

CUET · BUSINESS STUDIES · CLASS XI · CODE 305

Sources of Business Finance

CUET unit: Small Business (mapped); chapter content directly serves Sources of Business Finance topics in the CUET Business Studies syllabus.

By UniDrill · NCERT-grounded study material

WWW.UNIDRILL.IN

UniDrill



Snapshot

- Establishes that finance is the "life blood" of any business and that funds are needed for fixed capital, working capital, and growth/expansion.
- Classifies sources of funds on three bases — period (long/medium/short term), ownership (owner's funds vs borrowed funds) and source of generation (internal vs external).
- Surveys ten major sources of finance with merits and limitations of each — retained earnings, trade credit, factoring, lease financing, public deposits, commercial paper, equity shares, preference shares, debentures, commercial banks and financial institutions.
- Adds international financing avenues — GDRs, ADRs, IDRs and FCCBs — and concludes with the nine factors that influence the choice of source of funds.
- CUET routinely tests the merits/limitations of specific instruments, definitions of GDR/ADR/IDR/FCCB/ICD, and the distinctions between equity vs preference vs debentures.



Detailed Notes

2.1 Core concepts

- Business finance is the requirement of funds by a business to carry out its various activities; finance is called the "life blood" of any business (NCERT §8.2, p. 172).
- Financial needs of a business fall into two heads: **Fixed capital requirements** (for land, building, plant, machinery, furniture — funds invested for a long period) and **Working capital requirements** (for day-to-day operations, holding current assets such as stock, bills receivable, salaries, wages, taxes, rent) (NCERT §8.2, p. 173).
- A business unit selling on credit or having slow sales turnover needs more working capital than one selling on cash or with speedier turnover (NCERT §8.2, p. 173).
- **Period basis classification:** Long-term sources fulfil needs for a period exceeding 5 years (e.g., shares, debentures, long-term borrowings, loans from financial institutions). Medium-term sources are for more than 1 year but less than 5 years (commercial bank borrowings, public deposits, lease financing, loans from financial institutions). Short-term sources are for a period not exceeding one year (trade credit, loans from commercial banks, commercial papers) (NCERT §8.3.1, p. 175).

- **Ownership basis:** Owner's funds — provided by sole trader/partners/shareholders; includes capital and reinvested profits; basis of the right of control; main sources are equity shares and retained earnings. Borrowed funds — raised through loans/borrowings; sources include loans from commercial banks/financial institutions, debentures, public deposits and trade credit; carry a fixed rate of interest and have to be repaid; generally secured against fixed assets (NCERT §8.3.2, pp. 175-176).
- **Source of generation basis:** Internal sources are generated within the business (accelerating collection of receivables, disposing of surplus inventories, ploughing back of profits) and fulfil only limited needs. External sources lie outside the organisation (suppliers, lenders, investors) and include debentures, bank borrowings, public deposits; may be costly and may require mortgage of assets (NCERT §8.3.3, p. 176).
- **Retained earnings** (ploughing back of profits) is internal/self-financing; the portion of net earnings not distributed as dividends; depends on net profits, dividend policy and age of the organisation; merits include permanent funds, no explicit cost, operational flexibility, ability to absorb unexpected losses and potential rise in market price of equity shares; limitations include shareholder dissatisfaction if excessive, uncertainty due to fluctuating profits, and unrecognised opportunity cost leading to sub-optimal use (NCERT §8.4.1, pp. 176-177).
- **Trade credit** is credit extended by one trader to another for purchase of goods/services; appears in buyer's books as 'sundry creditors' or 'accounts payable'; volume and period depend on reputation, financial position, volume of purchases, past payment record and competition (NCERT §8.4.2, p. 177).
- **Factoring** — the factor renders services of (a) discounting of bills (with or without recourse) and collection of client's debts, and (b) providing information on credit worthiness of prospective clients. Two methods — recourse (client bears risk of bad debts) and non-recourse (factor bears the entire credit risk). Factoring appeared in India in the early nineties as a result of RBI initiatives; providers include SBI Factors and Commercial Services Ltd., Canbank Factors Ltd., Foremost Factors Ltd., SBI, Canara Bank, PNB, Allahabad Bank (NCERT §8.4.3, p. 178).
- **Lease financing** — contractual agreement where the lessor (owner) grants the lessee the right to use the asset for a periodic lease rental; at the end of the lease, asset reverts to lessor; useful for assets like computers and electronic equipment that become obsolete quickly (NCERT §8.4.4, pp. 179-180).
- **Public deposits** — deposits raised by organisations directly from the public; interest rates higher than bank deposits; cost to company is less than borrowing from banks; can take care of both medium- and short-term needs; companies generally invite public deposits up to three years; acceptance is regulated by the Reserve Bank of India (NCERT §8.4.5, p. 181).
- **Commercial Paper (CP)** — unsecured money market instrument in the form of a promissory note; introduced in India in 1990; can be issued for maturities between a minimum of 7 days and a maximum of one year, in denominations of Rs. 5 lakh or

multiples thereof; investors include individuals, banking and other corporate bodies, NRIs, FII's; maturity date cannot go beyond the validity of the issuer's credit rating (NCERT §8.4.6, pp. 181-182).

- **Equity shares** represent ownership; equity shareholders are "residual owners" who receive what is left after all other claims; liability is limited to capital contributed; carry voting rights and democratic control over management; dividend not compulsory; capital is permanent and repaid only at liquidation (NCERT §8.4.7(a), pp. 182-183).
- **Preference shares** — preferential right (i) to receive a fixed rate of dividend before equity shareholders and (ii) to receive capital before equity shareholders at liquidation; resemble debentures (fixed return) and equity (dividend only out of profit, payable at directors' discretion); generally do not enjoy voting rights (NCERT §8.4.7(b), pp. 183-184).
- **Debentures** — instrument for long-term debt capital carrying a fixed rate of interest; holders are creditors; public issue requires credit rating by an agency like CRISIL; Zero Interest Debentures (ZID) do not carry an explicit interest rate — the return is the difference between face value and purchase price (NCERT §8.4.8, pp. 184-185).
- **Commercial banks** provide cash credits, overdrafts, term loans, purchase/ discounting of bills, and letters of credit; bank credit is not a permanent source — generally used for medium-to-short periods; borrower must provide security or create a charge on assets (NCERT §8.4.9, pp. 186-187).
- **Financial institutions** ("development banks") are established by central and state governments to provide owned and loan capital for long- and medium-term needs; also provide market surveys, technical assistance and managerial services; suitable when large funds are required for expansion, reorganisation and modernisation (NCERT §8.4.10, p. 187).
- **International financing** sources: (i) Commercial Banks (foreign currency loans — e.g., Standard Chartered to Indian industry), (ii) International Agencies and Development Banks (IFC, EXIM Bank, Asian Development Bank), (iii) International Capital Markets — GDRs (issued abroad by an Indian company, denominated in US dollars, listed on foreign stock exchanges), ADRs (issued only to American citizens, traded on US stock exchanges), IDRs (denominated in Indian rupees, issued by a foreign company through an Indian Depository — Standard Chartered PLC was the first issuer in June 2010), and FCCBs (equity-linked debt securities in foreign currency convertible to equity/depository receipts after a specific period, listed on foreign stock exchanges) (NCERT §8.5, pp. 188-191).
- **Factors affecting the choice of source of funds:** Cost (of procurement and utilisation), Financial strength and stability of operations, Form of organisation and legal status, Purpose and time period, Risk profile, Control, Effect on credit worthiness, Flexibility and ease, Tax benefits (interest on debentures/loans is tax-deductible; dividend on preference shares is not) (NCERT §8.6, pp. 191-192).

- **Inter Corporate Deposits (ICDs)** are unsecured short-term deposits made by one company with another; minimum period as per RBI guidelines is 7 days, extendable to one year; three types — three months, six months and call deposits; interest higher than that of banks (NCERT Box D, p. 188).

2.2 Definitions to memorise

Term	Definition	Page
Business finance	The requirement of funds by business to carry out its various activities — called the "life blood" of any business	172
Fixed capital	Funds needed to purchase fixed assets like land, building, plant and machinery, furniture	173
Working capital	Funds needed for day-to-day operations, holding current assets such as stock, bills receivable, salaries, wages, taxes, rent	173
Owner's funds	Funds provided by the owners (sole trader, partners or shareholders); include capital and reinvested profits; basis of right of management	175
Borrowed funds	Funds raised through loans/borrowings; carry fixed interest; have to be repaid after the specified period	175
Retained earnings	Portion of the net earnings of a company not distributed as dividends but retained for future use; also called ploughing back of profits or self-financing	176
Trade credit	Credit extended by one trader to another for the purchase of goods and services; appears as 'sundry creditors'/'accounts payable' in buyer's books	177
Factoring	Financial service where a 'factor' discounts bills and collects debts of the client and provides credit information; two methods — recourse and non-recourse	178
Lease	Contractual agreement where the lessor (owner) grants the lessee the right to use the asset in return for a periodic lease rental	179
Public deposits	Deposits raised by organisations directly from the public, regulated by RBI; companies generally invite them for up to three years	181
Commercial Paper (CP)	Unsecured money market instrument issued in the form of a promissory note, introduced in India in 1990; maturity 7 days to 1 year; denominations of Rs. 5 lakh or multiples	181-182
Equity shares	Shares representing ownership; equity shareholders are residual owners with voting rights and fluctuating returns	182
Preference shares	Shares enjoying preferential rights to fixed dividend before equity and to repayment of capital before equity at liquidation; usually no voting rights	183

Term	Definition	Page
Debentures	Instrument acknowledging a long-term loan to the company carrying a fixed rate of interest; holders are creditors	184-185
Zero Interest Debentures (ZID)	Debentures that do not carry an explicit rate of interest; return is the difference between face value and purchase price	185
Development banks	Term applied to financial institutions established by central/ state governments that aim to promote industrial development by providing owned and loan capital	187
GDR	Negotiable instrument denominated in US dollars, issued abroad by an Indian company to raise funds in foreign currency, listed on a foreign stock exchange	189
ADR	Depository receipts issued by a company in the USA, traded on US stock exchanges, can be issued only to American citizens	189
IDR	Financial instrument denominated in Indian Rupees issued by an Indian Depository to enable a foreign company to raise funds in the Indian securities market; Standard Chartered PLC was the first issuer (June 2010)	189-190
FCCB	Equity-linked debt security issued in a foreign currency at a fixed interest rate, convertible into equity/depository receipts after a specific period, listed on foreign stock exchanges	190-191
ICD (Inter Corporate Deposit)	Unsecured short-term deposit made by one company with another; minimum period 7 days, extendable to one year; three types — three-month, six-month and call deposits	188
Lessor	Owner of the asset in a lease contract who grants the lessee the right to use the asset.	179
Lessee	User of the asset in a lease contract who pays periodic lease rentals.	179
CRISIL	Credit rating agency that rates debentures and other debt instruments; rating required before public issue of debentures.	185
Cumulative preference shares	Preference shares on which unpaid dividends accumulate as arrears.	185
Convertible preference shares	Preference shares convertible into equity within a stated period.	185
Secured debentures	Debentures secured by a charge on the company's assets.	186
Bearer debentures	Debentures transferable by mere delivery; holder is treated as the owner.	186
Cash credit		186

Term	Definition	Page
	Short-term banking facility allowing the borrower to withdraw up to a sanctioned limit against security.	
Overdraft	Banking facility allowing a current-account holder to overdraw the account up to a sanctioned limit.	186
Term loan	Bank loan repayable in instalments over a specified period; secured against fixed assets.	187
EXIM Bank	Export-Import Bank of India — international development bank financing exports and imports.	188
Asian Development Bank (ADB)	Regional development bank providing long-term financing to Asian member countries.	188

2.3 Diagrams / processes to remember

- **Table 8.1 — Classification of Sources of Funds (p. 174):** Shows the three classification bases — period (long/medium/short term), ownership (owner's/ borrowed) and source of generation (internal/external).
- **Box A — Lessors and Lessees (p. 180):** Lessors include specialised leasing companies, banks and bank-subidiaries (RBI allowed banks to directly enter leasing in February 1994), specialised financial institutions (ICICI was a pioneer), and manufacturer-lessors. Lessees include public sector undertakings, mid-market companies, consumers (car leasing), and government departments/authorities (e.g., Department of Telecommunications).
- **Box B — Types of Preference Shares (p. 185):** (1) Cumulative vs Non-Cumulative, (2) Participating vs Non-Participating, (3) Convertible vs Non-Convertible.
- **Box C — Types of Debentures (p. 186):** (1) Secured vs Unsecured, (2) Registered vs Bearer, (3) Convertible vs Non-Convertible, (4) First vs Second.
- **Box D — Inter Corporate Deposits (p. 188):** Unsecured short-term inter-company deposits, minimum 7 days extendable to one year; three types.
- **Box E — Companies rush to float GDR issues (p. 190):** Illustrative case showing small and medium companies preferring GDRs over FCCBs because of rising interest rates abroad.

2.4 Common confusions / NTA trap points

- **Equity vs Preference vs Debenture returns:** Equity dividend is residual and fluctuating; preference dividend is fixed but discretionary (only out of profit after tax); debenture interest is a fixed charge payable irrespective of profit (NCERT §§8.4.7-8.4.8).

- **Period buckets:** Long-term = exceeding 5 years; medium = more than 1 year but less than 5 years; short = not exceeding 1 year. NTA likes to flip "5 years" with "1 year" in distractors (NCERT §8.3.1).
- **Commercial Paper specifics:** Minimum maturity is 7 days, maximum is 1 year; denominations are Rs. 5 lakh or multiples (not Rs. 1 lakh, not Rs. 10 lakh — students often confuse) (NCERT §8.4.6).
- **GDR vs ADR vs IDR direction:** GDR = Indian company raising money abroad in foreign currency. ADR = depository receipt issued in the USA, can be issued only to American citizens. IDR = foreign company raising money in India in Indian Rupees through an Indian Depository (NCERT §8.5).
- **Recourse vs Non-recourse factoring:** Under recourse factoring the client is NOT protected against bad debts; under non-recourse factoring the factor assumes the entire credit risk (NCERT §8.4.3).
- **Tax-deductibility:** Debenture interest and loan interest are tax-deductible; preference dividend is NOT tax-deductible (NCERT §8.6).
- **First issuer of IDR:** Standard Chartered PLC, June 2010 (NCERT §8.5).
- **Commercial Paper was introduced in India in 1990;** factoring appeared in India only in the early nineties as a result of RBI initiatives — both regulated by the RBI (NCERT §§8.4.3, 8.4.6).
- **ICD minimum period is 7 days** — extendable to one year. Students often misremember this as 30 days or 90 days (NCERT Box D, p. 188).
- **Owner's funds vs Borrowed funds** — owner's funds (equity, retained earnings) carry no fixed return obligation; borrowed funds (debentures, loans, deposits) carry fixed interest and must be repaid. CUET sometimes plants debentures as "owner's funds" to test recall.
- **Functions of management vs sources of finance** — these are unrelated lists but examiners sometimes drop "lease financing" into a management-functions question. Sources are categorised by period/ownership/generation; functions are planning/organising/staffing/directing/controlling.

2.5 Case examples

- **Standard Chartered PLC IDR issue, June 2010 (NCERT §8.5, p. 190)** — Standard Chartered PLC was the **first issuer of an IDR** in India. The case is the canonical CUET stem for any IDR question: a foreign company raising rupee-denominated funds in the Indian capital market through an Indian Depository.
- **Reliance Industries — equity issue (NCERT §8.4.7(a) context, p. 182-183)** — Reliance's marquee public issues exemplify how an Indian company finances large-scale expansion through equity shares — residual ownership, voting rights and permanent capital that does not need repayment.

- **Infosys ADR listing on NASDAQ (NCERT § 8.5 ADR context, p. 189)** — Infosys was the first Indian company to list ADRs on the NASDAQ in 1999, raising capital from American investors. ADRs let Indian firms tap the deep US capital market without an Indian listing-only constraint.
- **ICICI as pioneer lessor (NCERT Box A, p. 180)** — ICICI is a pioneer specialised financial institution in lease financing. RBI allowed banks to directly enter leasing in February 1994.
- **Department of Telecommunications as lessee (NCERT Box A, p. 180)** — DoT is a major government-department lessee of equipment, showing how even government bodies use lease financing rather than outright purchase for fast-obssolescing technology.

Practice MCQs

Q1. the long-term sources of funds fulfil the financial requirements of an enterprise for a period:

- A.** not exceeding one year
- B.** of more than one year but less than five years
- C.** exceeding five years
- D.** of exactly five years

Q2. Which of the following statements about Commercial Paper (CP) is correct?

- A.** It is a secured debt instrument issued by the Government of India.
- B.** It is an unsecured money market instrument issued in the form of a promissory note, with maturity between 7 days and 1 year.
- C.** It was introduced in India in 1980 and is regulated by SEBI.
- D.** It can be issued only in denominations of Rs. 1 lakh.

Q3. Match the international financing instrument with its correct description: | Instrument | Description | |---|---| | 1. GDR | (i) Depository receipt issued only to American citizens, traded on a US stock exchange | | 2. ADR | (ii) Equity-linked debt security issued in a foreign currency, convertible to equity after a specific period | | 3. IDR | (iii) Instrument issued abroad by an Indian company to raise funds in foreign currency, denominated in US dollars | | 4. FCCB | (iv) Financial instrument denominated in Indian Rupees issued by an Indian Depository to enable a foreign company to raise funds in India |

- A. 1-(iii), 2-(i), 3-(iv), 4-(ii)
- B. 1-(i), 2-(iii), 3-(ii), 4-(iv)
- C. 1-(ii), 2-(iv), 3-(i), 4-(iii)
- D. 1-(iv), 2-(ii), 3-(iii), 4-(i)

 **8 more MCQs + answer key**

Get UniDrill Pro · ₹199/year · unidrill.in/pricing

PYQ Alignment

This chapter is one of the highest-yield areas in CUET Business Studies — typically 5-7 MCQs/year drawn from it. Question patterns include direct definitional MCQs on GDR/ADR/IDR/FCCB/ICD/CP, statement-based questions on the merits and limitations of specific instruments (equity vs preference vs debentures), period-classification questions (long/medium/short term), and case-based stems modelled on NCERT's opening restaurant example.

CUET 2023 — Actual PYQs from this chapter

Q.40 (CUET 2023) “He got the prospectus printed, so as to make a direct appeal to investors.” Identify the method of flotation.

- A) E-IPO B) Rights issue C) Offer for sale D) Offer through prospectus **Tests:** Methods of Flotation — Public Issue via Prospectus (Sources of Business Finance) **Answer:** Not in extracted key

Q.41 (CUET 2023) “He has invited offers from some brokers to buy shares at an absolute value.” Identify the method of flotation.

- A) Offer for sale B) Offer through prospectus C) Rights issue D) Private placement **Tests:** Methods of Flotation — Offer for Sale to brokers **Answer:** Not in extracted key

Q.42 (CUET 2023) “Mr Aman has a great circle of friends who are institutional investors.” Identify the method of flotation.

- A) Private placement B) Rights issue C) Offer for sale D) E-IPO **Tests:** Methods of Flotation — Private Placement to institutional investors **Answer:** Not in extracted key

CUET 2024 — Actual PYQs from this chapter

Q.23 (CUET 2024) Method of flotation where a company sells securities en bloc to a broker:

- A) Rights issue B) Offer for sale C) e-IPO D) Offer through prospectus **Tests:** Methods of Flotation — Offer for Sale (en bloc to broker) **Answer:** Not in extracted key

