal course of trade. It is a short term source of finance. SSI firms in particular are heavily dependent on this source for financing their working capital needs. The major advantages of trade credit are – easy availability, flexibility and informality.

There can be an argument that trade credit is a cost free source of finance. But it is not. It involves implicit cost. The supplier extending trade credit incurs cost in the form of opportunity cost of funds invested in trade receivables. Generally, the supplier passes on these costs to the buyer by increasing the price of the goods or alternatively by not extending cash discount facility.

Question 2

*What is debt securitisation? Explain the basics of debt securitisation process.*

Answer

Debt Securitisation: It is a method of recycling of funds. It is especially beneficial to financial intermediaries to support the lending volumes. Assets generating steady cash flows are packaged together and against this asset pool, market securities can be issued, e.g. housing finance, auto loans, and credit card receivables.

Process of Debt Securitisation

(i) *The origination function* – A borrower seeks a loan from a finance company, bank, HDFC. The credit worthiness of borrower is evaluated and contract is entered into with repayment schedule structured over the life of the loan.

(ii) *The pooling function* – Similar loans on receivables are clubbed together to create an underlying pool of assets. The pool is transferred in favour of Special purpose Vehicle (SPV), which acts as a trustee for investors.

(iii) *The securitisation function* – SPV will structure and issue securities on the basis of asset pool. The securities carry a coupon and expected maturity which can be asset-based/mortgage based. These are generally sold to investors through merchant bankers. Investors are – pension funds, mutual funds, insurance funds.

The process of securitization is generally without recourse i.e. investors bear the credit risk and issuer is under an obligation to pay to investors only if the cash flows are received by him from the collateral. The benefits to the originator are that assets are shifted off the balance sheet, thus giving the originator recourse to off-balance sheet funding.

Question 3

*Discuss the risk-return considerations in financing of current assets.*

Answer

The financing of current assets involves a trade off between risk and return. A firm can choose from short or long term sources of finance. Short term financing is less expensive than long term financing but at the same time, short term financing involves greater risk than long term financing.

Depending on the mix of short term and long term financing, the approach followed by a company may be referred as matching approach, conservative approach and aggressive approach.

In matching approach, long-term finance is used to finance fixed assets and permanent current assets and short term financing to finance temporary or variable current assets. Under the conservative plan, the firm finances its permanent assets and also a part of temporary current assets with long term financing and hence less risk of facing the problem of shortage of funds.

An aggressive policy is said to be followed by the firm when it uses more short term financing than warranted by the matching plan and finances a part of its permanent current assets with short term financing.

Question 4

*Discuss the eligibility criteria for issue of commercial paper.*

Answer

Eligibility criteria for issuer of commercial paper

The companies satisfying the following conditions are eligible to issue commercial paper.

- The tangible net worth of the company is ₹ 5 crores or more as per audited balance sheet of the company.

- The fund base working capital limit is not less than ₹ 5 crores.
- The company is required to obtain the necessary credit rating from the rating agencies such as CRISIL, ICRA etc.
- The issuers should ensure that the credit rating at the time of applying to RBI should not be more than two months old.
- The minimum current ratio should be 1.33:1 based on classification of current assets and liabilities.
- For public sector companies there are no listing requirement but for companies other than public sector, the same should be listed on one or more stock exchanges.
- All issue expenses shall be borne by the company issuing commercial paper.

Question 5

*Write short notes on the following:*

*(a) Global Depository Receipts or Euro Convertible Bonds.*

*(b) American Depository Receipts (ADRs)*

*(c) Bridge Finance*

*(d) Methods of Venture Capital Financing*

*(e) Advantages of Debt Securitisation*

*(f) Deep Discount Bonds vs. Zero Coupon Bonds*

*(g) Venture capital financing*

*(h) Seed capital assistance*

*(i) Global Depository Receipts vs. American Depository Receipts.*

*(j) Floating Rate Bonds*

*(k) Packing Credit*

Answer

(a) Global Depository Receipts (GDRs): It is a negotiable certificate denominated in US dollars which represents a Non-US company's publically traded local currency equity shares. GDRs are created when the local currency shares of an Indian company are delivered to Depository's local custodian Bank against which the Depository bank issues depository receipts in US dollars. The GDRs may be traded freely in the overseas market like any other dollar-expressed security either on a foreign stock exchange or in the over-the-counter market or among qualified institutional buyers.

By issue of GDRs Indian companies are able to tap global equity market to raise foreign currency funds by way of equity. It has distinct advantage over debt as there is no repayment of the principal and service costs are lower.

(or)

Euro Convertible Bond: Euro Convertible bonds are quasi-debt securities (unsecured) which can be converted into depository receipts or local shares. ECBs offer the investor an option to convert the bond into equity at a fixed price after the minimum lock in period. The price of equity shares at the time of conversion will have a premium element. The bonds carry a fixed rate of interest. These are bearer securities and generally the issue of such bonds may carry two options viz. call option and put option. A call option allows the company to force conversion if the market price of the shares exceeds a particular percentage of the conversion price. A put option allows the investors to get his money back before maturity. In the case of ECBs, the payment of interest and the redemption of the bonds will be made by the issuer company in US dollars. ECBs issues are listed at London or Luxemburg stock exchanges.

An issuing company desirous of raising the ECBs is required to obtain prior permission of the Department of Economic Affairs, Ministry of Finance, Government of India, Companies having 3 years of good track record will only be permitted to raise funds. The condition is not applicable in the case of projects in infrastructure sector. The proceeds of ECBs would be permitted only for following purposes:

(i) Import of capital goods

(ii) Retiring foreign currency debts

(iii) Capitalising Indian joint venture abroad

(iv) 25% of total proceedings can be used for working capital and general corporate restructuring.

The impact of such issues has been to procure for the issuing companies' finances at very competitive rates of interest. For the country a higher debt means a forex outgo in terms of interest.

(b) American Depository Receipts (ADRs): American Depository Receipts (ADRs) are securities offered by non- US companies who want to list on any of the US exchanges. It is a derivative instrument. It represents a certain number of company's shares. These are used by depository bank against a fee income. ADRs allow US investors to buy shares of these companies without the cost of investing directly in a foreign stock exchange. ADRs are listed on either NYSE or NASDAQ. It facilitates integration of global capital markets. The company can use the ADR route either to get international listing or to raise money in international capital market.

(c) Bridge Finance: Bridge finance refers, normally, to loans taken by the business, usually from commercial banks for a short period, pending disbursement of term loans by financial

institutions, normally it takes time for the financial institution to finalise procedures of creation of security, tie-up participation with other institutions etc. even though a positive appraisal of the project has been made. However, once the loans are approved in principle, firms in order not to lose further time in starting their projects arrange for bridge finance. Such temporary loan is normally repaid out of the proceeds of the principal term loans. It is secured by hypothecation of moveable assets, personal guarantees and demand promissory notes. Generally rate of interest on bridge finance is higher as compared with that on term loans.

(d) Methods of Venture Capital Financing: The venture capital financing refers to financing and funding of the small scale enterprises, high technology and risky ventures. Some common methods of venture capital financing are as follows:

(i) *Equity financing:* The venture capital undertakings generally requires funds for a longer period but may not be able to provide returns to the investors during the initial stages. Therefore, the venture capital finance is generally provided by way of equity share capital. The equity contribution of venture capital firm does not exceed 49% of the total equity capital of venture capital undertakings so that the effective control and ownership remains with the entrepreneur.

(ii) *Conditional Loan:* A conditional loan is repayable in the form of a royalty after the venture is able to generate sales. No interest is paid on such loans. In India Venture Capital Financers charge royalty ranging between 2 to 15 per cent; actual rate depends on other factors of the venture such as gestation period, cash flow patterns, riskiness and other factors of the enterprise. Some Venture Capital financers give a choice to the enterprise of paying a high rate of interest (which could be well above 20 per cent) instead of royalty on sales once it becomes commercially sound.

(iii) *Income Note:* It is a hybrid security which combines the features of both conventional loan and conditional loan. The entrepreneur has to pay both interest and royalty on sales but at substantially low rates. IDBI's Venture Capital Fund provides funding equal to 80-87.5% of the project's cost for commercial application of indigenous technology or adopting imported technology to domestic applications.

(iv) *Participating Debenture:* Such security carries charges in three phases- in the start-up phase, no interest is charged, next stage a low rate of interest is charged upto a particular level of operations, after that, a high rate of interest is required to be paid.

(e) Advantages of Debt Securitisation: Debt securitisation is a method of recycling of funds and is especially beneficial to financial intermediaries to support lending volumes. Simply stated, under debt securitisation a group of illiquid assets say a mortgage or any asset that yields stable and regular cash flows like bank loans, consumer finance, and credit card payment are pooled together and sold to intermediary. The intermediary then issue debt securities.

The advantages of debt securitisation to the originator are the following:

(i) The asset is shifted off the Balance Sheet, thus giving the originator recourse to off balance sheet funding.

(ii) It converts illiquid assets to liquid portfolio.

(iii) It facilitates better balance sheet management; assets are transferred off balance sheet facilitating satisfaction of capital adequacy norms.

(iv) The originator's credit rating enhances.

For the investors securitisation opens up new investment avenues. Though the investor bears the credit risk, the securities are tied up to definite assets.

(f) Deep Discount Bonds vs. Zero Coupon Bonds: Deep Discount Bonds (DDBs) are in the form of zero interest bonds. These bonds are sold at a discounted value and on maturity face value is paid to the investors. In such bonds, there is no interest payout during lock-in period.

IDBI was first to issue a Deep Discount Bonds (DDBs) in India in January 1992. The bond of a face value of ₹ 1 lakh was sold for ₹ 2,700 with a maturity period of 25 years.

A zero coupon bond (ZCB) does not carry any interest but it is sold by the issuing company at a discount. The difference between discounted value and maturing or face value represents the interest to be earned by the investor on such bonds.

(g) Venture Capital Financing: The term venture capital refers to capital investment made in a business or industrial enterprise, which carries elements of risks and insecurity and the probability of business hazards. Capital investment may assume the form of either equity or debt or both as a derivative instrument. The risk associated with the enterprise could be so high as to entail total loss or be so insignificant as to lead to high gains.

The European Venture Capital Association describes venture capital as risk finance for entrepreneurial growth oriented companies. It is an investment for the medium or long term seeking to maximise the return.

Venture Capital, thus, implies an investment in the form of equity for high-risk projects with the expectation of higher profits. The investments are made through private placement with the expectation of risk of total loss or huge returns. High technology industry is more attractive to venture capital financing due to the high profit potential. The main object of investing equity is to get high capital profit at saturation stage.

In broad sense under venture capital financing venture capitalist makes investment to purchase debt or equity from inexperienced entrepreneurs who undertake highly risky ventures with potential of success.

(h) Seed Capital Assistance: The seed capital assistance has been designed by IDBI for professionally or technically qualified entrepreneurs. All the projects eligible for financial assistance from IDBI, directly or indirectly through refinance are eligible under the scheme.

The project cost should not exceed ₹ 2 crores and the maximum assistance under the project will be restricted to 50% of the required promoters contribution or Rs 15 lacs whichever is lower.

The seed capital assistance is interest free but carries a security charge of one percent per annum for the first five years and an increasing rate thereafter.

(i) Global Depository Receipts and American Depository Receipts: Global Depository Receipts (GDRs) are basically negotiable certificates denominated in US dollars that represent a non-US company's publicly traded local currency equity shares. These are created when the local currency shares of Indian company are delivered to the depository's local custodian bank, against which the depository bank issues Depository Receipts in US dollars.

Whereas, American Depository Receipts (ADR) are securities offered by non-US companies who want to list on any of the US exchange. Each ADR represents a certain number of a company's regular shares. ADRs allow US investors to buy shares of these companies without the costs of investing directly in a foreign stock exchange. ADRs are issued by an approved New York bank or trust company against the deposit of the original shares. These are deposited in a custodial account in the US. Such receipts have to be issued in accordance with the provisions stipulated by the SEC USA which are very stringent.

The Indian companies have preferred the GDRs to ADRs because the US market exposes them to a higher level or responsibility than a European listing in the areas of disclosure, costs, liabilities and timing.

(j) Floating Rate Bonds: These are the bonds where the interest rate is not fixed and is allowed to float depending upon the market conditions. These are ideal instruments which can be resorted to by the issuers to hedge themselves against the volatility in the interest rates. They have become more popular as a money market instrument and have been successfully issued by financial institutions like IDBI, ICICI etc.

(k) Packing Credit: Packing credit is an advance made available by banks to an exporter. Any exporter, having at hand a firm export order placed with him by his foreign buyer on an irrevocable letter of credit opened in his favour, can approach a bank for availing of packing credit. An advance so taken by an exporter is required to be liquidated within 180 days from the date of its commencement by negotiation of export bills or receipt of export proceeds in an approved manner. Thus Packing Credit is essentially a short-term advance.

Normally, banks insist upon their customers to lodge the irrevocable letters of credit opened in favour of the customer by the overseas buyers. The letter of credit and firms' sale contracts not only serve as evidence of a definite arrangement for realisation of the export proceeds but also indicate the amount of finance required by the exporter. Packing Credit, in the case of customers of long standing may also be granted against firm contracts entered into by them with overseas buyers.

Question 6

*State the different types of Packing Credit.*

Answer

Different Types of Packing Credit

Packing credit may be of the following types:

(i) *Clean Packing credit:* This is an advance made available to an exporter only on production of a firm export order or a letter of credit without exercising any charge or control over raw material or finished goods. It is a clean type of export advance. Each proposal is weighted according to particular requirements of the trade and credit worthiness of the exporter. A suitable margin has to be maintained. Also, Export Credit Guarantee Corporation (ECGC) cover should be obtained by the bank.

(ii) *Packing credit against hypothecation of goods:* Export finance is made available on certain terms and conditions where the exporter has pledgeable interest and the goods are hypothecated to the bank as security with stipulated margin. At the time of utilising the advance, the exporter is required to submit alongwith the firm export order or letter of credit, relative stock statements and thereafter continue submitting them every fortnight and whenever there is any movement in stocks.

(iii) *Packing credit against pledge of goods:* Export finance is made available on certain terms and conditions where the exportable finished goods are pledged to the banks with approved clearing agents who will ship the same from time to time as required by the exporter. The possession of the goods so pledged lies with the bank and is kept under its lock and key.

(iv) *E.C.G.C. guarantee:* Any loan given to an exporter for the manufacture, processing, purchasing, or packing of goods meant for export against a firm order qualifies for the packing credit guarantee issued by Export Credit Guarantee Corporation.

(v) *Forward exchange contract:* Another requirement of packing credit facility is that if the export bill is to be drawn in a foreign currency, the exporter should enter into a forward exchange contact with the bank, thereby avoiding risk involved in a possible change in the rate of exchange.

Question 7

*Name the various financial instruments dealt with in the International market.*

Answer

Financial Instruments in the International Market

Some of the various financial instruments dealt with in the international market are:

(a) Euro Bonds

(b) Foreign Bonds

(c) Fully Hedged Bonds

(d) Medium Term Notes

(e) Floating Rate Notes

(f) External Commercial Borrowings

(g) Foreign Currency Futures

(h) Foreign Currency Option

(i) Euro Commercial Papers.

Question 8

*Discuss the advantages of raising funds by issue of equity shares.*

Answer

Advantages of Raising Funds by Issue of Equity Shares

(i) It is a permanent source of finance. Since such shares are not redeemable, the company has no liability for cash outflows associated with its redemption.

(ii) Equity capital increases the company's financial base and thus helps further the borrowing powers of the company.

(iii) The company is not obliged legally to pay dividends. Hence in times of uncertainties or when the company is not performing well, dividend payments can be reduced or even suspended.

(iv) The company can make further issue of share capital by making a right issue.

Question 9

*"Financing a business through borrowing is cheaper than using equity." Briefly explain.*

Answer

"Financing a business through borrowing is cheaper than using equity"

(i) Debt capital is cheaper than equity capital from the point of its cost and interest being deductible for income tax purpose, whereas no such deduction is allowed for dividends.

(ii) Issue of new equity dilutes existing control pattern while borrowing does not result in dilution of control.

(iii) In a period of rising prices, borrowing is advantageous. The fixed monetary outgo decreases in real terms as the price level increases.

Question 10

*State the main features of deep discount bonds.*

Answer

Features of Deep Discount Bonds: Deep discount bonds are a form of zero-interest bonds. These bonds are sold at discounted value and on maturity; face value is paid to the investors. In such bonds, there is no interest payout during the lock- in period. The investors can sell the bonds in stock market and realise the difference between face value and market price as capital gain.

IDBI was the first to issue deep discount bonds in India in January 1993. The bond of a face value of ₹ 1 lakh was sold for ₹ 2700 with a maturity period of 25 years.

Question 11

*Explain in brief the features of Commercial Paper.*

Answer

Features of Commercial Paper (CP)

A commercial paper is an unsecured money market instrument issued in the form of a promissory note. Since the CP represents an unsecured borrowing in the money market, the regulation of CP comes under the purview of the Reserve Bank of India which issued guidelines in 1990 on the basis of the recommendations of the Vaghul Working Group. These guidelines were aimed at:

(i) Enabling the highly rated corporate borrowers to diversify their sources of short term borrowings, and

(ii) To provide an additional instrument to the short term investors.

It can be issued for maturities between 7 days and a maximum upto one year from the date of issue. These can be issued in denominations of ₹ 5 lakh or multiples therefore. All eligible issuers are required to get the credit rating from credit rating agencies.

Question 12

*Explain the term 'Ploughing back of Profits'.*

Answer

Ploughing back of Profits: Long-term funds may also be provided by accumulating the profits of the company and ploughing them back into business. Such funds belong to the ordinary shareholders and increase the net worth of the company. A public limited company must plough back a reasonable amount of its profits each year keeping in view the legal requirements in this regard and its own expansion plans. Such funds also entail almost no risk. Further, control of present owners is also not diluted by retaining profits.

Question 13

*Explain the concept of Indian depository receipts.*

Answer

Concept of Indian Depository Receipts: The concept of the depository receipt mechanism which is used to raise funds in foreign currency has been applied in the Indian capital market through the issue of Indian Depository Receipts (IDRs). Foreign companies can issue IDRs to raise funds from Indian market on the same lines as an Indian company uses ADRs/GDRs to raise foreign capital. The IDRs are listed and traded in India in the same way as other Indian securities are traded.

Question 14

*Discuss the features of Secured Premium Notes (SPNs).*

Answer

Secured premium notes are issued along with detachable warrants and are redeemable after a notified period of say 4 to 7 years. This is a kind of NCD attached with warrant. It was first introduced by TISCO, which issued the SPNs to existing shareholders on right basis. Subsequently the SPNs will be repaid in some number of equal instalments. The warrant attached to SPNs gives the holder the right to apply for and get allotment of equity shares as per the conditions within the time period notified by the company.

Question 15

*Explain the concept of closed and open- ended lease.*

Answer

In the close-ended lease, the assets gets transferred to the lessor at the end of lease, the risk of obsolescence, residual values etc. remain with the lessor being the legal owner of the assets. In the open-ended lease, the lessee has the option of purchasing the assets at the end of lease period.

Question 16

*Distinguish between Operating lease and financial lease.*

Answer

Difference between Financial Lease and Operating Lease

| S.No. | Finance Lease | Operating Lease |
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| 1. | The risk and reward incident to ownership are passed on the lessee. The lessor only remains the legal owner of the asset. | The lessee is only provided the use of the asset for a certain time. Risk incident to ownership belongs only to the lessor. |
| 2. | The lessee bears the risk of obsolescence. | The lessor bears the risk of obsolescence. |

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| 3. | The lease is non-cancellable by either party under it. | The lease is kept cancellable by the lessor. |
| 4. | The lessor does not bear the cost of repairs, maintenance or operations. | Usually, the lessor bears the cost of repairs, maintenance or operations. |
| 5. | The lease is usually full payout. | The lease is usually non-payout. |

Question 17

*State the main elements of leveraged lease.*

Answer

*Main Elements of Leveraged Lease: Under this lease, a third party is involved beside lessor and lessee. The lessor borrows a part of the purchase cost (say 80%) of the asset from the third party i.e., lender. The asset so purchased is held as security against the loan. The lender is paid off from the lease rentals directly by the lessee and the surplus after meeting the claims of the lender goes to the lessor. The lessor is entitled to claim depreciation allowance.*

Question 18

*Discuss the advantages of preference share capital as an instrument of raising funds.*

Answer

Advantages of Issue of Preference Shares are:

(i) No dilution in EPS on enlarged capital base.

(ii) There is no risk of takeover as the preference shareholders do not have voting rights.

(iii) There is leveraging advantage as it bears a fixed charge.

(iv) The preference dividends are fixed and pre-decided. Preference shareholders do not participate in surplus profit as the ordinary shareholders

(v) Preference capital can be redeemed after a specified period.

Question 19

*Explain briefly the features of External Commercial Borrowings (ECBs).*

Answer

External Commercial Borrowings are loans taken from non-resident lenders in accordance with exchange control regulations. These loans can be taken from:

- International banks
- Capital markets
- Multilateral financial institutions like IFC, ADB, IBRD etc.
- Export Credit Agencies
- Foreign collaborators
- Foreign Equity Holders.

ECBs can be accessed under automatic and approval routes depending upon the purpose and volume.

In automatic there is no need for any approval from RBI / Government while approval is required for areas such as textiles and steel sectors restructuring packages.

Question 20

*Discuss the benefits to the originator of Debt Securitization.*

Answer

Benefits to the Originator of Debt Securitization

The benefits to the originator of debt securitization are as follows:

(a) The assets are shifted off the balance sheet, thus giving the originator recourse to off balance sheet funding.

(b) It converts illiquid assets to liquid portfolio.

(c) It facilitates better balance sheet management as assets are transferred off balance sheet facilitating satisfaction of capital adequacy norms.

(d) The originator's credit rating enhances.

Question 21

*Differentiate between Factoring and Bills discounting.*

Answer

Differentiation between Factoring and Bills Discounting

The differences between Factoring and Bills discounting are:

(a) Factoring is called as "Invoice Factoring' whereas Bills discounting is known as 'Invoice discounting."

(b) In Factoring, the parties are known as the client, factor and debtor whereas in Bills discounting, they are known as drawer, drawee and payee.

(c) Factoring is a sort of management of book debts whereas bills discounting is a sort of borrowing from commercial banks.

(d) For factoring there is no specific Act, whereas in the case of bills discounting, the Negotiable Instruments Act is applicable.

Question 22

*What is factoring? Enumerate the main advantages of factoring.*

Answer

Concept of Factoring and its Main Advantages: Factoring involves provision of specialized services relating to credit investigation, sales ledger management purchase and collection of debts, credit protection as well as provision of finance against receivables and risk bearing. In

factoring, accounts receivables are generally sold to a financial institution (a subsidiary of commercial bank – called "factor"), who charges commission and bears the credit risks associated with the accounts receivables purchased by it.

### Advantages of Factoring

The main advantages of factoring are:

(i) The firm can convert accounts receivables into cash without bothering about repayment.

(ii) Factoring ensures a definite pattern of cash inflows.

(iii) Continuous factoring virtually eliminates the need for the credit department. Factoring is gaining popularity as useful source of financing short-term funds requirement of business enterprises because of the inherent advantage of flexibility it affords to the borrowing firm. The seller firm may continue to finance its receivables on a more or less automatic basis. If sales expand or contract it can vary the financing proportionally.

(iv) Unlike an unsecured loan, compensating balances are not required in this case. Another advantage consists of relieving the borrowing firm of substantially credit and collection costs and from a considerable part of cash management.

### Question 23

*Discuss the factors that a venture capitalist should consider before financing any risky project.*

### Answer

Factors to be considered by a Venture Capitalist before Financing any Risky Project

(i) Quality of the management team is a very important factor to be considered. They are required to show a high level of commitment to the project.

(ii) The technical ability of the team is also vital. They should be able to develop and produce a new product / service.

(iii) Technical feasibility of the new product / service should be considered.

(iv) Since the risk involved in investing in the company is quite high, venture capitalists should ensure that the prospects for future profits compensate for the risk.

(v) A research must be carried out to ensure that there is a market for the new product.

(vi) The venture capitalist himself should have the capacity to bear risk or loss, if the project fails.

(vii) The venture capitalist should try to establish a number of exist routes.

(viii) In case of companies, venture capitalist can seek for a place on the Board of Directors to have a say on all significant matters affecting the business.