2 SOURCES OF CORPORATE FINANCE

INTRODUCTION :

Finance holds the key to all business activities. No business activity can ever be pursued without financial support. Finance is necessary through out the activities of promotion, organisation and regular operations of business. All functions of business are ultimately dependent on finance.

The Finance needed by business organisation is termed as 'Capital'. Every business organisation needs certain capital for its activities. A joint stock company, which is a modern form of business organisation and being a large undertaking, requires huge capital for business. This huge capital collection or capital formation has special significance in the management of joint stock company.

Capital formation is a process of collection of capital from various sources according to financial plan of company.

A joint stock company collects huge funds through different sources. These various sources of finance available to business may be explained with the following chart :

Sources of Finance based on Types of Capital

- Owned Capital
  - Shares
    - Equity Shares
    - Preference Shares
  - Retained Earning
- Borrowed Capital
  - Debentures, Public Deposits, Bonds, ADR / GDR, Banks, Financial Institutions, Trade Credit

The above sources of finance may be external or internal.

External Source : When capital is raised from outsiders.

Internal Source : When capital is made available from within the organisation.

2.1 SOURCES OF OWNED CAPITAL

The capital raised by company with the help of owners (shareholders) is called owned capital or ownership capital. The shareholders purchase shares of the company and supply necessary capital. It is one form of owned capital.

Another form of owned capital is retained earnings. It is also known as ploughing back of profit. It is reinvestment of profit in the business by the company itself. Retained earning is an internal source of finance.

Owned capital is regarded as a permanent capital, as it is returned only at the time of winding up of the company.

Owned capital in the form of share capital, provides initial source of capital for a new company. It can be raised any time later to satisfy additional capital needs of a company. However, retained earnings cannot be an initial source of capital but it can be important source of capital when company runs it's business profitably during it's existence.

Promoters decide the share capital required by a company. This amount of share capital is known as authorised capital. It is stated in the Capital clause of Memorandum of Association of the company. Let us learn in detail the various sources of owned capital.

2.1.1 Shares

The term share is defined by Section 2 (84) of the Companies Act 2013, 'Share means a share in the share capital of a company and includes stock'.

Share is a unit by which the share capital is divided. The total capital of company is divided into small parts and each part is called share and the value of each part / unit is known as face value. Share is a small unit of capital of a company. It facilitates the public to subscribe to the capital in smaller amount.

A person can purchase any number of shares as he wishes. A person who purchases shares of a company is known as a shareholder or a member of that company.

- **Features of Shares :**

1. **Meaning :** Share is a smallest unit in the total share capital of a company.
2. **Ownership :** The owner of share is called as shareholder. It shows the ownership of a shareholder in the company.
3. **Distinctive Number :** Unless dematerialised, each share has distinct number for identification. It is mentioned in the Share Certificate.
4. **Evidence of title :** A share certificate is issued by a company under it's common seal. It is a document of title of ownership of shares. A share is not any visible thing. It is shown by share certificate or in the form of Demat share.
5. **Value of a Share :** Each share has a value expressed in terms of money. There may be:
   - **(a) Face value :** This value is written on the share certificate and mentioned in the Memorandum of Association.
   - **(b) Issue price :** It is the price at which company sells it's shares.

(c) **Market Value :** This value of share is determined by demand and supply forces in the share market.

6. **Rights :** A share confers certain rights on its holder such as right to receive dividend, right to inspect statutory books, right to attend shareholders' meetings and right to vote at such meetings, etc.
7. **Income :** A shareholder is entitled to get a share in the net profit of the company. It is called dividend.
8. **Transferability :** The shares of public limited company are freely transferable in the manner provided in the Articles of Association.
9. **Property of Shareholder :** Share is a movable property of a shareholder.
10. **Kinds of Shares :** A company can issue two kinds of shares :

    (a) Equity shares. (b) Preference shares.

- **Kinds of Shares** (As per Section 43 of the Companies Act 2013

A company can issue different types of shares depending upon right to control, income and risk. The following chart shows different kinds of shares.

Shares

(A) Equity Shares

1) Equity Shares with voting right.
2) Equity Shares with differential voting right.

(B) Preference Shares

1) Cumulative Preference Shares.
2) Non Cumulative Preference Shares.
3) Participating Preference Shares.
4) Non-participating Preference Shares.
5) Convertible Preference Shares.
6) Non Convertible Preference Shares.
7) Redeemable Preference Shares.
8) Irredeemable Preference Shares.

A. Equity Shares : Equity shares are also known as ordinary shares.

Companies Act defines equity shares as 'those shares which are not preference shares'.

The above definition reveals that :

a) The equity shares do not enjoy preference for dividend.

b) The equity shares do not have priority for repayment of capital at the time of winding up of the company.

Equity shares are fundamental source of financing business activities. Equity share holders own the company and bear ultimate risk associated with the ownership.

After paying claims of all other investors the remaining funds belong to equity shareholders. Thus equity shareholders are 'residual claimants' of the income and assets.

Equity shareholders do not carry any fixed commitment of dividend. They are paid dividend at the rate recommended by Board of Directors. If there is no profit, no dividend will be payable. Similarly if there is less profit, lesser dividend will be paid. Thus the fortune of equity shareholders is tied up with the ups and downs of the company. If the company is successful, they enjoy great financial rewards and if the company fails, the risk falls mainly on them. It is exactly because of this position equity share capital is known as 'venture capital' or 'risk capital'. The owners of equity shares are real risk bearers.

However, equity shareholders participate in the management of their company. They are invited to attend general meetings. They are allowed to vote on all matters discussed at the general meeting. They elect their representatives to manage the company. Equity shareholders are thus real owners of the company.

■ Features of Equity Shares :

1. **Permanent Capital :** Equity shares are irredeemable shares. The amount received from equity shares is not refundable by the company during its life time. Equity shares become refundable only in the event of winding up of the company or company decides to buyback shares. Thus equity share capital is long term and permanent capital of the company.

2. **Fluctuating Dividend :** Equity shares do not have a fixed rate of dividend. The rate of dividend depends upon amount of profit earned by company. If company earns more profit, dividend is paid at higher rate. On the other hand if there is insufficient profit or loss, Board of Directors may postpone the payment of dividend. Equity shareholders cannot compel them to declare and pay dividend. The income of equity shares is uncertain and irregular. The equity shares get dividend at fluctuating rate.

3. **Rights :** Equity Shareholders enjoy certain rights :

   a) **Right to vote :** It is the basic right of equity shareholders through which they elect directors, alter Memorandum and Articles of Association, etc.

   b) **Right to share in profit :** It is an important right of equity shareholders. They have right to share in profit, when distributed as dividend. If the company is successful and makes handsome profit, they have advantage of getting large dividend.

   c) **Right to inspect books :** Equity shareholders have right to inspect statutory books of their company.

   d) **Right to transfer shares :** The equity shareholders enjoy the right to transfer shares as per the procedure laid down in the Articles of Association.

4. **No preferential right :** Equity shareholders do not enjoy preferential right in respect of payment of dividend. They are paid dividend only after dividend on preference shares has been paid.

Similarly, at the time of winding up of the company, the equity shareholders are paid last. Further, if no surplus amount is available, equity shareholders will not get anything.

5. **Controlling power :** The control of company is vested with the equity shareholders. They are often described as 'real masters' of the company. It is because they enjoy exclusive voting rights. The Act provides the right to cast vote in proportion to share holding. They can exercise their voting right by proxies, without even attending meeting in person.

   By exercising voting right they can participate in the management and affairs of the company. They elect their representatives called Directors for management of the company. They are allowed to vote on all matters discussed at the general meeting. Thus equity shareholders enjoy control over the company.

6. **Risk :** Equity shareholders bear maximum risk in the company. They are described as 'shock absorbers' when company has financial crisis.

   If the income of company falls, the rate of dividend also comes down. Due to this, market value of equity shares comes down resulting into capital loss. Thus equity shareholders are main risk takers.

7. **Residual claimant :** Equity shareholders as owners are residual claimants to all earnings after expenses, taxes, etc. are paid. A residual claim means the last claim on the earnings of company.

   Although equity shareholders come last, they have advantage of receiving entire earnings that is left over.

8. **No charge on assets :** The equity shares do not create any charge over assets of the company.

> ***Charge on assets :*** *Means an interest or lien created on assets of the company in favour of creditors. In case company fails to pay the debt, creditors can claim it from the company's assets.*

9. **Bonus Issue :** Bonus shares are issued as gift to equity shareholders. These shares are issued free of cost to existing equity shareholders. These are issued out of accumulated profits. Bonus shares are issued in proportion to the shares held. Thus capital investment of (ordinary) equity shareholder tends to grow on its own. This benefit is available only to the equity shareholder.

10. **Right Issue :** When a company needs more funds for expansion purpose and raises further capital by issue of shares, the existing equity shareholders may be given priority to get newly offered shares. This is called 'Right Issue'. The shares are offered to equity shareholder first, in proportion to their existing shareholding.

11. **Face Value :** The face value of equity shares is low. It can be generally ₹ 10 per share or even ₹ 1 per share.

12. **Market Value :** Market value of equity shares fluctuates according to the demand and supply of these shares. The demand and supply of equity shares depend on profits earned and dividend declared. When a company earns huge profit, market value of its shares increases. On the other hand when it incurs loss, the market value of it's shares decreases. There are frequent fluctuations in the market value of equity shares

in comparison to other securities. Therefore equity shares are more appealing to the speculator.

Speculator tries to make profit from a security's price change.

13. **Capital Appreciation :** Share Capital appreciation takes place when market value of shares increases in the share market. Profitability and prosperity of the company enhances reputation of company in the share market and it facilitates appreciation of market value of equity shares.

■ Types of Equity Shares :

The equity share can be of two types :

a) with voting rights.

b) with differential voting right.

- **a) Equity shares with normal voting right :** Voting right of such equity holders is in proportion to his share holdings.
- **b) Equity shares with differential voting right :** Such equity holders shall have varying rights regarding dividend, voting or otherwise in accordance with Rule 4 of Companies (Share Capital and Debentures) Rules 2014.

Thus company can issue shares with limited voting rights or no voting rights. They may be entitled to extra rate of dividend, if any.

B. Preference Shares :

As the name indicates, these shares have certain preferential rights distinct from those attached to equity shares.

The shares which carry following preferential rights are termed as preference shares:

a) A preferential right as to payment of dividend during the life time of company.

b) A preferential right as to the return of capital in the event of winding up of company.

The holder of preference share have a prior right to receive fixed rate of dividend before any dividend is paid to equity shares. The rate of dividend is prescribed at the time of issue.

Normally preference shares do not carry any voting power. They have voting right only on matters which affect their interest, such as selling of undertaking or changing rights of preference shares, etc. or they get voting rights if dividend remains unpaid.

The preference shareholders are co-owners of the company but not controllers. These shares are purchased by cautious investors who are interested in safety of investment and who want steady returns on investments.

■ Features of Preference Shares :

1. **Preference for dividend :** Preference shares have the first charge on the distributable amount of annual net profit. The dividend is payable to preference shareholders before it is paid to equity shareholders.

2. **Preference for repayment of capital :** Preference shareholders have a preference over equity shareholders in respect of return of capital when the company is liquidated. It saves preference shareholders from capital losses.
3. **Fixed Return :** These shares carry dividend at fixed rate. The rate of dividend is pre-determined at the time of issue. It may be in the form of fixed sum or may be calculated at fixed rate.

   The preference shareholders are entitled to dividend which can be paid only out of profits. If the directors, in financial crisis, decide not to pay dividend, the preference shareholders have no claim for dividend.
4. **Nature of Capital :** Preference shares do not provide permanent share capital. They are redeemed after certain period of time. A company can not issue irredeemable preference shares.

   Preference capital is generally raised at a later stage, when the company gets established. These shares are issued to satisfy the need for additional capital of the company.

   Preference share capital is safe capital as the rate of dividend and market value does not fluctuate.
5. **Market Value :** The market value of preference share does not change as the rate of dividend payable to them is fixed. The capital appreciation is considered to be low as compared with equity shares.
6. **Voting rights :** The preference shares do not have normal voting rights. They do not enjoy right of control on the affairs of the company. They have voting rights on any resolution of the company directly affecting their rights e.g. : Change in terms of repayment of capital, dividend payable to them are in arrears for last two consecutive years, etc.
7. **Risk :** The investors who are cautious, generally purchase preference shares. Safety of capital and steady return on investment are advantages attached with preference shares. These shares are boon for shareholders during depression period when interest rate is continuously falling.
8. **Face Value :** Face value of preference shares is relatively higher than equity shares. They are normally issued at a face value of Rs. 100/-.
9. **Rights or Bonus Issue :** Preference shareholders are not entitled for Rights or Bonus issues.
10. **Nature of Investor :** Preference shares attract moderate type of investors. Investors who are conservative, cautious, interested in safety of capital and who want steady return on investment generally purchase preference shares.

■ Types of Preference Shares.

Types of Preference Shares

Cumulative and Non-cumulative Preference Shares	Participating and Nonparticipating Preference Shares	Convertible and Non convertible Preference Shares	Redeemable and Irredeemable Preference Shares

1. **Cumulative Preference Shares :** Cumulative Preference Shares are those shares on which dividend goes on accumulating until it is fully paid. This means, if the dividend is not paid in one or more years due to inadequate profits, then this unpaid dividend gets accumulated. This accumulated dividend is paid when company performs well. The arrears of dividend are paid before making payment to equity shareholders.

   The preference shares are always cumulative unless otherwise stated in the Articles of Association. It means that if dividend is not paid any year, the unpaid amount is carried forward to the next year and so on, until all arrears have been paid.

2. **Non-cumulative Preference Shares :** Dividend on these shares does not get accumulated. This means, the dividend on shares can be paid only out of profits of that year. The right to claim dividend will lapse, if company does not make profit in that particular year. If dividend is not paid in any year, it is lost forever.

3. **Participating Preference Shares :** The holders of these shares are entitled to participate in surplus profit besides preferential dividend. The surplus profit which remains after the dividend has been paid to equity shareholders, up to certain limit, is distributed to preference shareholders.

4. **Non-participating Preference Shares :** The preference shares are deemed to be non-participating, if there is no clear provision in the Articles of Association. These shareholders are entitled to fixed rate of divided, prescribed at the time of issue.

5. **Convertible Preference Shares :** The holders of these shares have a right to convert their preference shares into equity shares. The conversion takes place within a certain fixed period.

6. **Non-convertible Preference Shares :** These shares cannot be converted into equity shares.

7. **Redeemable Preference Shares :** Shares which can be redeemed after certain fixed period of time are called redeemable preference shares. A company limited by shares, if authorised by Articles of Association, issues redeemable preference shares. Such shares must be fully paid. These shares are redeemed out of divisible profit only or out of fresh issue of shares made for this purpose.

8. **Irredeemable Preference Shares :** Shares which are not redeemable i.e. payable only on winding up of the company are called irredeemable preference shares. As per Section 55(1) of the Companies Act 2013, a company cannot issue irredeemable preference shares.

2.1.2 Retained Earnings :

Business organisations are subject to variation in earnings. It would be a wise decision to keep aside a part of earning during a period of high profit. A prudent company does not distribute the entire profit earned among shareholders. A part of profit is retained by company in the form of reserve fund. These reserves are the retained earnings of the company. The sum total of retained earnings gets accumulated over the years. This accumulated profits are reinvested in the business rather than distributed as dividend.

"The process of accumulating corporate profits and their utilisation in business is called retained earnings."

In simple words, a part of net profit, which is not distributed to shareholders as dividend is retained by company in the form of 'Reserve Fund'. Company converts it's reserves into 'bonus share capital' and capitalise it's profit. This capitalisation of profit by issue of bonus shares is known as ploughing back of profit or self financing. Bonus shares are issued free of cost to the existing equity shareholders out of the retained earnings.

The Management can convert retained earnings into permanent share capital by issuing bonus shares. It is an important source of raising long term capital. It is simple and cheapest method of raising finance. It is used by established companies. It is an internal source of finance.

Determinants of retained earnings. :

1. **Total earnings of company :** If there is ample profit, company can save and retain some parts of profit. More the earnings, a company can save more. Attitude of top management also determines the amount of retained earnings.
2. **Taxation Policy :** The taxation policy of government is also an important determinant of corporate savings. If the taxes levied are at high rates, company cannot save much of the profits in the form of reserves.
3. **Dividend Policy :** It is a policy of Board of Directors in regards to distribution of profits. A conservative dividend policy is needed for having good accumulation of profit. But this policy affects shareholders as they get dividend at a lower rate.
4. **Government Control :** A government is regulatory body of economic system of the country. It's policies, rules and regulations ensures that the companies work as per its regulations. Company has to formulate it's dividend policy in accordance with the rules and regulations framed by the Government.

2.2 SOURCES OF BORROWED CAPITAL

Only owned capital is not sufficient to carry on all business activities of a joint stock company. A company needs borrowed capital to supplement it's owned capital.

Every trading company is entitled to borrow money. However, it is a normal practice to have an express provision in the Memorandum of Association, enabling a company to borrow money. Memorandum authorises company to exercise borrowing powers where as Articles of Association provides as to how and by whom these powers shall be exercised. The power to borrow money is normally exercised by Board of Directors of the company.

A private company may exercise it's borrowing powers immediately after incorporation. However public company cannot exercise it's borrowing power until it secures certificate of commencement of business.

The capital may be borrowed for short, medium or long term requirement. It is better to raise borrowed capital at a later stage of company's business, when company want to expand or diversify it's business and it requires additional capital. This additional capital can be raised by : a) issue of debentures b) Accepting deposits c) bonds d) Loans from commercial banks and Financial institutions, etc. Interest is paid on borrowed capital. It is paid at fixed rate. Borrowed capital is repayable after a specific period of time.

2.2.1 Debentures

Debentures are one of the principal sources of raising borrowed capital to meet long and medium term financial needs. Over the years debentures have occupied a significant position in the financial structure of the companies.

The term debenture has come from the latin word 'debere' which means to 'owe'.

The term debenture has not been defined clearly under Companies Act.

Sec 2(30) of the Companies Act 2013, only states that, 'the word debenture includes debenture stock, bonds and any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not'.

Under the existing definition, debenture includes debenture stock. Debenture means a document which either creates or acknowledges debt. Ordinarily, debenture constitutes a charge on some property of company, but there may be a debenture without any such charge.

Palmer defines : "A debenture as an instrument under seal evidencing debt, the essence of it being admission of indebtedness."

Topham defines : "A debenture is a document given by a company as evidence of debt to the holder, usually arising out of loan, and most commonly secured by charge."

According to the above definitions, debenture is an evidence of indebtedness. It is an instrument issued in the form of debenture certificate, under the common seal of the company.

- **Features**

1. **Promise :** Debenture is a promise by company that it owes specified sum of money to holder of the debenture.
2. **Face Value :** The face value of debenture normally carries high denomination. It is ₹ 100 or in multiples of ₹ 100.
3. **Time of Repayment :** Debentures are issued with the due date stated in the debenture certificate. The principal amount of debenture is repaid on maturity date.
4. **Priority of Repayment :** Debentureholders have a priority in repayment of debenture capital over the other claimants of company.
5. **Assurance of Repayment :** Debenture constitutes a long term debt. They carry an assurance of repayment on due date.

6. **Interest :** A fixed rate of interest is agreed upon and is paid periodically in case of debentures. Payment of interest is a fixed liability of the company. It must be paid by company irrespective of the fact, whether the company makes profit or not.

7. **Parties to Debentures :**

   a) **Company :** This is the entity which borrows money.

   b) **Trustees :** A company has to appoint Debenture Trustee if it is offering Debentures to more than 500 people. This is a party through whom the company deals with debentureholders. The company makes an agreement with trustees, it is known as Trust Deed. It contains the obligations of company, rights of debentureholders, powers of Trustee, etc.

   c) **Debentureholders :** These are the parties who provide loan and receive, 'Debenture Certificate' as an evidence.

8. **Authority to issue debentures :** According to the Companies Act 2013, Section 179 (3), the Board of Directors has the power to issue debentures.

9. **Status of Debentureholder :** Debentureholder is a creditor of the company. Since debenture is a loan taken by company, interest is payable on it at fixed rate, at fixed interval until the debenture is redeemed.

10. **No Voting Right :** According to Section 71 (2) of the Companies Act 2013, no company shall issue any debentures carrying any voting right. Debentureholders have no right to vote at general meeting of the company.

11. **Security :** Debentures are generally secured by fixed or floating charge on assets of the company. If a company is not in a position to make payment of interest or repayment of capital, the debentureholder can sell off charged property of the company and recover their money.

12. **Issuers :** Debentures can be issued by both private company and public limited company.

13. **Listing :** Debentures must be listed with at least one recognised stock exchange.

14. **Transferability :** Debentures can be easily transferred, through the instrument of transfer.

- **Types of Debentures**

Debentures

On the basis of security	On the basis transfer	On the basis of repayment	On the basis conversion
1. Secured and	3. Registered and	5. Redeemable and	7. Convertible and
2. Unsecured Debentures.	4. Bearer Debentures.	6. Irredeemable Debenture.	8. Non convertible Debenture.

1. **Secured debentures :** The debentures can be secured. The property of company may be charged as security for loan. The security may be for some particular asset (fixed charge) or it may be the asset in general (floating charge). The debentures are secured through 'Trust Deed'.

2. **Unsecured debentures :** These are the debentures that have no security. The issue of unsecured debentures is now prohibited by the Companies Act, 2013.

3. **Registered Debentures :** Registered debentures are those debentures on which the name of holders are recorded. A company maintains 'Register of Debentureholders' in which the name, address and particulars of holdings of debentureholders are entered. The transfer of registered debentures requires the execution of regular transfer deed.
4. **Bearer Debentures :** Name of holders are not recorded on the bearer debentures. Their names do not appear on the 'Register of Debentureholders'. Such debentures are transferable by mere delivery. Payment of interest is made by means of coupons attached to debenture certificate.
5. **Redeemable Debentures :** Debentures are mostly redeemable i.e. Payable at the end of some fixed period, as mentioned on the debenture certificate. Repayment can be made at fixed date at the end of specific period or by instalment during the life time of the company. The provision of repayment is normally made in 'Trust Deed'.
6. **Irredeemable Debentures :** These kind of debentures are not repayable during life time of the company. They are repayable only after the liquidation of the company, or when there is breach of any condition or when some contingency arises.
7. **Convertible Debentures :** Convertible debentures give right to holder to convert them into equity shares after a specific period of time. Such right is mentioned in the debenture certificate. The issue of convertible debenture must be approved by special resolution in general meeting before they are issued to public. These debentures are advantageous for the holder. Because of this conversion right, convertible debentureholder is entitled to equity shares at a rate lower than market value.
8. **Non-convertible Debentures :** Non-convertible debentures are not convertible into equity shares on maturity. These debentures are redeemed on maturity date. These debentures suffer from the disadvantage that there is no appreciation in value.

2.2.2 Acceptance of Deposit

Public deposit is an important source of financing short term requirements of company. Companies receive fixed deposits from the public for the period ranging from 6 months to 36 months. Such deposits are called as Public Deposits.

Under this method, general public is invited to deposit their savings with the company for varied period. Interest is paid by companies on such deposits. The company issues 'Deposit Receipt' to depositor. The terms of deposit are mentioned in the 'Deposit Receipt'. Deposit Receipt is an acknowledgement of debt/loan by the company. Deposits are either secured or unsecured loans offered to the company.

Meaning :

As per section 2 (31) of Companies Act, 2013, 'deposit' includes any receipt of money by way of deposit or loan or in any other form by a company, but does not include such categories of amount as may be prescribed in consultation with the Reserve Bank of India.

The above expression has been further elaborated by Rule 2 (1)(c) of Companies (Acceptance of Deposits) Rules 2014. This Rule provides that 'deposit' means any receipt of money, in the form of deposit or loan by a company. However, 'deposit' does not include following :

1. Any amount received from Central Government or a State Government.
2. Any amount received as loan from any banking company.
3. Any amount received from foreign government or international banks.
4. Any amount received by a company from any other company.
5. Any amount raised by issuing commercial paper.
6. Any amount raised by issue of bonds.
7. Any amount received in trust.
8. Any amount received by way of subscription to any shares or debentures.

(Terms and conditions of acceptance of Deposits are discussed in detail in Chapter 5.)

2.2.3 Bond

Bond is a debt security. It is a formal contract to repay borrowed money with interest. Bond is a loan. The holder of bond is a lender to the institution. He is a creditor of the company. He gets fixed rate of interest.

All bonds have maturity date and is paid in cash at certain date in future.

According to Webster Dictionary, 'A bond is an interest bearing certificate issued by the government or business firm, promising to pay the holder a specific sum at a specified date.'

Thus a company borrows money and issues bonds as an evidence of debt. Interest is payable on bonds at fixed interval or on maturity of bonds.

Features

1. **Nature of Finance :** It is a debt Finance. It provides long term finance. The bonds can be issued for longer period i.e. 5 years, 10 years, 25 years, 50 years.
2. **Status of bondholder :** The bondholders are creditors. Since they are creditors and non-owners they are not entitled to participate in general meeting. They have no voting right and hence no participation in the management.
3. **Return on bonds :** The bondholder gets a fixed rate of interest. It is payable at regular interval or on the maturity of bond.
4. **Repayment :** Bonds have specific maturity date on when the principal amount is repaid.

2.2.4 American Depository Receipt (ADR) and Global Depository Receipt (GDR)

In India, the shares of public company are listed and traded on various stock exchanges like Bombay Stock Exchange (BSE) and National Stock Exchange (NSE).

With adoption of free economic policy and due to globalization some of the Indian company's shares are also listed and traded on foreign stock exchanges like New York Stock Exchange (NYSE) or National Association of Securities Dealer Automated Quotation (NASDAQ). To list shares on these stock exchanges, company has to comply with policies of those stock exchanges. The policies of these stock exchanges are different than the policies of Indian Stock Exchanges. Therefore, those Indian companies which can not list their shares directly on foreign stock exchanges, get listed indirectly using ADR and GDR.

ADR and GDR are Dollar/Euro denominated instrument traded in USA and Europe Stock Exchanges.

Indian Company issues shares to an intermediary called 'Depository'. Bank of New York, Citigroup etc. act as foreign Depository Bank. This Depository bank issues ADR and GDR to investors against these shares. The ADR / GDR represent fixed number of shares. These ADR / GDR are then sold to people in foreign country. The ADR / GDR are traded like regular shares. They are listed on stock exchanges. The prices fluctuate depending on demand and supply.

Both ADR and GDR are depository receipts, but only difference is the location where they are traded. If the Depository Receipt is traded in USA, it is called American Depository Receipts (ADR) and if it is traded in a country other than USA is called Global Depository Receipts (GDR).

Non-Resident Indians (NRI) and Foreign nationals can invest their money in India by purchasing ADR and GDR. They can buy ADR / GDR using their regular equity trading Account.

The company pays dividend in home currency to the depository bank and the depository bank converts it into the currency of investor and pays dividend.

The exchanges on which GDR is traded are as follows :

1) London stock exchange.
2) Luxembourg Stock exchange.
3) NASDAQ Dubai.
4) Singapore Stock exchange.
5) Hongkong Stock exchange.

Activity : Find out Indian Companies who have issued ADR as well as GDR.

2.2.5 Commercial Banks

There are number of sources of financing short and medium term business requirements. Among these, commercial bank constitute the most predominant source. Commercial banks play significant role in corporate financing in India. Commercial banks, by introducing variety of deposit schemes tailored to individual depositor's need, mop up savings of people and make use of these savings to meet varied requirements of corporate enterprises.

Commercial banks assist corporate enterprises -

1) By Granting term loans to companies.
2) By subscribing to shares and debentures of companies.
3) By underwriting the issue of securities of the Company.

Commercial banks also play an important role in providing short term finance. They have become primary source of financing working capital of the business. In India, primary source of financing working capital are bank credit and trade credit.

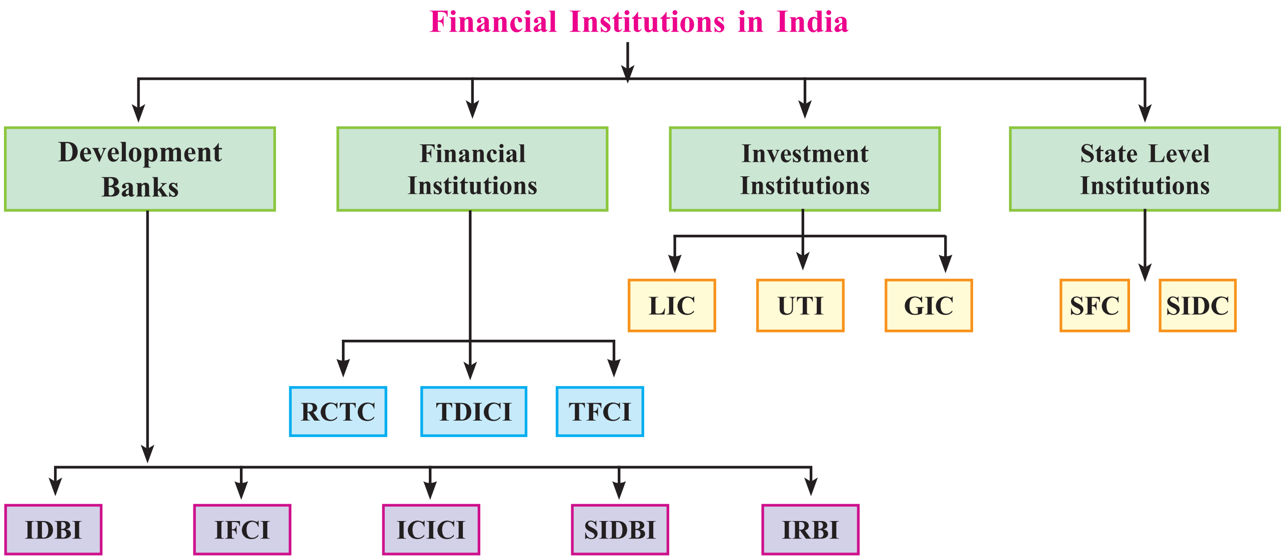
Banks have introduced many innovative schemes for disbursement of credit. They are as follows :

1. **Overdraft :** A company having current account with bank is allowed overdraft facility. The borrower can withdraw funds as and when needed. He is allowed to overdraw on his current account, up to the credit limit which is sanctioned by bank. Within this stipulated limit any number of drawings are permitted. Repayments can be made whenever required during the time period. The interest is determined on the basis of actual amount withdrawn.
2. **Cash Credit :** It is also an important and popular form of financial aid. This form of credit is operated in same manner as overdraft facility. The borrower can withdraw amount from his cash credit account up to a stipulated limit based on security margin. Cash credit is given against pledge or hypothecation of goods or by providing alternative securities. Interest is charged on outstanding amount borrowed and not on the credit limit sanctioned.
3. **Cash loans :** Under this, the total amount of loan is credited by bank to the borrowers account. Interest is payable on actual balance outstanding.
4. **Discounting bills of exchange :** The drawer of the bill i.e. (seller) can receive money from drawee (i.e. buyer) on due date or after the due date. Drawer can receive money before due date by discounting the bill with the bank. This is nothing but selling the bill to the bank. The bank gives money to drawer less than the face value of the bill. Thus bill of exchange are trade bills. They are accepted by bank and cash is advanced against them.

2.2.6 Financial Institutions

First industrial policy was declared in 1948 for rapid industrial development in the country. The Central Government and State Government have established special financial institutions for providing industrial finance. These institutions provide medium and long term finance. The assistance of these institutions has become important for new companies as well as going concerns.

Financial Institutions are classified into four categories as follows.



I. Development Banks

1. Industrial Development Bank of India (IDBI).
2. Industrial Finance Corporation of India Ltd. (IFCI)
3. Industrial Credit and Investment Corporation of India (ICICI)
4. Small Industries Development Bank of India (SIDBI)
5. Industrial Reconstruction Bank of India (IRBI)

II. Financial Institutions

1. Risk Capital and Technology Finance Corporation Ltd. (RCTC)
2. Technology Development and Information Companyof India Ltd. (TDICI)
3. Tourism Finance Corporation of India Ltd. (TFCI)

III. Investment Institutions

1. Life Insurance Corporation of India (LIC)
2. Unit Trust of India (UTI)
3. General Insurance Corporation of India (GIC)

IV. State Level Institutions

1. State Finance Corporations (SFC)
2. State Industrial Development Corporation (SIDC)

Above mentioned institutions provide financial assistance in the following forms :

1. To provide term lending facilities.
2. To subscribe to shares and debentures.
3. To underwrite the issue of securities.
4. To lend money.
5. To guarantee term loans raised by company.

Activity :

Study the role of different financial institutions in raising funds for companies.

2.2.7 Trade Credit

No business can be run without 'credit'. Credit is the soul of business. Trade credit financing is major source of short term financing.

Manufacturers, wholesalers and suppliers of goods or materials are called 'trade creditors'. They sell tangible goods to other business concerns on the basis of deferred payment i.e. future payment credit is extended by these business concerns with an intention to increase their sales. The business firm extends credit, also because of custom that has been built up overtime.

Trade credit is not cash loan. It results from a credit sale of goods / services, which has to be paid at a future date after the sale takes place. In other words, when goods are delivered by supplier to a customer and the payment is made after some time, it is called as trade credit.

In distributive trade this kind of credit has great significance. The small retailers, to large extent rely on obtaining trade credit from supplier. It is an easy kind of credit which can be obtained without signing any debt instrument. It is readily available and is cheap method of financing.

Suppliers sell goods and willingly allow 30 days or more, for bill to be paid. They even offer discount, if bills are cleared within a short period such as 10 days or 15 days, etc. The terms of trade credit are not rigid.

2.3 DISTINCTION

1. Shares and Debentures

Points	Shares	Debentures
1. Meaning	A share is a part of share capital of a company. It is known as ownership securities.	A debenture is a certificate of loan taken by a company. They are also known as creditorship securities.
2. Status	A holder of shares is the owner of company. Therefore share capital is owned capital.	A holder of debenture is creditor of the company. Debenture capital is loan capital or borrowed capital.
3. Nature	It is permanent capital. It is not repaid during the life time of the company.	It is temporary capital. Generally it is repaid after a specific period.
4. Voting / Right	Shareholders being owners enjoy normal voting rights in general meeting. They participate in the management of the company.	Debentureholders being creditors, do not have any voting right. They can not participate in the management of the company.
5. Return on Investment	Return on shares is called dividend. Equity shareholders receive divided at fluctuating rate where as preference shareholders receive divided at fixed rate.	Return on debenture is called interest. It is fixed at the time of issue. Interest is paid even when company has no profit.
6. Security	Share capital is unsecured capital. No security is offered to the shareholder.	Debenture capital being loan capital is secured by creating a charge on Company's property.
7. Time of Issue	Shares are issued in the initial stages of the company formation.	Debentures are issued at a later stage, when the company has properties to offer as security.
8. Suitability	Shares are suitable for long term finance.	Debentures are suitable for medium term finance.

Points	Shares	Debentures
9. Types	Shares are classified into – a) Equity shares b) Preference	Debentures are classified as : a) Registered Debentures b) Bearer Debentures c) Secured Debentures d) Unsecured Debentures e) Redeemable Debentures f) Irredeemable Debentures g) Convertible Debentures h) Non - convertible Debentures
10. Position on liquidation	On liquidation of a company, share holders rank last in the list of claimants.	Debentureholders being creditors, rank prior to shareholders for repayment on liquidation of company.

2. Equity Shares and Preference Shares

Points	Equity Shares	Preference Shares
1. Meaning	Shares that are not preference shares are called equity shares i.e. these shares do not have preferential right for payment of dividend and repayment of capital.	Preferences shares are Shares that carry preferential right as to payment of : a) Dividend and b) Repayment of capital.
2. Rate of Dividend	Equity shares are given dividend at fluctuating rate depending upon the profits of the company.	Preference shareholders get dividend at fixed rate.
3. Voting Right	Equity shareholders enjoy normal voting right. They participate in the management of their company.	Preference shareholder do not enjoy normal voting right. They can vote only on matters affecting their interest.
4. Return of Capital	Equity capital can not be returned during the life time of the company. (except in case of buy back)	A company can issue redeemable preference shares, which can be repaid during the life time of the company.
5. Nature of capital	Equity capital is known as 'Risk Capital.'	Preference capital is ‘Safe Capital’ with stable return.
6. Nature of investor	The investors who are ready to take risk invest in equity shares.	The investors who are cautious about safety of their investment, invest in preference shares.

Points	Equity Shares	Preference Shares
7. Face value	The face value of equity shares is generally ₹ 1/- or ₹ 10/- it is relatively low.	The face value of preference shares is relatively higher i.e. ₹ 100/- and so on.
8. Right and bonus issue	Equity shareholder is entitled to get bonus and right issue.	Preference shareholders are not eligible for bonus and right issue.
9. Capital appreciation	Market value of equity shares increases with the prosperity of company. It leads to increase in the value of shares.	Market value of preference shares does not fluctuate, so there is no possibility of capital appreciation.
10. Risk	Equity shares are subject to higher risk. That is because of fluctuating rate of dividend and no guarantee of refund of capital.	Preference shares are subject to less risk. It is because of fixed rate of dividend and preferential right as regards to dividend and repayment of capital.
11. Types	Equity shares are classified into : a) equity shares with normal voting right. b) equity shares with differential voting right.	Preference shares are classified as : a) Cumulative Preference Shares b) Non-Cumulative Preference Shares c) Convertible Preference Shares d) Non-Convertible Preference Shares e) Redeemable Preference Shares f) Irredeemable Preference Shares g) Participating Preference Shares h) Non-Participating Preference Shares

3. Owned capital and Borrowed capital

Points	Owned Capital	Borrowed Capital
1. Meaning	It is that capital which is contributed by shareholders.	It is that capital which is borrowed from creditors. It is also known as debt capital.
2. Sources	This capital is collected by issue of equity shares and preference shares.	It is collected by way of issue of debentures, fixed deposits, loan from bank/financial institutions, etc.

Points	Owned Capital	Borrowed Capital
3. Return on Investment	The shareholders get dividend as income on their investment. Rate of dividend is fluctuating in case of equity shares but fixed in case of preference shares.	The debt capital holders get interest as income on their investment. Interest is paid at fixed rate.
4. Status	The shareholders are owners of the company.	The debt holders are creditors of the company.
5. Voting right	The equity shareholders enjoy normal voting right at the general meeting.	The creditors do not enjoy voting rights at the general meeting.
6. Repayment of Capital	The shareholders do not enjoy priority over creditors. They are eligible for repayment of Capital only after making payment to creditors at the time of winding up of the company.	The creditors get priority over the shareholders in case of return of principal amount at the time of winding up of the company.
7. Charge on assets	The shareholders do not have any charge on the assets of the company.	The secured debenture holders have a charge on assets of the company.

SUMMARY

- The various sources of finance can be divided as owned capital and borrowed capital.
- Share is a small unit of share capital of a company.
- Equity Shares do not enjoy preference for dividend and do not have priority for payment of capital at the time of winding up of company.
- Preference shares have prior right to receive fixed rate of dividend and return of capital in the event of winding up of the company.
- The debt acknowledged by a company by issuing debenture certificate is called debenture.
- Bond is an instrument issued by government or business firm as an evidence of debt.
- Retained earning is sum total of accumulated profit which are reinvested in the business.
- Public deposit is a loan accepted by company for short period of time ranging from 6 months to 36 months.
- Company can raise loan from banks in the form of overdraft,cash credit, cash loans, etc.
- Trade credit is a credit extended by manufactures and suppliers to customers.
- ADR and GDR are depository receipts through which Indian companies raise equity capital in international market.

EXERCISE

Q.1 A) Select the correct answer from the options given below and rewrite the statement.

1. .... is a smallest unit in the total share capital of the company.
   a) Debenture b) Bonds c) Share
2. The benefit of Depository Receipt is ability to raise capital in .... market.
   a) National b) Local c) International
3. .... are residual claimants against the income or assets of the company.
   a) Bondholders b) Equity Shareholders c) Debentureholders
4. .... participate in the management of their company.
   a) Preference shareholders b) Depositors c) Equity shareholders
5. .... shares are issued free of cost to existing equity shareholders.
   a) Bonus b) Right c) Equity
6. The holder of preference share has right to receive .... rate of divided.
   a) fixed b) fluctuating c) lower
7. Accumulated dividend is paid to .... preference shares.
   a) redeemable b) cumulative c) convertible
8. The holder of .... preference shares have right to convert their shares into equity shares.
   a) cumulative b) convertible c) redeemable
9. Debenture holders are .... of the company.
   a) creditors b) owners c) suppliers
10. .... is paid on borrowed capital.
    a) Interest b) Discount c) Dividend
11. Debentureholders get fixed rate of .... as return on their investment.
    a) interest b) dividend c) discount
12. Convertible debentures are converted into................ after a specific period.
    a) equity shares b) deposits c) bonds
13. Retained earnings are .... source of financing.
    a) internal b) external c) additional
14. The holder of bond is .... of the company.
    a) secretary b) owner c) creditor
15. Company can accept deposits from public, minimum for .... months.
    a) six b) nine c) twelve

16. Company can accept deposits from public, maximum for .... months.
   a) 12   b) 24   c) 36
17. A depository receipt traded in .... is called American Depository receipt.
   a) London   b) Japan   c) U.S.A.

B) Match the pairs.

Group 'A'		Group 'B'	
a)	Equity Share Capital	1)	Agreement
b)	Debenture Trustees	2)	Capitalisation of Profit
c)	Preference Shareholders	3)	Bold Investor
d)	Debenture Certificate	4)	Venture Capital
e)	Bonus Shares	5)	Document of Ownership
		6)	Capitalisation of Loan
		7)	Safe Capital
		8)	Instrument of Debt
		9)	Trust Deed
		10)	Cautious Investor

C) Write a word or a term or a phrase which can substitute each of the following statement.

1. The 'real masters' of the company.
2. A document of title of ownership of shares.
3. The holders of these shares are entitled to participate in the surplus profit.
4. A party through whom the company deals with debentureholders.
5. Name the shareholders who participate in the management.
6. The value of share which is written on the share certificate.
7. The value of share which is determined by demand and supply forces in the share market.
8. The policy of using undistributed profit for the business.
9. It is an acknowledgement of loan issued by company to depositor.
10. A Dollar denominated instrument traded in USA.
11. The Depository Receipt traded in country other than USA.
12. Money raised by company from public for minimum 6 months to maximum 36 months.
13. Credit extended by the suppliers with an intention to increase their sales.
14. The credit facility provided to a company having current account with bank.

D) State whether the following statements are true or false.

1. Equity share capital is known as venture capital.
2. Equity shareholders enjoy fixed rate of dividend.
3. Equity shareholders are described as 'shock absorber' when company has financial crisis.

4. Debenture holders have right to vote at general meeting of the company.
5. Bond holders are owners of the company.
6. Depository bank stores the shares on behalf of GDR holder..
7. Financial institutions underwrite the issue of securities.
8. Cash credit is given against hypothecation of goods or any security.
9. Trade credit is major source of long term finance.

E) Find the odd one.

1. Debenture, Public deposit, Retained earnings.
2. Face value, Market value, Redemption value.
3. Share Certificate, Debenture Certificate, ADR.
4. Trade Credit, Overdraft, Cash Credit.

F) Complete the sentences.

1. The finance needed by business organisation is termed as ....
2. The convertible preference share holders have a right to convert their shares into........... .
3. Equity shareholders elect their representatives called ....
4. Bonus shares are issued as gift to ....
5. The bond holders are .... of the company.
6. Depository receipt traded in a country other than USA is called ....
7. First Industrial policy was declared in the year ....
8. When goods are delivered by supplier to customer on basis of deferred payment it is called as ....

G) Select the correct option from the bracket.

Group 'A'		Group 'B'	
a)	Equity shares	1)	....
b)	....	2)	Dividend at fixed rate
c)	Debentures	3)	....
d)	....	4)	Accumulated corporate profit
e)	Public Deposit	5)	....

(Fluctuating rate of dividend, Preference shares, Interest at fixed rate, Retained earnings, Short term loan.)

H) Answer in one sentence.

1. What is a share ?
2. What are Equity shares ?

3. What are preference shares ?
4. What are retained earnings ?
5. What is a debentures ?
6. What is a bond ?
7. In which country can ADR be issued ?
8. In which country can GDR be issued ?
9. What are convertible debentures ?
10. What are cumulative preference shares ?

I) Correct the underlined word/s and rewrite the following sentences.

1. Owned capital is <u>temporary</u> capital.
2. Equity shares get dividend at <u>fixed</u> rate.
3. Preference shares get dividend at <u>fluctuating</u> rate.
4. Retained earnings is an <u>external</u> sources of finance.
5. Debentureholder is <u>owner</u> of the company.
6. Bond is a source of <u>short</u> term finance.
7. Depository Receipt traded in USA is called as <u>Global Depository Receipt</u>.

Q.2 Explain the following terms / concepts.

1. Borrowed Capital
2. Owned capital
3. Ploughing back of profit
4. Overdraft
5. Trade credit

Q.3 Study the following case / situation and express your opinion.

(1) The Balance-sheet of a Donald Company for the year 2018-19 reveals equity share capital of Rs. 25,00,000 and retained earnings of Rs. 50,00,000.

a) Is the company financially sound ?

b) Can the retained earnings be converted into capital ?

c) What type of source retained earning is ?

(2) Mr. Satish is a speculator. He desires to take advantage of growing market for company's product and earn handsomely.

a) According to you which type of share Mr. Satish will choose to invest ?

b) What does he receive as return on investment ?

c) State any one right which he will enjoy as a shareholder.

(3) Mr. Rohit, an individual investor, invests his own funds in the securities. He depends on investment income and does not want to take any risk. He is interested in definite rate of income and safety of principal.

a) Name the type of security that Mr. Rohit will opt for.

b) What does he receive as return on his investment ?

c) The return on investment which he receives is fixed or fluctuating ?

Q.4 Distinguish between the following.

1. Equity shares and Preference shares.
2. Share and Debenture.
3. Owned capital and borrowed capital.

Q.5 Answer in brief.

1. What is public deposit ?
2. What is Global Depository Receipt ?
3. What is trade credit ?
4. What are the schemes for disbursement of credit by bank ?
5. State the features of Bonds.

Q.6 Justify the following statements.

1. Equity shareholders are real owners and controllers of company.
2. Preference shares do not carry any voting right.
3. The debentures are secured by charge on assets of the company.
4. Retained earning is simple and cheapest method of raising finance.
5. Public deposit is good source of short term financing.
6. Bond holder is creditor of the company.
7. Trade credit is not cash loan.
8. Different investors have different preferences.
9. Equity share capital is risk capital.

Q.7 Answer the following questions.

1. What is share and state it's features ?
2. What is an equity share ? Explain it's features.
3. Define preference shares. What are the different types of preference shares.
4. What are preference shares? State it's features.
5. What is Debenture ? Discuss the different types of debentures.
6. Define Debenture and explain the features of debentures.

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