of capital alone. Hence, capital of corporate bodies may be raised from different alternative sources. The following chart shows the different alternative sources wherefrom finance can be made available for Joint Stock Companies.

Sources of Capital / Finance

- **External sources**
  - **Owned capital**
    - **Equity Shares**
      - (1) Ordinary or Common shares
      - (2) Right shares
      - (3) Bonus shares
      - (4) Sweat Equity shares
    - **Preference Shares**
      - On the basis of Dividend
        - Cumulative
        - Non-cumulative
      - On the basis of Redeemability
        - Redeemable
        - Irredeemable
      - On the basis of Participation
        - Participating
        - Non-participating
      - On the basis of Convertibility
        - Convertible
        - Non-convertible
  - **Borrowed/Debt capital**
    - **Debentures**
      - (1) Redeemable
      - (2) Irredeemable
      - (3) Convertible
      - (4) Bearer
      - (5) Naked
      - (6) Registered
      - (7) Mortgage
      - (8) Collateral
    - **Financial Institutions**
      - National
        - (1) IFCI
        - (2) SFCs
        - (3) IDBI
        - (4) NIDC
        - (5) ICICI
        - (6) LIC
        - (7) UTI
        - (8) IRBI
        - (9) SIDCs
        - (10) SIDBI etc.
      - International
        - (1) World Bank
        - (2) International Finance Corporation (IFC)
        - (3) Asian Development Bank (ADB) etc.
    - **Other medium/short-term sources**
      - (1) Lease financing
      - (2) Hire purchase
      - (3) Loan from banks
      - (4) Cash credit
      - (5) Overdraft from banks
      - (6) Bill of exchange
      - (7) Public deposits
      - (8) Inter-corporate deposits
      - (9) Issue of Commercial papers
      - (10) Factoring
      - (11) Customer advance
      - (12) Trade creditors
- **Internal sources**
  - (1) Retained profit
  - (2) Provision for depreciation
  - (3) Provision for taxation
  - (4) Proposed dividend

The sources of capital can also be classified according to the repayment period, as Short-term

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(ii) **Simple, Naked or Unsecured Debentures :** When no asset is pledged under mortgage to raise loan by issuing a debenture paper, it is called the simple or naked or unsecured debenture. They have no priority as compared to other creditors. They are treated as the ordinary creditors at the time of winding up of the company.

(B) ***On the basis of redemption :***

On the basis of redemption, debentures may be classified under two heads :

(i) **Redeemable Debentures :** Redeemable debentures are those on which the repayment of the principal is to be made on a specific date or in installments either at the company's option or at fixed intervals as long as the company is a going concern. The time and mode for redeeming the debentures are fixed at the time of their issue.

(ii) **Irredeemable Debentures :** Irredeemable debentures or perpetual debentures are those in respect of which no time is fixed within which the company is bound to pay, although it may pay back at any time it chooses. So, generally, it is not paid back during the life time of the company. The debentureholders cannot demand payment as long as the company is a going concern and does not default in the payment of interest. But all debentures, whether redeemable or irredeemable, becomes payable if the company goes into liquidation.

(C) ***On the basis of priority of redemption***

Under this category also debentures are classified under two heads :

(i) **First Mortgage Debentures :** The debenture that should be redeemed first on priority basis at the time of liquidation is called the first mortgage debenture. Such a situation arises when a single asset is mortgaged to raise loans more than once.

(ii) **Second Mortgage Debentures :** These debentures are redeemed only after the redemption of the first mortgage debenture. These debentures are also called as ordinary debentures.

(D) ***On the basis of transferability :***

On the basis of transferability, the debentures are classified under two heads :

(i) **Registered Debentures :** If the names and addresses of debentureholders and the serial numbers of debenture papers are recorded in the register book of the company, such debentures are called registered debentures. These debentures are not transferable by delivery. They can be transferred by a regular transfer deed and the transfer must be registered with the company. Only the registered holders are entitled to receive interest and repayment of principal sum on maturity.

(ii) **Unregistered/ Bearer Debentures :** If no records of the names and addresses of debentureholders are maintained in the register of the company such debentures are known as bearer debentures or unregistered debentures. Bearer debentures are just like bearer cheques and currency notes. Interest coupons are attached to these debentures and interest is paid to a person who holds the debenture at the time of payment. Refund of money at the time of redemption is also made to the bearer of debenture paper, whether the bearer is the actual owner or not. No stipulated formalities are to be obtained for transfer of such debentures.

(E) ***On the basis of convertibility :***

On the basis of convertibility, the classification of debentures are :

(i) **Convertible Debentures :** Convertible debentures are those in which an option is given the debentureholders to exchange their debentures for shares in the company under certa conditions and limitations imposed regarding the period during which the option may ...nvert and the terms are mentioned in the Articles of Associatic

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3.4. Internal Sources

Other than the external sources of capital there are also some internal sources of capital. Exp
even diversification of production capacity is carried out by the established companies
through internal resources such as retained profit or ploughing back of profits, pro
depreciation, proposed dividend etc. But a new company can raise funds only throug
sources, such as shares, debentures, loans, public deposits etc.

3.4.1. Retained Earnings / Ploughing Back of Profit

As already mentioned, retained earnings or ploughing back or reinvestment of a part of t
an ideal method of financing expansions and improvements. Every growing concern req
for extension and improvement. The concept of ploughing back of profits is a mana
under which the entire profits are not distributed among the owners of capital but
earned profits is 'ploughed back' or retained to be utilised in future. It is also called 's
'inter-financing' or 'financing from internal resources'. This is the only internal sourc
financing. A company may before the declaration of any dividend in any financial yea
percentage of profits for that financial year as it may consider appropriate to the
company as per section 123(1) of the Companies Act, 2013.

Other than expansion and improvements, retained earnings can be utilised for the long
such as purchase or construction of assets, modernisation, repayment of loan, redempt
share capital or debentures, meeting the long-term working capital etc. This is the c
financing and also strengthens the financial position of the company.

The practice of ploughing back of profits is influenced by many factors, such as :

(1) **Net profit :** Ploughing back of profits depends largely upon the amount of
company earned in a particular year. If a company has earned huge profi
capacity to retain profits will be higher.

(2) **Dividend policy :** Dividend policy of the company determines the extent to
retained for ploughing back.

(3) **Taxation policy :** Taxation policy of the Government also affects ploughi
retention is available only from the profit after tax.

(4) **Statutory requirement :** According to section 123(1) of the Companies Act,
transfer such percentage of profits as it may consider appropriate to the re
before the declaration of dividend in any financial year.

(5) **Future Financial Requirement :** Future financial requirement of the
retention. If there are highly profitable investment opportunities in the f
go for more retention.

(6) **Desires of shareholders :** Retention also depends on the shareholders'
have a regular income they may desire maximum distribution of profi

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etc. It is to be mentioned here that equity capital can be repaid only at the time of liquidation of a company.

Again, according to the ownership, sources can be classified as *Owned Capital*, eg. share capital, retention of profit, etc. and *Borrowed Capital* eg., debentures, loans, public deposit etc.

3.3. External Sources

The external sources of finance are classified as owned capital and borrowed capital. Owned capital can be raised from two sources — issue of equity shares and issue of preference shares.

3.3.1. Equity Shares

Equity shares are an important source of capital. These are also known as **ordinary shares or common shares**. Equity shares represent the ownership position in a company. The holders of such shares are called shareholders or stockholders who are the legal as well as the real owners of the company. They have a control over the working of the company and have voting rights at the general meeting of the company. Being the owner of the company they are to bear all the losses and risks of the company but they are paid dividend only after payment has been made to the preference shareholders. So they are paid dividend only if there is a positive profit. If profit is high, the rate of dividend will be high and *vice versa*. Equity shareholders have a residual claim on the assets of the company in the event of liquidation and they get back their capital after the claims of the creditors and preference shareholders have been met. If the value of assets is insufficient, their claims may remain unpaid in case of liquidation. These shares are preferred by persons who prefer taking risks to gain a better return and also desire to have a say in the management of the company. Inspite of so much importance, they do not have effective control over the management since the Board of Directors exercise control over the affairs of the company.

Raising of equity capital can be made directly from the public by issue of fresh equity shares or through right issue or issue of bonus shares or through issue of sweat equity shares.

Right issue represents the issue of shares of a firm among its existing share-holders only on a *pro rata* basis. To safeguard the interest of equity shareholders and enable them maintain their proportional ownership, section 62(1) of the Companies Act, 2013 provides that if a Public Limited Company intends to increase its subscribed capital by the allotment of further shares, after the expiry of two years from the formation of the company or the expiry of one year from the date when the first allotment of shares was made in the company, whichever is earlier, such shares must be offered to holders of existing equity shares in proportion to purchase of those shares. Shares so offered to the existing shareholders are called ***right shares*** and this right is known as *pre-emptive right*. The shareholders may exercise rights or may sell the rights through a broker. It is important that the rights have to be exercised within a specified period as stated by the firm. Right shares may be issued at par or at a premium. Generally the issue price of such shares is fixed much below the existing market price.

Issue of *Bonus Shares* is not in fact an issue of shares to raise further capital. Through bonus issue a firm capitalises a portion of accumulated profits and reserves. So, it involves transfer of money from reserves and surplus to equity share capital. Bonus shares are issued to the existing shareholders by the existing company without any consideration, i.e., free of cost. These shares are also issued in a fixed proportion only to the fully paid equity shareholders. The bonus issue is not made to the partly paid shares until they are fully paid up.

There are different sources from where issue of bonus shares can be made. They are : (*i*) accumulated profits, (*ii*) general reserve, (*iii*) capital reserve (reserve created out of revaluation of fixed assets can not be utilised), (*iv*) capital redemption reserve u/s 55(2) of the Companies Act, 2013, (*v*) Security premium u/s 52(2) etc.

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The total amount of bonus shares issued out of free reserves shall not exceed the total amount of paid up capital. The issue of bonus shares have to be made according to the guidelines issued by SEBI (Securities and Exchange Board of India). These shares cannot be issued in lieu of cash dividend.

As a result of bonus issue, earnings per equity share comes down as the same amount of profit has to be distributed among the increased number of equity shares. If earnings do not increase after the issue of shares, future earnings per share is affected.

Other than the issue of equity shares to the public, a company can issue same class of equity shares among its employees or directors to ensure their loyalty and participation. According to section 54 of the Companies Act, 2013, a company can issue equity shares to its employees or directors at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called. These equity shares are called as *Sweat Equity*. The issue of these shares should be authorised by a special resolution passed by the company in general meeting. The company cannot issue these shares within a period of one year from the date on which the company is entitled to commence business.

Features of Equity Share :

Equity shares have a number of features which distinguishes them from other shares and securities. These shares have some special features in terms of rights and claims of their holders. Some of the basic characteristics of equity shares may be summarised as follows :

(*a*) **Claim on income :** The equity shareholders have residual claim on the income of the company. The earnings of a company after deduction of interest, tax and preference dividend are the earnings of the equity shareholders. The rate of dividend on these shares are not fixed, it depends upon the earnings of the company. For this reason, equity shares are also known as *'variable income security'*. Again, equity shareholders may not get the full amount of residual earnings as the company may retain a portion of it for future developments. The payment of dividends to the equity shareholders depends on the discretion of the management.

(*b*) **Claim on assets :** The claim of the equity shareholders on the assets of the company is also residual and is relevant only when the firm is being liquidated. Other claimants, i.e., creditors, preference shareholders, etc. are paid first in the event of liquidation and after satisfying their claims if anything is left, it belongs to the equity shareholders. If the value of the assets is insufficient, their claims may remain unpaid.

(*c*) **Right to control :** As equity shareholders are the real owners of the company, they have the right to control the operations of the company. But they have indirect control over the affairs of the company. The major policies and decisions are taken by the board of directors.

(*d*) **Voting rights :** Ordinary shareholders have voting rights in the meeting of the company. An ordinary shareholder has votes equal to the number of shares held by him. They exercise their right to control through voting. They are required to vote on a number of important matters which include election of directors, changes in the memorandum of association etc. Though the members of the board are elected by the holders of the majority of ordinary shares, the proportionate voting system enables the minority shareholders to have some representation on the board.

(*e*) **Pre-emptive right :** The ordinary shareholders of a company enjoy pre-emptive right which gives them the first opportunity to subscribe to the issue of additional shares (right shares) offered by the company on *pro rata* basis. To safeguard the interest of equity shareholders and enable them maintain their proportional ownership, the law grants shareholders the right to purchase new shares in the same proportion as their current ownership. Shares so offered to existing shareholders are called right shares and their prior right to such shares is known as

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pre-emptive right. This right protects ordinary shareholders by ensuring that management cannot issue additional shares to strengthen its control by selling them to persons of their choice.

(*f*) **Limited liability :** This is another important feature of equity shares. Although ordinary shareholders are the true owners of the company, their liability is limited to the value of shares they have subscribed. In the event of liquidation they are liable to pay only the issue price of shares purchased. If a shareholder has already paid the full price of shares purchased, he cannot be held liable to contribute anything more in the event of a financial distress or liquidation. Thus, the equity shareholders enjoy the ownership without taking the risk of unlimited liability. This feature encourages unwilling investors to invest in the company and helps companies to raise funds.

(*g*) **Maturity :** Equity share do not have any maturity date. Equity share capital is a permanent form of capital and it is not repayable during the life time of the company. Equity shareholders are paid back only at the time of liquidation of a company after meeting all other claims including the claim of preference shareholders. But the company can buy back its own shares as per Section 68, 69 and 70 of the Companies Act. 2013.

(*h*) **Rules for issue :** The issue of equity shares should be made strictly according to the Companies Act and SEBI guidelines. The issue of these shares should be made within the limit of authorised equity share capital as mentioned in the memorandum of association of the company. These can be issued at par, at a premium or at a discount.

(*i*) **Capital gain :** Ordinary shareholders may have an opportunity of gain in capital appreciation of shares. As the listed equity shares can be traded freely in the stock market, they have high marketability. Thus, an equity shareholder can easily sell his holding in favourable market condition and can earn capital gain besides earning the normal dividend.

(*j*) **Tax on dividend :** A differential rule exists regarding tax on dividend for the company which declares dividend and for the recipient, i.e., the equity shareholders who actually receives the dividend. A dividend tax is to be paid on dividend payable by the company u/s 115O, 115P, and 115Q of the Income Tax Act, 1961 and, thereby, such dividend is tax-free in the hands of the recipient. Thus, it encourages investors to invest their funds in the company for earning a regular source of non-taxable income. But, the payment of dividend entails an additional burden on the company in the form of dividend tax.

(*k*) **Right to receive annual report :** Equity shareholders have the right to receive the annual report of the company at least 21 days prior to the annual general meeting as per section 136 of the Companies Act, 2013. This enables the equity shareholders to be aware of the affairs and the operations of the company.

Advantages of Equity Share :

Advantages of the equity shares can be stated from the company's point of view and from the shareholders' point of view.

From the company's point of view :

(1) **Permanent capital :** It represents a permanent source of capital. Equity share is available for use as long as the company is a going concern. It does not require any repayment except in the case of liquidation.

(2) **No financial burden :** Financing through equity shares does not impose any financial burden on the company as the company is not legally obliged to pay dividend at the time of financial difficulties. Dividend is payable only if there remains a surplus profit after the payment of tax and preference dividend.

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(3) **Issue of other securities :** Equity shares do not carry any charge against the assets of the company. This helps the company to raise funds easily by issuing other securities like preference shares and debentures, i.e., the assets are free for raising additional finance.

(4) **Creditworthiness :** It enhances the creditworthiness of the company. As the equity shares have no charge on the assets of the company, additional funds can be raised through borrowings, with the assets as the security.1

(5) **Stability in control :** Controlling power remains in the hands of the equity shareholders. Hence, instability in control gets reduced.

(6) **New company :** Issue of equity shares is the most important source for raising funds for a new company having no market familiarity and a sound financial structure.

From the shareholders' point of view :

(1) **Ownership :** Equity shareholders are the true owner of the company. By investing in equity shares, investors become owner of the company.

(2) **Controllability :** Equity shareholders have the right to control the operations of the company. They have an indirect control over the affairs of the company.

(3) **Voting rights :** Ordinary shareholders have the voting rights in the meeting of the company. They exercise their 'right to control' through voting.

(4) **Pre-emptive right :** Ordinary shareholders enjoy pre-emptive right which enables them with the first opportunity to subscribe to the issue of additional/right shares offered by the company on *pro rata* basis before they are offered to the public.

(5) **Scope of getting bonus shares :** Equity shares get the benefit of acquiring high-priced shares without any consideration as bonus shares.

(6) **Liability :** Liability of equity shareholders is limited to the face value of equity shares held by them. They are not liable to contribute anything at the time of liquidation if their shares are already paid up in full.

(7) **Return :** Equity shareholders share the residual income. If the company runs successfully and profitably, the equity dividend can be very high. Not only do they enjoy a high rate of dividend, they also have a regular source of income.

(8) **Non-taxable dividend :** Equity shareholders also enjoy the benefit of non-taxable dividend as the dividend received by them is a fully tax-free income.

(9) **Marketability :** Equity shares have high marketability. They are readily saleable.

(10) **Capital gain :** As the equity shares have high marketability, equity shareholders always have an opportunity of earning capital gain transferring their shares at high market price.

(11) **Liquidity :** Whenever equity shareholders need money, they can dispose the shares in the stock market which increases their liquidity position.

Disadvantages of Equity Share :

Equity capital has some disadvantages compared to other sources of capital. This can also be stated from the company's point of view and from the shareholders' point of view.

From the company's point of view :

(1) **High cost :** The equity share capital has the highest specific cost of capital among all the sources. The rate of return required to be paid to the equity shareholders is generally higher than the rate of return required to be paid to the other investors.

(2) **Cost of issue :** The cost of equity issue which comprises underwriting commission, brokerage and other issue expenses, is generally very high. Moreover, the dividend on equity shares is not deductible as an expense out of the profits of the company for taxation purpose.

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(3) **Rigidity in capital structure :** As equity capital is a permanent source of capital, it provides no flexibility in the capital structure.

(4) **Over-capitalisation :** If excess amount of capital is invested in the business by way of equity financing, the same may-g result in the accumulation of idle capital which earn nothing and at the same time leads to over-capitalisation.

(5) **Trading on equity :** Excessive reliance on financing through equity shares reduces the capacity of the company to trade on equity. It cannot get the advantage of use of cheaper sources of debt capital for magnifying the return of equity shareholders if the amount of equity capital is more in the capital structure.

(6) **Creation of inefficiency :** Substantially owned funds create inefficiency in the organisation, as it does not have a permanent obligation either to repay the principal amount or the interest, as in the case of borrowings.

(7) **Passive investors :** A new company having no reputation in the market may find it difficult to raise funds through equity financing since equity shares do not attract passive investors who always prefer to have a steady income and the safety of their investments.

(8) **Capital market :** Issue of equity capital is dependent on the efficient system of the capital market.

From the shareholders' point of view :

(1) **Uncertain return :** As the rate of return to equity shareholders depend on the amount of profit, there is no certainty of their income. Even if the company makes substantial profit, they do not have any guarantee of receiving dividend. Equity shareholders cannot contest the dividend decision of the board of directors.

(2) **Risky investment :** Equity investment is a risky investment. Equity stock prices tend to fluctuate widely which makes equity investments risky. Downward price movement may result in a considerable capital loss for the equity shareholders.

(3) **Controllability :** Though theoretically equity shareholders enjoy the controlling power over the firm, small equity investors cannot really exercise such power over the firm. As the equity shareholders are scattered and ill-organised, it is not possible for them to control the affairs of the company in the real sense.

(4) **Lowest priority :** As the equity shareholders are the last claimants of the assets of the company, they may not get anything in the event of liquidation.

(5) **Earnings dilution :** New issue of equity capital may reduce the earnings per share and thus may have an adverse effect on the market price of the equity share if the profits do not increase immediately in proportion to the increase in the number of equity shares.

(6) **Dilution of ownership and control :** If the equity shareholders are unable to exercise their pre-emptive right for any reason, i.e., if they are unable to invest in additional shares, the shares are issued to outsiders. This may result in dilution of ownership as well as dilution of control of the existing shareholders.

3.3.2. Preference Shares

The second important source of finance is the issue of preference shares. As the name itself implies, preference share is a type of security through which a company obtains funds in exchange for certain

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preference shares. Preference capital represents a hybrid form of financing possessing some characteristics of debt, such as, fixed dividend rate, no voting right, priority over equity capital etc. and some characteristics of equity, such as, payment of preference dividend is made out of distributable profits etc. As the preference shareholders do not enjoy any voting right, they do not have to bear any risks and hence, ownership is not affected. These shareholders are not treated as the true owners of the company. The investors who are not willing to take any risk and are satisfied with the fixed lower rate of dividend like to invest in preference shares.

Features of Preference Share :

The following are some of the features of preference shares :

(1) **Ownership :** Preference shares are a part of ownership of the company. But they do not have any controlling power on the affairs of the company. Again, they enjoy only a fixed rate of dividend. Hence, it can be said that they are the owners of the company but not in its true sense.

(2) **Preference dividend :** Dividends at a fixed rate are payable on preference shares, the rate of which is declared at the time of issue of such shares. Preference dividend is an appropriation of profit and not a charge against profit.

(3) **Cumulative dividends :** Unless otherwise stated in the terms of issue, the preference shares are cumulative in the sense that all unpaid dividends are carried forward, gets accumulated and are paid in future whenever the company wants to pay equity dividend.

(4) **Claim on Income :** Preference capital has a prior claim on income over equity capital. Whenever a company has distributable profits, the dividend on preference share capital is to be paid first before the payment of equity dividend. Thus, preference share is referred to as a 'senior security'.

(5) **Claim on assets :** Preference shares also have a prior claim on assets of the company. They get a preference for the repayment of capital in the event of liquidation of the company. Their claim is to be settled first before making any payment to the equity shareholders.

(6) **Redeemability :** According to section 55(1) of the Companies Act, 2013, company cannot issue any preference shares which are irredeemable in nature. Section 55(2) states that a company, if so authorised by its articles, issue preference shares which are liable to be redeemed within a period not exceeding 20 years from the date of their issue. However, for a company engaged in infrastructural projects may issue preference shares for a period more than 20 years but not exceeding 30 years subject to the redemption of a minimum 10% of such preference shares per year from the 21st year onwards or earlier on proportional basis.

(7) **Voting right :** Preference shareholders ordinarily do not possess any voting right. However, preference shareholders can exercise the voting right on a resolution which directly affects the rights attached to preference shares. So, the voice of the preference shareholders in the management of the company is quite limited.

(8) **Hybrid form of security :** As it is already mentioned, preference capital represents a hybrid form of security, which satisfy some of the characteristics of equity capital and some of the characteristics of debt capital.

(9) **Cost :** Preference share capital is much costlier than debt capital. The cost of debt capital is the interest amount which is an admissible charge against profit for taxation purpose. So, tax benefit can be obtained for the payment of interest. But preference dividend is an appropriation of profit, i.e., dividend is declared from the post-tax profit. Hence, the full amount of preference dividend is treated as the cost of preference capital as no tax benefit is obtained for such payment.

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(10) Security : Though preference capital has some of the features of debt capital, no collateral or mortgage is required for obtaining capital by issuing preference shares.

Classification of Preference Shares :

Preference shares may be of different classes. According to the rights and advantages enjoyed by the preference shareholders, it can be classified under four categories :

(A) According to the right to get dividend at a fixed rate :

Under this category preference shares are of two types :

(i) **Cumulative preference shares :** Preference share gets a fixed amount of dividend every year. In the absence of profit or insufficient profit for a particular year if the dividend is not paid, the arrear dividend will accumulate and the whole amount of arrear dividend is to be paid in the year when the company earns sufficient amount of profit. So, the dividend on these preference shares is guaranteed. The preference shares which carry the right to get arrear dividends are known as cumulative preference shares.

(ii) **Non-cumulative preference shares :** The preference shares which have no right to carry arrear dividends are known as non-cumulative preference shares. If preference dividend is not paid in any particular year due to loss or insufficient profit, the dividend for that year will not accumulate to be paid in future. Thus holders of such shares have only a preferential current dividend right.

(B) According to redeemability :

Preference shares under this classification fall under two heads :

(i) **Redeemable preference shares :** When preference share capital is redeemed after a stipulated time, such shares are called redeemable preference shares. As per section 55(1) of the Companies Act, 2013, the stipulated period within which preference shares are to be redeemed is 20 years. However, a company engaged in infrastructural projects may issue preference shares for a period exceeding 20 years.

(ii) **Irredeemable preference shares :** These shares are also called ordinary preference shares. Preference shares which cannot be redeemed during the lifetime of the company are known as irredeemable preference shares. It is already mentioned that irredeemable preference shares cannot be issued in India as per section 55(1) of the Companies Act, 2013.

(C) According to the right to participate in the surplus profit :

Preference shares are divided into two heads under this category :

(i) **Participating preference shares :** Participating preference shares are those shares which participate in the surplus profits of the company. A company having participating preference shares first pays the preference dividend at a fixed rate, and then pays a reasonable rate of dividend to the equity shareholders. If some profits still remain after paying both these dividends, then preference shareholders participate in the surplus profits in a stated manner. The mode of dividing surplus profits among preference shareholders and equity shareholders is given in the Articles of Association. Similarly, these shares are also entitled to participate in the residual assets after the payment of their normal claim at an agreed rate in the event of liquidation of company.

(ii) **Non-participating preference shares :** When the preference shareholders get only preference dividend at a fixed rate and do not enjoy the right to participate in the surplus profits, such preference shares are called as non-participating preference shares.

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(D) ***According to convertibility :***

Preference shares under this category fall under two heads :

(*i*) **Convertible preference shares :** The holders of preference shares which are given a right to convert their holdings into equity shares after a stipulated period of time are called convertible preference shares. The option of conversion and the specific period after which the conversion may take place should be mentioned by the company at the time of the issue of these shares. The right of conversion must also be authorised by the Articles of Association.

(*ii*) **Non-convertible preference shares :** When the right of conversion of preference shares to equity shares is not permissible to the preference shareholders, such preference shares are known as non-convertible preference shares.

Cumulative Convertible Preference Shares (CCP) :

Apart from the above classification a new financial instrument was introduced in the capital market in March, 1985. This instrument is issued as preference share carrying cumulative dividend right at ten per cent. These shares are compulsorily to be converted within a period of 5 years but conversion may take place at any time after a period of 3 years. According to the guidelines for issue of these shares, such shares ordinarily be of the face value of ₹ 100 and it could be listed in one or more stock exchanges in the country. These shares should be issued only by the public limited companies.

Following are the various set of objectives for the issue of this instrument. These are :

(*i*) Setting up new projects.

(*ii*) Expansion or diversification of existing projects.

(*iii*) Normal capital expenditure for modernization, and

(*iv*) Working capital requirement.

When the projects are assisted by the financial institutions, it is required to take the approval of those institutions before the issue of CCP shares.

The CCP shares assure investors a minimum fixed return together with the prospect of capital appreciation and high equity dividend after conversion. But it also faces certain limitations, such as, it represents an expensive source of finance, it does not provide any benefit under the Income Tax Act. etc.

Advantages of Preference Share :

Preference shares provide a number of advantages both to the company as well as investors or shareholders.

From the company's point of view :

The Company has the following advantages by issuing the preference shares :

(1) Payment of dividend : There is no legal obligation to pay preference dividend. The non-cumulative shares need not to pay any dividend if there is no profit.

(6) **Flexibility in capital structure :** Issue of preference shares brings flexibility in the capital structure of the company as they can be redeemed after a specific period of time.

(7) **Future expansion :** These shares can be issued to finance capital expenditure involved in expansion programmes and to strengthen the present equity base with a view to future expansion.

(8) **Trading on equity :** The company can take the advantage of trading on equity by the issue of preference shares. In case the company's rate of return is more than the cost of capital of preference shares, the financial leverage generated by the issue of preference shares produces magnified increase in Earnings Per Share (EPS) for the equity shareholders.

(9) **Creditworthiness :** Preference shares add to the net worth of the company and thereby strengthen the financial position of the company. Additional net worth enhances the ability of the company to borrow in future.

(10) **Hedge against inflation :** As a fixed financial commitment is given to the preference shareholders which is unaffected by inflation, hence financing through these shares provide a hedge against inflation.

(11) **No threat of liquidation :** If the company fails to pay the preference dividends, it does not face any threat of liquidation or other legal proceedings as there is no legal compulsion to pay preference dividend.

▸ *From the shareholder's point of view :*

Investors in preference shares enjoy the following advantages :

(1) **Fixed return with less risk :** These shares have a special appeal to investors who are not inclined to take great risk and are satisfied with a fixed return on their investments.

(2) **Preferential right :** Preference shareholders always enjoy the preferential right in respect of payment of dividend and repayment of capital, in the event of winding up of the company, over other classes of shares.

(3) **Guarantee of refund :** Ordinary investors prefer to invest in preference shares as there is a guarantee of refund of capital after a definite period.

(4) **Protection of right :** Although preference shareholders carry no voting rights, they can vote on matters which affect directly their rights and on all resolutions if the dividend due on their shares is unpaid.

(5) **Tax free dividend :** As per section 10(34) of the Income Tax Act, 1961, dividends are tax free in the hands of receipient.

▸ Disadvantages of Preference Share :

Inspite of many advantages, preference shares suffer from many shortcomings which are discussed both from the company's point of view and investors'/shareholders' point of view.

▸ *From the company's point of view :*

The following are the main disadvantages of preference shares from the company's point of view :

(1) **Cost of capital :** The issue of preference shares is costlier than the issue of debt capital. These shares are to be given a rate of dividend which is higher than the prevailing rate of interest on debt capital.

(2) **Financial burden :** Cumulative preference shares require payment of arrear dividend. This is no doubt a great burden on the company and the equity shareholders suffer on this account.

(3) **Claim on assets :** The issue of preference shares mean diminution of equity shareholder's claim over the assets of the company.

(4) **Repayment :** Unlike equity capital, preference capital cannot be used permanently by a company. Like borrowed capital, it is to be repaid.

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(5) **Affects credit worthiness :** Although there is no legal obligation to pay dividend on preference shares, but frequent delays or non-payment adversely affect the credit worthiness of the firm.

(6) **Affects value of the firm :** For the same reason as mentioned above, it adversely affects the market position of the company and may reduce the market price of the equity shares and therefore, it affects the value of the firm.

(7) **Cash outflow :** As the preference shares are to be redeemed compulsorily within a period of 20 years, it entails a substantial cash outflow from the company.

(8) **No tax benefit :** Like interest on debt capital preference dividend is not a deductible expense for taxation purpose. This causes heavy strain on the company.

(9) **Decrease in EPS for the equity shareholders :** If the company is not able to earn a return at least equal to the cost of preference share capital, it may result in decrease in EPS for the equity shareholders.

(10) **Liquidation :** The payment of dividend on preference shares in times of bad trade cause serious strain on the finance of the company and may ultimately bring about liquidation.

(11) **Affects flexibility in company management :** When the consent of preference shareholders is required to incur further indebtedness, it means a restrictive clause in regard to the flexibility of company management.

◗ ***From the shareholders' point of view :***

Shareholders suffer from the following demerits of preference shares :

(1) **Rate of dividend :** Preference shareholders are to remain satisfied with a fixed rate of dividend and that too at a moderate rate. So, investment in preference shares is less attractive than investment in equity shares.

(2) **No voting right :** Preference shareholders are deprived of voting rights except in cases which directly affects their right. They remain at the mercy of the management for the payment of dividend and redemption of their capital.

(3) **No participation in management :** As the preference shareholders do not enjoy any voting right, they do not have any voice in the management of the affairs of the company.

(4) **Status :** Preference shareholders do not enjoy any right of either owners or creditors. They cannot claim dividend at a higher rate in case the firm earns high profit. Again, if there is a loss, preference shareholders do not get any dividend. So, they neither enjoy the right of owners or the right of creditors.

(5) **Capital appreciation :** The prospect of capital appreciation in preference share is lower than the equity shares.

(6) **Marketability :** Preference shares are not easily marketable as equity shares.

(7) **Market price fluctuation :** The market prices of preference shares fluctuate much more than that of debentures.

(8) **Market situation :** In a good market situation, the return on equity shares is much higher than the return on preference shares as the preference shares do not get anything more than the preference dividend which has a fixed rate. So, in a good market situation, investment in these shares is not much attractive.

◗ Difference between Equity Shares and Preference Shares :

Both equity shares and preference shares are the part of ownership securities, yet there are numerous differences between these two shares. These are enumerated in the next pages :

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Equity Shares	Preference Shares
1. Equity shares are issued to provide long-term finance.	1. Preference shares are issued to provide long and medium-term finance.
2. Holders of these shares are treated as the real owners.	2. Holders of these shares are the owners but not in true sense.
3. Being true owners of the company, equity shareholders bear all related risks.	3. Usually preference shareholders have no such risk except in case of non-cumulative preference shareholders who bear the risk of not getting dividend in a no-profit year.
4. Equity shareholders exercises full control over the management of the company.	4. Preference shareholders exercises no control over the management of the company.
5. Equity shareholders always enjoy full voting right in the meetings of the company.	5. Preference shareholders do not have any voting rights except in the cases which directly affects their right.
6. Equity shares are not redeemble before liquidation but a company can buy back its own equity shares u/s 68, 69 and 70 of the Companies Act, 2013.	6. Preference shares are to be redeemed within a period of 20 years.
7. A joint stock company must issue some equity shares as per Companies Act.	7. Issue of preference shares is not compulsory. It depends upon the discretion of the company.
8. Equity shareholders have residual claim on the income of the company.	8. Preference shareholders enjoy preferential claim over the equity shareholders on the income of the company.
9. Rate of dividend is not fixed for these shares. It depends upon the profit earned by the company and the dividend policy adopted by the company.	9. As per the directives of the Articles of Association, there is a fixed rate of dividend for these shares. In case of no profit, preference shareholders do not get any dividend except cumulative dividend.
10. In case of liquidation, equity shares enjoy residual claim on the assets of the company.	10. They enjoy preferential claim on assets of the company over equity shareholders in the event of liquidation. Participating shareholders gets a part of surplus profit, if any, after meeting the dues to the equity shareholders.

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Different Aspects	Equity Shares	Preference Shares
11. Types	11. Equity shares are of single type. There is no classification of equity shares.	11. Preference shares may be of different types, such as cumulative, non-cumulative, participating, non-participating, convertible, non-convertible, redeemable and irredeemable preference shares.
12. Burden	12. It causes least burden on the finance of the company.	12. It causes fixed burden on the finance of the company.
13. Participation in meeting	13. Equity shareholders are entitled to participate in the general meeting of the company.	13. Preference shareholders do not have such right.
14. Nomination of directors	14. Equity shareholders are empowered to nominate the board of directors of the company.	14. Preference shareholders do not have any power to nominate the members of the board of directors.
15. Participation in prosperity	15. The holders of equity shares get the scope for participation in the prosperity of the company.	15. There is no scope for participation in the prosperity of the company.
16. Capital reduction	16. Reduction of equity share capital is possible through reorganisation.	16. Reduction of preference share capital is possible only through payment.
17. Marketability	17. These shares are marketable even to investors of small means because of its low denomination.	17. These shares are marketableonly to investors of moderate means because of its higher denomination.
18. Market price	18. The market price of equity shares fluctuates very widely.	18. Price fluctuation of preference shares is relatively less.
19. Capital appreciation	19. In case the market value of equity shares goes up, the holders get the benefit of capital appreciation of their investment.	19. Preference shareholders do not get the benefit of capital appreciation of their investment as they usually do not enjoy any right in the surplus profit earned by the company.
20. Capital structure	20. Equity shares make the capital structure rigid as the redemption of equity shares cannot be possible.	20. As the preference share capital can be redeemed easily in case of necessity, it provides much flexible capital structure.
21. Borrowing strength	21. It strengthens the borrowing capacity of the company.	21. It lessens the borrowing capacity of the company.
22. Trading on equity	22. Trading on equity is possible with preference shares and debentures.	22. Trading on equity is not possible without preference shares.
23. Choice of investors	23. Investors of adventurous spirit and risk-bearing capacity are mainly interested to invest in equity shares.	23. Conservative investors of less adventurous spirit and risk-bearing capacity and who prefer to have a fixed earning, like to invest in preference shares.

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3.3.3. Debentures

So far we have dealt with 'owned capital'. But a company may wish to borrow money from persons who are willing to lend instead of buying shares. Money received as a loan is called *'Borrowed capital'*, and we shall now deal with it. The money lent to the company must be recorded and acknowledged by the issue of a document which is called a 'Debenture'. A company may raise long-term loan by the issue of debentures.

According to the Companies Act, debentures include debenture stocks, bonds and other securities of a company, whether constituting a charge on the assets of the company or not. From the view point of the company, a debenture may be defined as an instrument executed by a company under its common seal acknowledging indebtedness to some person or persons to secure the sum advanced. Debentures are termed as "Creditorship Securities". According to **Thomas Evelyn,** *"A debenture is a document under the company's seal which provides for the payment of a principal sum and interest thereon at regular intervals, which is usually secured by a fixed or floating charge on the company's property or undertaking and which acknowledges a loan to the company's property or undertaking and which acknowledges a loan to the company"*. A debentureholder is a creditor of the company. They get a fixed rate of interest even if the company makes no profit. The debentures are generally given a floating charge over the assets of the company. In order to meet its initial needs and also for extension and development, a company supplements its capital by the issue of debentures. They are normally repayable at the end of the period for which the loan is taken.

Features of Debentures :

As already mentioned, a debenture is a creditorship security with a fixed rate of interest, a fixed maturity period and a certainty in income. The salient features of debentures are as follows :

(1) **Trustee :** A trustee is appointed through an indenture/trust deed when a debenture issue is sold to public. The trustee is usually a financial institution or bank or insurance company or a firm of attorneys, who protects the interest of debentureholders. The trustee is responsible to see that the borrower fulfills all its contractual obligation.

(2) **Security :** Generally, debentures are secured through a charge on the present and future immovable assets of the company. This is called equitable mortgage.

(3) **Interest :** A fixed rate of interest is paid annually or half yearly or quarterly on the value of debentures. The rate is fixed at the time of issue of debentures. It is called the contractual or *coupon rate of interest*. A company has a legal obligation to pay the interest on due dates irrespective of its level of earnings. Debenture interest is tax deductible for computing the company's corporate tax.

(4) **Maturity :** Although debentures provide long-term finance to a company, they mature after a specific period at a definite time as stipulated in the issue. In India, a debenture is typically redeemed after 7 to 10 years in installments. The debentureholders may force winding up of the company as creditors, if the company does not pay back the principal amount on the specific date.

(5) **Debenture redemption reserve :** A Debenture Redemption Reserve (DRR) is created with at least 50% of the amount of issue/redemption before commencement of redemption for the purpose of redeeming all debentures which have maturity period of more than 18 months.

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(6) **Sinking fund :** A sinking fund may be created under the control of the trustee for which cash is set aside periodically for retiring debentures. Sometimes, the company can itself handle the retirement of debentures using these funds.

(7) **Call and put provision :** Issue of debentures sometimes provide a call feature which entitles the company to redeem its debentures at a certain price before the maturity date. The call price may be more than the issue price which is generally 5% of the par value in India. This difference in prices is called the *call premium*. This provision is also called a 'buy-back' provision.

The put option gives a right to the debentureholder to seek redemption of debentures at a predetermined price on a specific date.

(8) **Credit rating :** Debentures are rated by professional bodies, such as, CRISIL, ICRA, CARE etc. to indicate the degree of their safety. Credit rating ensures timely payment of interest and redemption of principal by a borrower. Credit rating should be done compulsorily.

(9) **Claim on income :** Debentureholders enjoy preferential claim on income of the company over shareholders. The payment of interest and repayment of principal is a contractual obligation enforced by law and is to be paid before paying any dividend either to preference shareholders or equity shareholders. A company can be forced to bankruptcy if it fails to pay interest to debentureholders.

(10) **Claim on assets :** Debentureholders also enjoy prior claim on the assets of the company over the shareholders in the event of liquidation of the company. Debentureholders may have specific charge on the assets of the company or a floating charge over all the assets of the company. The claim of debentureholders on assets ranks *parispassu* with other unsecured creditors if the assets pledged to them are not sufficient to satisfy their claims.

(11) **Control :** As the debentureholders are treated as the creditors of the company, they do not have any control over the management of the company. They do not enjoy any voting right. But at the time of liquidation, if their claim remains unpaid, they may take control over the company.

Types of Debentures :

There are several types of debentures which have appeared in the market. To attract more and more debentureholders, companies are adding different innovative features to these instruments. The types of debentures may be classified in the next page :

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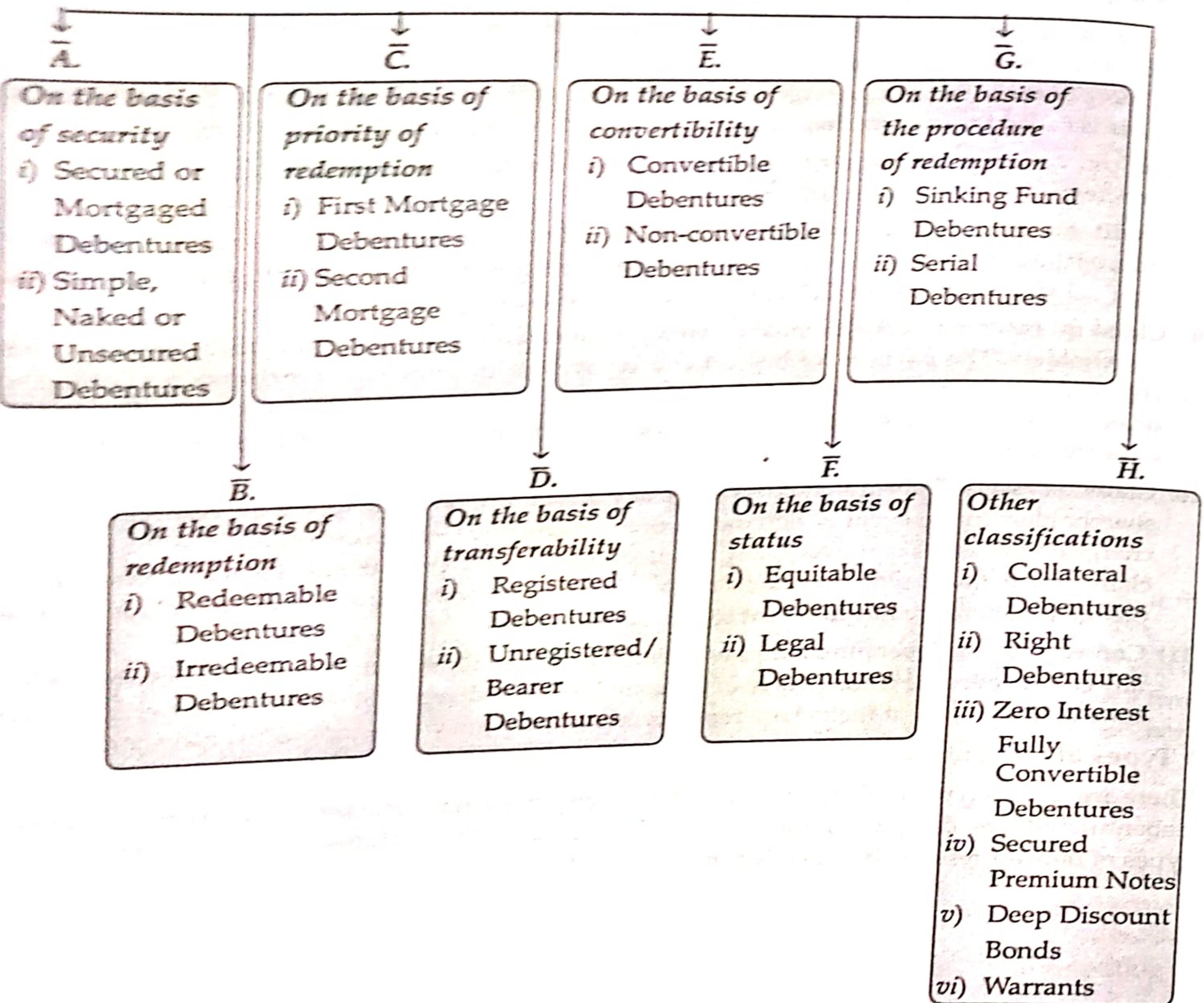

1) ***On the basis of security :***

On the basis of security, debentures may be classified under two heads :

(i) **Secured or Mortgaged Debentures :** If a debenture is issued against mortgage of an asset, it is called the Mortgaged Debenture. Mortgaged debentures again can be classified into two categories :

(a) Debentures with a fixed charge, the holders of which have prior right over the particular asset, and

(b) Debentures with floating charges, the holders of which carry a charge on all the assets of the company.

The security helps reducing the risk of debentureholders.

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(ii) **Simple, Naked or Unsecured Debentures :** When no asset is pledged under mortgage to raise loan by issuing a debenture paper, it is called the simple or naked or unsecured debenture. They have no priority as compared to other creditors. They are treated as the ordinary creditors at the time of winding up of the company.

(B) *On the basis of redemption :*

On the basis of redemption, debentures may be classified under two heads :

(i) **Redeemable Debentures :** Redeemable debentures are those on which the repayment of the principal is to be made on a specific date or in installments either at the company's option or at fixed intervals as long as the company is a going concern. The time and mode for redeeming the debentures are fixed at the time of their issue.

(ii) **Irredeemable Debentures :** Irredeemable debentures or perpetual debentures are those in respect of which no time is fixed within which the company is bound to pay, although it may pay back at any time it chooses. So, generally, it is not paid back during the life time of the company. The debentureholders cannot demand payment as long as the company is a going concern and does not default in the payment of interest. But all debentures, whether redeemable or irredeemable, becomes payable if the company goes into liquidation.

(C) *On the basis of priority of redemption*

Under this category also debentures are classified under two heads :

(i) **First Mortgage Debentures :** The debenture that should be redeemed first on priority basis at the time of liquidation is called the first mortgage debenture. Such a situation arises when a single asset is mortgaged to raise loans more than once.

(ii) **Second Mortgage Debentures :** These debentures are redeemed only after the redemption of the first mortgage debenture. These debentures are also called as ordinary debentures.

(D) *On the basis of transferability :*

On the basis of transferability, the debentures are classified under two heads :

(i) **Registered Debentures :** If the names and addresses of debentureholders and the serial numbers of debenture papers are recorded in the register book of the company, such debentures are called registered debentures. These debentures are not transferable by delivery. They can be transferred by a regular transfer deed and the transfer must be registered with the company. Only the registered holders are entitled to receive interest and repayment of principal sum on maturity.

(ii) **Unregistered/ Bearer Debentures :** If no records of the names and addresses of debentureholders are maintained in the register of the company such debentures are known as bearer debentures or unregistered debentures. Bearer debentures are just like bearer cheques and currency notes. Interest coupons are attached to these debentures and interest is paid to a person who holds the debenture at the time of payment. Refund of money at the time of redemption is also made to the bearer of debenture paper, whether the bearer is the actual owner or not. No stipulated formalities are to be obtained for transfer of such debentures.

(E) *On the basis of convertibility :*

On the basis of convertibility, the classification of debentures are :

(i) **Convertible Debentures :** Convertible debentures are those in which an option is given to the debentureholders to exchange their debentures for shares in the company under certain conditions and limitations imposed regarding the period during which the option may be exercised. The right to convert and the terms are mentioned in the Articles of Association. The conversion may take place at a given rate or at a given ratio. Convertible debentures

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g a secured creditor of the company and then to change

be of two types :

es (FCD) : When the full amount of debentures is converted lapse of a certain period as specified at the time of issue, fully convertible debentures.

ntures (PCD) : When a part amount of debentures is converted he balance part is not converted, the debentures are called ntures. The inconvertible part of the PCD is redeemed after the riod. The offer for debenture contains the details of the conversion of these debentures get the advantage of both convertible and entures blended in one debenture.

tures : If there is no option to convert debentures into equity shares, d non-convertible debentures. So, a holder of this debenture cannot shareholder. All debentures, generally, are non-convertible unless the fically get the option for conversion.

this category are :

tures : Equitable Debentures are those debentures which are secured by leeds of the property with a memorandum in writing, creating a charge perty.

res : Legal Debentures are those in which the legal ownership of the property ny is transferred by a deed to the debenture holders as security for loans.

ne procedure of redemption :

classified under two heads in this category :

und Debentures : Sinking Fund debentures are those debentures which are out of sinking fund created for the purpose of redemption. Such redemption ce in installments at a regular interval.

Debentures : Serial debentures are those debentures which are redeemed serially. of the total debentures are redeemable according to their serial numbers in installments.

ssifications :

om the above classifications, debentures may also be divided into some other categories. re :

ollateral Debentures : Collateral debentures are those debentures which are issued as ollateral or secondary security by a company to raise a loan or overdraft etc. generally from the banks and financial institutions. These debentures are issued to provide security against raising a loan. Company does not get cash or anything else against the issue of such debentures. The lender simply holds the debentures and no interest is payable on these instruments. These become effective only when the company makes a default in the repayment of loan against which these have been issued. At that time, the lender becomes a debentureholder of the company like other debentures.

(ii) **Right Debentures** : Right debentures are issued to raise the long-term working capital requirement of a company. These debentures are issued to the existing resident Indian shareholders on a right basis in proportion to their shareholding. These debentures cannot be converted into equity shares but can be redeemed after a specific period of time as indicated in offer document.

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(iii) **Zero Interest Fully Convertible Debentures (ZFCD) :** Zero interest fully convertible debentures are those debentures which are to be converted compulsorily into equity shares at the expiry of a given period (not exceeding 3 years) from the date of issue. No interest is payable by the company on these debentures from the date of issue to the date of conversion. If the company wants to convert these debentures into equity shares just after 18 months from the date of issue, the debentures are to be credit-rated by an approved credit rating agency as per the SEBI guidelines. The return to debentureholders is available in the form of difference between the issue price of the ZFCD and the market price of the converted shares.

(iv) **Secured Premium Notes (SPNs) :** Secured premium notes is a tradable instrument in which debentureholders do not get any scope of conversion of their holding to equity shares, rather a detachable warrant is attached against which the holder gets the right to purchase equity shares at a pre-fixed price after a specific 'lock in' period. No interest is payable on such debentures. In India, Tisco Ltd. had first issued SPNs during the month of August in the year 1992.

(v) **Deep Discount Bonds (DDBs) :** Another innovative debt instrument is the deep discount bond which is issued at a discount to the face value. It is also a type of zero interest bond and not convertible. The DDB is redeemed at the expiry of a specified period at the face value. The return available to the holders of DDB is the difference amount between the face value and issue price. Industrial Development Bank of India was the first institution to issue DDB in the year 1992 for a 'deep discount' price of ₹ 2,700, the face value of which is ₹ 1 Lakh over the maturity period of 25 years. The investor of DDB were given an option to redeem at the end of 5th, 10th, 15th and 20th year at different values.

(vi) **Warrants :** A warrant is a security or a right that permits the holder to buy a specified number of shares of common stock during or at the expiry of a specified period and at a given price. So, a warrant gives the holder the right to purchase a fixed number of shares in the future at a pre-determined price from the company. The holder of a warrant may or may not exercise his right for purchasing the company's share. If he exercises his right by paying the specified amount, he becomes an equity shareholder of the company and if he does not, then the warrant lapses. The holder of a warrant is also allowed to transfer or sell his right in the secondary market. Warrants are brought and sold in the same way as stocks. Warrants are long-term rights. They may have expiry dates that lie between 5 to 10 years.

Warrants are generally issued with other securities, i.e., a bond or a preference share, in a package. Warrants are often employed as "sweeteners" to a public issue of bonds or debts, to add to the marketability of the issue. During a period of financial crunch, a company may decide to use warrants to make their debt issue attractive to the investors and to obtain the required amount of capital easily. The investor not only obtains the fixed return associated with the debt but also gets an option to purchase common stock at a stated price.

Warrants are attached with the bond or with the preference shares in a definite proportion which is known as the *exercise ratio*. It reflects the number of shares that can be acquired per warrant. A warrant can either be detachable or non-detachable. Detachable warrants can be sold separately from the bond as a result of which the holder can continue to retain the instrument to which the warrant was tied up. But a non-detachable warrant cannot be sold separately from the bond with which it was tied up. The holders of the warrants are not the shareholders of the company until they exercise their options.

For many years, warrants were considered speculative instruments rather than investment securities, since the warrant has no value other than as a right to purchase other securities. Deepak Fertiliser and Petrochemical Corporation Ltd. issued debentures with warrants attached in 1987. In 1992, the Tata Iron and Steel Company issued secured premium notes with warrants attached to attract investors ; Ranbaxy and Reliance Ltd. issued securities with warrants attached in 1995.

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A warrant is different from convertible securities (i.e., convertible debentures and convertible preference shares). A holder has the right to receive equity shares through the exchange of the convertible securities. But in case of a warrant, the security holder has a right to purchase equity shares at a specified price. In the case of convertible securities, the securities and the right are not separable but a warrant may be detachable. In case of exercising right, convertible securities have to be surrendered. But in case of detachable warrants the right can be exercised separately and there is no need to surrender the securities with which the warrants were actually tied up. Warrants are exercisable against cash only. But in case of convertible securities there is no need to pay any cash. Conversion of securities against equity shares is made at a conversion rate.

So, warrants play a crucial role in funding expansion and growth programmes of an organisation. Warrants enable companies to raise funds cheaply and provide an opportunity for them to issue equity shares in future at a premium over the current price.

There are also some other innovative debt instruments which are issued to raise funds from the market, such as Callable Bond, Adjustable Rate Bonds, Inflation Adjusted Bonds (IABs) etc.

Advantages of Debentures :

Debentures as the source of capital have many advantages that can be discussed from the point of view of the company and from the point of view of debentureholders.

From the point of view of the company :

The advantages from the company's view point are :

(1) **Financial plan :** Company can raise medium term and long-term finance through the issue of debentures. Thus, adjustment in financial plan can be possible by the company to suit its requirements.

(2) **Dilution in control :** Debentures enable the company to raise finance without giving any control to the debentureholders. They do not weaken the control of existing shareholders as they do not have any voting rights. So, controls on ownership and on affairs of the company remain in the hands of the shareholders.

(3) **Rate of interest :** The rate of interest payable on debentures is fixed as well as lower than the rates of dividend paid on shares.

(4) **Tax benefit :** Interest paid on debentures is a tax deductible expenditure and thus reduces the tax burden of the company.

(5) **Cost of financing :** As the rate of interest on debentures is low as well as it is a tax deductable expenditure, the effective cost of financing by debentures becomes very low for the company.

(6) **Flexibility in capital structure :** Inclusion of debentures in the capital structure makes the capital structure of the company flexible. It enables a company to correct a situation of over capitalisation through the redemption of debentures.

(7) **Possibility of Trading on equity :** The company is able to trade on equity because of low effective cost of debentures. As a result, the company is able to pay better rates of dividend to equity shareholders.

(8) **Hedging against inflation :** Debentures provide a hedge against inflation as the interest amount as well as the principal repayment amount are fixed in monetary terms. If there is inflation at the time of repayment then the creditors are not benefited but the debtor company get the benefit of hedging.

(9) **Fund raising during depression :** A company is able to raise funds through issue of debentures even during depression since the risk of investing in debentures is low and debentures are considered to be a source of stable income.

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From the point of view of the debentureholders :

The advantages from the debentureholders point of view are :

(1) **Fixed regular income :** Debentureholders get a regular fixed rate of interest which is payable by the company even out of capital if profits are not available. So, debentures provide a stable source of income to its investors.

(2) **Less risky investment :** Debentures are a good investment from the point of view of cautious investors who do not want to risk their investments too much and yet wish to earn high and regular income.

(3) **Security :** Debentures offer a definite security to the investors and so it appeals to the conservative minds. The better the security, the greater will be the chance of a successful debenture issue.

(4) **Protection of interest :** The interest of debentureholders is protected by various provisions of the Debenture Trust Deed. There are trustees to protect their interest. Their interest is also protected by the guidelines issued by the Securities and Exchange Board of India in this regard.

(5) **Maturity period :** Generally debentures have a fixed maturity period and many investors prefer this instrument because of a fixed maturity period.

(6) **Claim on assets :** In the event of liquidation, debentureholders enjoy a preferential claim on the assets of the company over the shareholders.

(7) **Scope for becoming the owner :** Holders of convertible debentures get the scope for becoming the owners of the company after conversion of debentures into equity shares either in part or full. Not only that, they also get an additional benefit of capital appreciation and higher income in the form of dividend after conversion.

(8) **Liquid investment :** A debenture is more a form of liquid investment and an investor can obtain loan from financial institutions by mortgaging or selling debentures.

Disadvantages of Debentures :

Debenture issue is an important source of long-term financing no doubt. However, its advantages are set off, at least to some extent by its limitations. These are also observed from the company's point of view and from the debentureholders' point of view.

From the point of view of the company :

A company suffers from the following disadvantages of financing through debentures :

(1) **Permanent liability :** Payment of interest on debenture as well as repayment of the principal amount on maturity are the permanent liabilities of the company. These have to be paid even when there are no profits. Hence, it is a permanent burden of the company.

(2) **Winding up :** Failure in payment of interest and in repayment of the principal amount adversely affect the credit worthiness of the company and may force a company to go into liquidation.

(3) **Threatens liquidity position :** As the debentures are to be redeemed compulsorily at the time of maturity, it threatens the liquidity position of the company except in case of convertible debentures.

(4) **Restriction to raise other loans :** Charge on assets of the company for issuing debentures restrict a company from getting further loans against the security of assets already mortgaged to debentureholders. If the capital structure of a company is heavily loaded with debentures, banks and other financial institutions do not show favourable attitude towards the company. The goodwill of the company falls in the eyes of public too.

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(5) **Cost of capital :** The use of too much debt finacing may push the market price of equity shares down. So, it usually increases the risk perception of the investors in the firm and as a result, the overall cost of equity capital of the company will increase.

(6) **Trading on equity :** If the company earns a rate of return on capital employed which cannot meet the debenture interest, then the company cannot take the advantage of debt financing. This will have a magnified adverse effect on Earnings Per Share (EPS).

(7) **Cost of issue :** Cost of issue of debentures for raising finance is also high because of high stamp duty.

(8) **Financial burden for sinking fund :** Creation of sinking fund for the purpose of redemption of debentures results in a regular financial burden on business. An instalment amount has to be set aside every year from the profit of the company and that has to be invested in some outside securities. This creates a regular financial burden.

(9) **Not suitable for all companies :** A company whose expected future earnings are not stable, cannot issue debenture for raising long-term capital. If market demand for products of a business enterprise fluctuates severely causing heavy fluctuations in profit, then the issue of debenture is not suggested. Again a company which does not have sufficient fixed assets to offer as security to raise finance through the issue of debentures, cannot use this source of raising funds to its benefit.

(10) **Conditions in the capital market :** Conditions prevailing in the capital market is also very important in case of debenture issue, especially when the required rate of return on new debentures is too high. This may cause delay in debt financing and/or the company may resort to equity financing.

From the point of view of the debentureholders :

Many investors do not find debentures or bonds as an attractive investment opportunity because of the following limitations :

(1) **No control :** Having no right of voting, debentureholders do not have any controlling power over the management of the company.

(2) **Tax burden :** The interest received by the debentureholders is fully taxable in their hands which they can avoid by way of equity dividend.

(3) **Participation in surplus profit/asset :** Debentureholders get interest only at a fixed rate. They cannot participate in the surplus profit of the company nor can they participate in the surplus assets of the company since they are treated merely as creditors and not as the owners of the company.

(4) **Type of investors :** Normally the face value of each unit of debenture paper is high. Therefore, it is not possible for a middle income group of people to invest in debentures.

(5) **Fluctuation in debenture price :** The prices of debentures in the market fluctuate with the changes in the interest rate.

(6) **Favourable market condition :** In a favourable market condition, investors would like to invest in equity shares because of high expected return from the stock investment and not in debentures which earns only a fixed return.

(7) **New company :** In case of a new company it is very difficult for a prospective investor to decide on the financial future. They cannot have faith in investment of debentures inspite of its guaranteed fixed regular interest income, rather they like to invest in shares of such a company.

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Differences between Shares and Debentures :

The following are the differences between Shares and Debentures.

Different Aspects	Shares	Debentures
1. Object of issue	1. Shares are mainly issued to provide long-term finance.	1. Debentures are issued for both long and medium-term finance.
2. Ownership	2. Shareholders are treated as the owners of the company.	2. Debentureholders are the lenders of the company.
3. Nature	3. The amount of share capital is treated as the ownership capital of the company.	3. The amount received from the issue of debentures is treated as debt or borrowed capital.
4. Return	4. The return on shares is known as dividend.	4. The return on debentures is known as interest.
5. Rate of return	5. The rate of dividend depends upon the availability of profit though the rate of preference dividend is fixed.	5. The rate of interest on debenture is fixed. It does not depend on the availability of profit.
6. Accounting treatment	6. Dividend paid is not an expense of the company. It is an appropriation of profit.	6. Debenture interest is a compulsory payment and it is treated as a charge against profit.
7. Tax benefit	7. As the dividend paid to shareholders is an appropriation of profit, it is not tax deductible.	7. As the debenture interest is a charge against profit, the company gets the benefit of tax deductibility.
8. Burden	8. It causes least burden on the finance of the company.	8. It causes fixed burden on the finance of the company.
9. Voting right	9. Equity shareholders enjoy full voting rights in the meetings of the company, whereas the preference shareholders enjoy restricted voting rights.	9. Debentureholders have no voting right in any circumstances.
10. Control	10. Equity shareholders exercise full control over the management of the company, whereas preference shareholders do not have any power to control.	10. Debentureholders exercise no control over the management of the company.
11. Type of investors	11. Investors who are of adventurous spirit and risk-bearing capacity invest in shares.	11. Cautious investors who are reluctant to take risk generally invest in debentures.
12. Charge on assets	12. It does not create any charge on assets as security at the time of issue.	12. It creates charge on assets in many cases as security at the time of issue.
13. Claim on assets	13. At the time of liquidation, shareholders have residual claim on assets of the company after meeting the outsiders' claim.	13. Debentureholders enjoy preferential claim on assets of the company over the shareholders in the event of liquidation.

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Different Aspects	Shares	Debentures
14. Other rights	14. Shareholders enjoy different rights and privileges as are mentioned in the Articles of Association.	14. Debentureholders have only the right to get the contractual interest and repayment of the principal amount at the stipulated period.
15. Marketa-bility	15. Marketability is possible to small and moderate investors.	15. Marketability is generally possible to the big investors because of its high denomination.
16. Compulsion to issue	16. It is compulsory for a joint stock company to have share capital. So, issue of shares is compulsory as per statutory requirement.	16. There is no such legal compulsion to issue debentures for a joint stock company.
17. Risk	17. Shareholders are to bear all financial risks of the company as they are the owners of the company.	17. Debentureholders are treated as the creditors of the company. So, they are not supposed to bear any risk related to the affairs of the company.
18. Trading on equity	18. Trading on equity is possible with preference shares and debentures.	18. No trading on equity is possible without debentures.
19. Redeema-bility	19. There is no question of redemption of equity shares before winding-up of the company. However, preference shares are to be redeemed within a period of 20 years.	19. Debentures are always required to be redeemed at a stipulated period of time or at any time as per the choice of the company.

3.3.4. Term Loans

Term loans, also referred to as Term Financing, are generally raised by the business concerns from financial institutions to meet their medium-term and long-term financial needs. Medium-term loans are granted for periods ranging from 1 to 5 years and long-term loans are granted for periods beyond 5 years. Term loans are also known as term or project finance. The amount raised from term-loans is used mainly for the purpose of financing fixed assets and to meet permanent working capital. It can also be used for the purpose of expansion, diversification, modernisation as well as to redeem preference capital, debentures or bonds. The term loan carries a moderate rate of interest and is paid in installments. A term loan is granted on the basis of a formal agreement between the borrower and the lending institution. The main features of term finacing are security, interest, principal repayment and conditions of the lender. Term loans may take the form of an ordinary loan or a revolving credit. In India term loans are being provided mainly by commercial banks and specialised financial institutions or development banks. Some major financial institutions which provide term loans are :

(1) Industrial Finance Corporation of India (IFCI) : IFCI is the first term financing institution in India. It was set up as a statutory corporation in the year 1948 under the IFC Act, 1948. The objective of the corporation as laid down in the preamble of the IFC Act, 1948, is *to make medium and long-term credits more available to individual concern in India, particularly in circumstances where normal banking accommodation is inappropriate or recourse to capital issue method is impracticable*. The corporation pays due attention to the need for dispersal of new industries, industrial development

of relatively developed districts/areas in the country, growth of industries in the cooperative sector and reasonably well-developed investment portfolio for itself. The IFCI was converted into a company in 1993 as IFCI Ltd. under the provisions of the Industrial Finance Corporation (Transfer of undertaking and Repeal) Act, 1993.

(2) State Financial Corporation (SFCs) : The Government of India passed the State Financial Corporation Act in 1951 to facilitate the formation of State Financial Corporations. The first SFC was setup in Punjab in 1953. At present, there are altogether 18 SFCs functioning in the country. These corporations are expected to be complementary to the IFCI. The IFCI was setup to offer financial assistance to only large and medium sized undertakings while SFCs were set-up to offer financial assistance to small and medium sized industrial concerns. SFCs render assistance to all kinds of industries which may be in the form of private limited companies, partnership firms or sole-trading concerns.

(3) Industrial Development Bank of India (IDBI) : The Industrial Development Bank of India was established under the IDBI Act, 1964 as a wholly owned subsidiary of the Reserve Bank of India on July, 1964. However, in February, 1976, it was delinked from the Reserve Bank; its ownership was transferred to the Government of India. For greater operational flexibility, a portion of its share was offered to the public in 1995 and as a result of which government holdings had come down to 72 per cent. It serves as an apex financial institution. The Bank has been assigned a special role in respect of co-ordinating the activities of other financial institutions and to act as a reservoir from which the other financial institutions can draw. It also provides direct financial assistance to industrial units for planning, promoting and developing industries in order to fill the gaps in the industrial structure by providing medium and long-term finance.

(4) National Industrial Development Corporation (NIDC) : NIDC was set up in 1954 as a statutory corporation owned by the Government of India. The main objectives for setting up the NIDC were to formulate and execute projects for setting up new industries, to provide consultancy services and to finance the rehabilitation and modernisation of certain industries, such as cotton and jute textiles, machine tools etc.

(5) Industrial Credit and Investment Corporation of India Ltd. (ICICI) : The ICICI was set up on January 5, 1955 as a public limited company by the Government of India, the World Bank and representatives of the Indian private industry. It is the second all India development bank after IDBI. It was established mainly for developing medium and small industries of the private sector. It provides foreign currency loans to industrial projects and provides finance in the form of long or medium term loans.

ICICI also started leasing operations in 1983 and took up merchant banking activities too. Other than the companies, institutions and individuals, its equity capital is also owned by public sector institutions, such as LIC, GIC, Banks etc. Since 2002, ICICI Ltd. has been merged with the ICICI bank, and it functions like a **universal bank**, i.e., it provides both short-term loans to small investors and long-term loans to large industrial houses.

(6) Life Insurance Corporation of India (LICI) : The LICI was set up in 1956 with the nationalisation of insurance business in India. It took over the assets and liabilities of 245 private insurers engaged in the business of life insurance in India. LICI also provides industrial finance to different types of organisations. LIC is very much suited for participation in industrial financing as it has long-term funds available at its disposal. Generally, LIC takes part in industrial financing through the subscription of shares and bonds of developing financial institutions, by direct lending to industry and by purchasing securities of joint stock companies from the industrial securities market.

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(7) Unit Trust of India (UTI) : UTI came into existence on February 1, 1964 under the Unit Trust of India Act, 1963. It was a closed-end mutual fund to mobilize the resources/savings of small investors. Its establishment has been a land mark in the history of investment trusts in India. The main objective of the UTI was to pool the savings of the middle and low-income groups and thus develop the savings habit of the people. As the UTI has long-term available funds it can assist financially the industrial organisations by subscribing directly to their equity shares, preference shares, debentures, bonds and also by providing short-term loans.

(8) Industrial Reconstruction Bank of India (IRBI) : Industrial Reconstruction Bank of India was established on March 20, 1985 under the IRBI Act, 1984. It emerged as the principal credit and reconstruction agency for assisting the rehabilitation of sick and closed industrial units. Other than reviving sick and closed industrial units, it also acted as the prime loan and reconstruction agency. The Government of India reconstituted the IRBI into a new company which is known as Industrial Investment Bank of India (IIBI) on March 27, 1997. Now it acts as an autonomous development finance institution like IFCI, IDBI, ICICI etc.

(9) State Industrial Development Corporation (SIDCs) : In order to accelerate the pace of industrial development in their states, many State Governments have set up State Industrial Development Corporations to supplement the efforts of SFCs. Andhra Pradesh and Bihar were the first states to set up such corporations in 1960. At present there are 28 such SIDCs working in the country. SIDCs were established as wholly owned undertakings of the State Governments but two SIDCs have been set up under the statutes of the legislative bodies. Other than granting financial assistance they also help in promotion and management of an Industrial concern.

(10) Small Industries Development Bank of India (SIDBI) : SIDBI was set up in April 1990 under the Small Industries Development Bank of India Act, 1990, passed by the parliament. It came into existence on April, 1990. The main objective of SIDBI has been to work as a principal financial institution for the promotion, financing and development of industries in the small-scale sector. It is also expected to co-ordinate the functions of the financial institutions, viz., SFCs, State Small Industries Development Corporations, Scheduled Banks and State Co-operative Banks etc., engaged in the promotion, financing and developing the small-scale industries.

There are also some other financial institutions, such as, Infrastructure Development Finance Co. Ltd. (IDFC), National Bank for Agriculture and Rural Development (NABARD), Export Import Bank of India (EXIM Bank), National Small Industries Corporation Ltd (NSIC) etc. which also provide term loans.

Besides the above national financial institutions there are also some international financing institutions which provide industrial finance through their member countries while some of them directly to the companies. The assistance rendered by all such institutions have geared up the pace of industrialisation. This includes the institutions like the World Bank and its affiliates such as International Bank for Reconstruction and Development (IBRD), International Finance Corporation (IFC), International Development Association (IDA), Multilateral Investment Guarantee Agency (MIGA) etc.

Features of Term Loans :

There are certain cardinal features of term loans which are sharply distinct from short-term as well as long-term loans. These features have therefore made it imperative to study it separately. These are :

(1) Maturity : In India Financial Institutions (FIs) provide term loans generally for a period of 6 to 10 years. A grace period (moratorium) of 1 to 2 years may be allowed in some cases. The repayment starts 2 or 3 years after sanctioning of loan but the payment should be made only in accordance with the specified schedule. Commercial banks advance term loans generally for a period of 3 to 5 years.

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(2) **Cost :** No flotation cost is associated with the raising of term loans as the lender institutions grant loans after a thorough and detailed appraisal of applications made by the borrower for the purpose of taking loans.

(3) **Negotiation :** The term loans are negotiated loans between the borrowers and the lenders. The sanction of loan depends on the negotiation made between them.

(4) **Security :** Term loan is a secured borrowing. If the term loan is secured by the assets acquired using term loan funds, it is called *primary security* and when it is secured by company's existing and future assets, it is called secondary or *collateral security*. Again, the lender may create a fixed charge on specific assets or a floating charge, i.e. a general mortgage covering all assets. Assets with floating charge may be dealt with freely in the normal course of business without obtaining the approval of the lender.

(5) **Interest :** A fixed rate of interest is associated with any kind of term loans. The borrower has to pay the interest compulsorily. But deferment of interest payment is also possible during the project stage. If the interest amount is deferred, it will accumulate along with the amount of the principal and the total accumulated amount is required to be repaid at the time of maturity.

(6) **Repayment of loan :** Repayment of loan can be made annually, half-yearly or quarterly as per the requirements of the lending institutions after allowing an initial grace period of 1-2 years. Repayment of loan includes payment for interest as well as the principal amount.

(7) **Penal interest :** If the borrower is in default in respect of both the interest and principal amount, a penal interest at a specified rate for the period of default is to be paid on the amount of total default.

(8) **Commitment charge :** A borrower may have to pay a commitment charge if he does not utilise or draw the total amount of loan sanctioned by the lender in his favour. Though he has to pay a commitment charge, such deferment saves interest payment.

(9) **Restrictive covenants :** To protect the interest of the lenders, loan agreement may contain a number of restrictive terms and conditions which are known as *covenants*. These covenants create some restrictions in the conduct of the operations of the borrowing enterprises and which are mainly related to assets, liabilities, cash flows and control. The borrowing firm generally has to keep the lender informed by furnishing financial statements and other information periodically.

◗ Advantages of Term Loan :

Term loans have merits both for the borrowers and for the lenders.

◗ *For the borrowers :*

Advantages of term loans from the borrower's point of view are :

(1) **Low cost :** Cost of term financing is much lower than the cost of equity capital or preference capital financing. Again, no flotation cost is associated with term financing.

(2) **Control :** Term loan financing does not result in dilution of control since the lenders of term financing are not entitled to vote. So, it does not affect the control of existing shareholders.

(3) **Tax-deductibility :** Interest paid on term-loans is a compulsory payment and thus it is a charge against profit. So, the borrowers can get the benefit of tax-deductibility regarding interest payment which also lowers the cost of term financing.

(4) **Flexibility :** The agreement made between the borrowers and the lenders are quite flexible in a sense that the term of loan, drawal of loan, the repayment schedule etc. are adjustable according to their requirement.

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▸ *For the lender :*

Advantages from the lender's point of view are :

(1) Rate of interest : Term loans earn a fixed rate of interest which signifies a permanent regular source of income.

(2) Maturity period : Term loans have a definite maturity period which helps the lender to plan for a proper roll over of the amount.

(3) Risk : The lender does not face any risk to provide term loans as this, together with interest and other charges, remain fully secured.

(4) Restrictive covenants : The interest of the lender is adequately protected by incorporating restrictive covenants in the loan agreement.

▸ Disadvantages of Term Loans :

Term loans are also not free from drawbacks. These are :

▸ *To the borrower :*

Disadvantages of term loans from the borrower's point of view are :

(1) Legal compulsion : The interest payment and capital repayment are a compulsory statutory obligation. Failure to meet these payments can cause a lot of embarrassment, it can even threaten the existence of the borrower's business.

(2) Penal interest : Not only in the case of failure, even for a slight default in payment for interest or repayment of loan, the borrower is required to pay penal interest.

(3) Commitment charge : A borrower may have to pay a commitment charge if he does not utilise or draw the total amount of loan sanctioned by the lender in his favour.

(4) Interference : Sometimes financial institutions may force the borrower company to induct their nominee in the board which may cause interference in the decision making process of the company.

(5) Financial risk : Term loan financing enhances the financial risk associated with the firm for which the market price of equity shares may fall. This may increase the overall cost of capital.

(6) Restrictive covenants : Term loan agreement may contain a number of restrictive terms and conditions, known as covenants. These may be derogatory to the interest of the borrower and may reduce managerial freedom.

▸ *To the lender :*

Disadvantages from the view point of the lender are :

(1) No voting right : Term loans do not carry the right to vote. So, the lender of term loans cannot participate in the management of the company.

(2) Negotiable securities : Term loans are not represented by negotiable securities. Term loans cannot be securitized like debentures or bonds against the loan which can be negotiated in favour of others.

To conclude, it can be said that apart from the advantages and disadvantages stated above, term loans provide all the advantages and disadvantages of debenture financing to the lender as well as to the borrowers. It carries low cost but involve high risk. It does not affect control but reduces managerial freedom to some extent.

3.3.5. Lease Financing

In addition to debt and equity financing, leasing has emerged as another important source of intermediate and long-term financing of corporate enterprises. A lease is a financing device which

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has developed rapidly during 1960s and 1970s in the U.S. and in India just before the middle of the 1980s.

It is a specialised means of financing which focuses on equipment leasing. If a firm wishes to get the service of a specific asset, they can choose from two alternatives — the particular asset can be purchased or the asset can be taken on lease. If the firm wishes to purchase the asset it has to incur a lump sum capital expenditure and on the other hand, if the asset is taken on lease the firm gets the asset's services without necessarily incurring any capital liability. Leasing is therefore, a source of finance as it enables the firm to obtain the use of assets in exchange of agreeing to pay a periodic rent without purchasing the asset in exchange of a huge capital outlay.

Leasing is an arrangement under which a company acquires the right to make use of the asset without purchasing the asset or holding title to it. ***A lease, thus, is the written agreement under which the owner gives the right to economic use of the assets to the user for a stated period of time against a consideration.*** A lease is essentially the renting of an asset for some specific period. The owner of the asset is called the *'lessor'* and the other party that uses the asset is known as the *'lessee'*. The periodic payment which the lessee has to pay to the lessor is known as the *'lease rental'*. A lessor may be seller, supplier, manufacturer or a finance company while a lessee can be an individual, a firm or a company interested in the use of assets without owning it. Thus, lease can be defined as a specialised means of acquiring the use of assets without ownership. So, in the leasing procedure, the ownership of the leased property is retained with the owner/lessor. Thus, as a legal owner, the lessor is also entitled to claim depreciation on the assets. At the end of the leasing period, the asset generally reverts back to the lessor unless the lease contract contains a provision for the renewal of the contract. Hence, leasing is a source of finance as it enables the firm to obtain the use of assets against payment of lease rentals without necessarily incurring capital expenditure for the purchase of the same asset.

According to **Woolf, Tanna & Singh** *"Leasing is effectively a source of finance but it always relates to a specific assets. Under a lease contract, the ownership of the assets remains with the lessor whilst the use of assets is available to the lessee in return for the payment of a fixed rental. Lease finance is very similar to debt in that the lease payments are fixed financial contractual obligations. Leasing will therefore, increase the level of gearing and financial risk of the company. There is need to look at the financial implications of leasing and especially at the tax implications for both the lessor and the lessee"*. As per **Accounting Standard – 19** issued by the Council of the Institute of Chartered Accountants of India, *a lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use on asset for an agreed period of time*. It comes into effect in respect of all assets leased during the accounting period that commences on or after 1.4.2001. Lease is often called as *off balance sheet* financing because neither the leased assets nor the liabilities under lease contracts appear on a firm's balance sheet. The terms and conditions regulating the lease arrangement are given in the lease contract made between the lessor and the lessee.

Features of Lease Financing :

From the above discussion we can see that lease financing has a number of features which distinguishes it from debt and equity financing. The following are the most significant features of lease financin :

(1) Equipment leasing : It is a specialised means of financing in which the asset, property or equipment is leased instead of providing direct cash to the company.

(2) Related party : There are two parties involved in lease financing. The owner who gives the right of economic use of the assets to the user is known as the lessor and the user who uses the asset is known as the lessee.

(3) Ownership : Ownership is retained in the hands of lessor. The title of holding the asset does not pass to the lessee. They are only eligible to use the asset and at the end of the lease period, the particular asset reverts back to the lessor.

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(4) **Depreciation :** As the lessor is the legal owner of the asset, he is entitled to claim depreciation on the assets.

(5) **Lease rentals :** A payment which has to be made periodically by the lessee to the lessor for using the asset is known as the lease rental.

(6) **Period :** The arrangement of leasing has to be made for a specific period of time which may cover the entire economic life of the asset or may cover a shorter period than the useful life of the asset.

(7) **Legal aspect :** There is no definite statute which governs lease financing. The provisions relating to bailment in the Indian Contract Act govern equipment leasing.

(8) **Taxation :** Lease rentals paid by the lessee is a fully tax deductible expense whereas the lease rentals received by the lessor are taxable as Business Income in the hands of lessor.

(9) **Off-balance sheet item :** As neither the leased assets nor the liabilities under lease contracts appear in the balance sheet, it is often called as an off-balance sheet item.

(10) **Lease contract :** A contract is made between the lessor and the lessee which contains the terms and conditions regulating the lease arrangements.

Classification of Lease Financing :

The classification of leases adopted in AS-19 is based on the extent to which risk and rewards incident to ownership of a leased asset lie with the lessor or the lessee. Broadly speaking, the lease may be classified as a **'Finance Lease'** and an **'Operating Lease'**.

(A) Finance Lease :

A finance lease is also known as a 'Capital Lease', 'Full pay-out lease', 'Long-term lease', 'Close-ended lease' etc. It is generally a non-cancellable contractual obligation which usually covers the full useful economic life of the assets or a period that is close to the economic life. It transfers substantially all the risks and rewards of ownership of an asset. As the lessee gets an unrestricted right to use the asset over its entire working life, the lessee's position is quite similar to that of an owner though the lessor retains title of the asset.

The lessor receives a lease rental during the non-cancellable period or primary lease period which covers fully the cost of the asset as well as a reasonable return on the funds used to purchase that particular asset. As the lease rental covers fully the cost of asset over the term of lease, financial leases are, therefore, also called as capital or full payment leases. The responsibility of repairs, maintenance and insurance of the assets generally lies with the lessee. The lessee has also to bear the risk of obsolescence. Lessee has the right of uninterrupted use of the asset till lease payments are made but he has no right to sell the asset without the permission of the lessor. At the end of the lease period, the assets may be returned to the lessor or handled as per the lease contract.

Financial lease is essentially a form of borrowing. The lessor buys the asset which is identified by the lessee as per his requirement. The lessor may not be involved in dealing with the assets in respect of the negotiation of price, delivery schedule etc. It may be fixed by the lessee with the manufacturer or supplier of asset. The lessor only pays the purchase price to the manufacturer or supplier and signs contract to lease it out to the lessee.

According to Financial Accounting Standards Board Statement No. 13 (FASBS No. 13), if at the inception, a lease meets one or more of the following criteria, the lease shall be classified as a financial or capital lease by the lessee :

(i) The lessor transfers title to the lessee at the end of the lease period.

(ii) That lessee contains an option to purchase the asset at a bargain price.

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(*iii*) The lease period is equal to or greater than 75% of the estimated economic life of the asset.

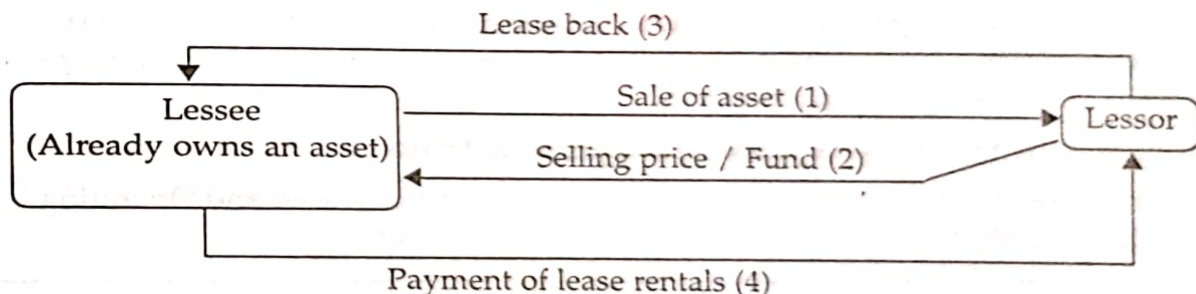
(*iv*) At the beginning of the lease, the present value of the minimum lease payments/rentals equals or exceeds 90% of the fair value of the leased property to the lessor (*less* any investment or tax credit realised by the lessor).

On the basis of how the lessee acquires the asset, financial lease may be of different types :

(1) Direct Lease : Most financial leases are direct leases. The lessor purchases the asset identified by the lessee from the manufacturer or supplier and hands it over to the lessee. A manufacturer instead of entering in a sale agreement to act as a seller can act as a lessor under the lease agreement and can deliver the asset to the lessee. This direct lease again be classified into two groups :

- **(a) Bi-partite lease :** When only two parties are involved in a direct lease, it is called a bi-partite lease. Here, the two parties are the *lessor* and the *lessee*. Here, the supplier of the asset and the lessor are same entities.
- **(b) Tri-partite lease :** When three parties are involved in a direct lease, it is considered as a tripartite lease. Here, the three parties are the *lessor*, the *lessee* and the *supplier* of the leased-out asset.

(2) Sale and Lease Back : The sale and lease back arrangement is essentially helpful for the firms having fixed assets but there is a shortage of funds. This is a special financing lease arrangement in which the lessee who is already the owner of the asset, sells the asset to the lessor, who, in turn, leases the asset back to the owner in return of periodic lease payments. Under this arrangement, lessee not only retains the economic use of the assets but also gets the fund from the sale of the assets to the lessor which augments the liquidity position of the company. The mechanism of sale and lease back can be shown in the following figure :



(3) Leveraged Lease : Leveraged lease involves three parties to the transaction (*i*) lessor (equity investor) (*ii*) lessee and (*iii*) financier or lender. When the cost of the asset is too high, lessor may borrow a substantial portion (almost 75%) of the purchase price of the asset from some lender which may be a financial institution or a bank. The loan taken by the lessor is secured by the assets and lease rental. Then the asset is given to the lessee who in return pays lease rentals to the lessor or to the financier of the asset directly as a part of the loan repayment as per the lease agreement. The surplus, if there is any, which arises out of the difference between the lease rental and the repayment portion goes to the lessor. So, lease payment must be large enough to meet the loan repayment, payment of interest to the lender as well as provide a return to the lessor. The lease rentals are distributed first to the lender to repay the loan amount taken by the lessor to purchase the leased asset and the balance, if any, goes to the lessor. The transaction is routed through a trustee who looks after the interest of the lender and lessor. This whole arrangement is called leveraged lease. Under this arrangement, the lessor acts as an equity participant who supplies only a part of the cost of the assets and the lender supplies the balance.This process of leveraged lease can be shown by a flow-chart.

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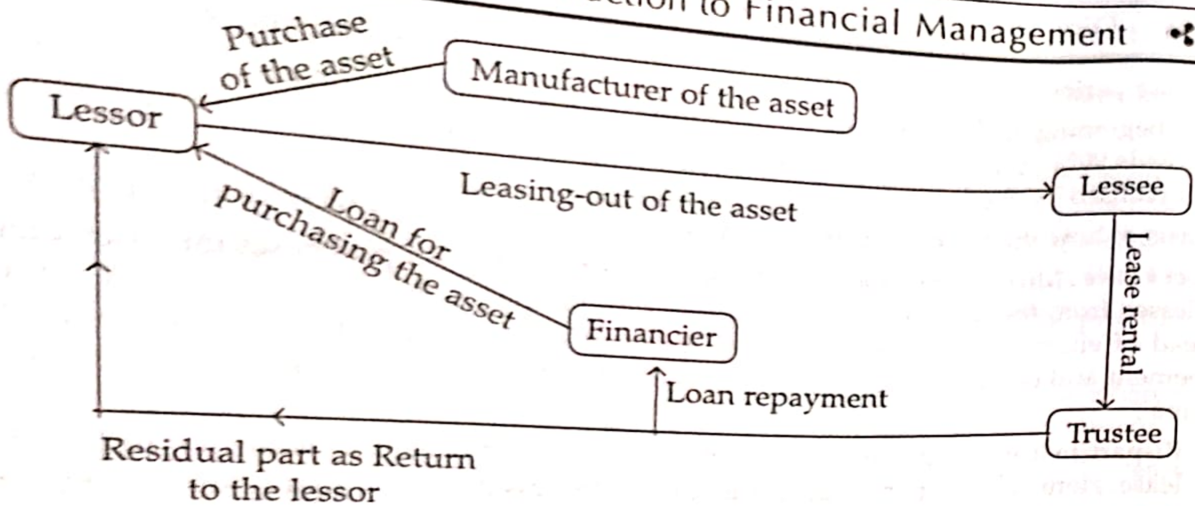

(B) Operating Lease :

As per AS-19, the operating lease is a lease which is not a finance lease. Any lease which does not satisfy any one of the four conditions stated in FASBS No. 13, is known as 'Operating Lease' or a 'True Lease' or 'Non-financial Lease' or 'Open-ended Lease' or 'Service lease'. An operating lease or service lease is an arrangement under which the lessee acquires the economic use of the asset on a time to time basis. It is a short-term, cancellable lease agreement. Under this agreement, the lessor is responsible for repairs, maintenance and insurance of the assets. The lessor is also responsible to pay tax on lease rentals. The asset may be given on lease to different lessees one after another on time to time basis. The lease rentals payable by different lessees during the lease period are not sufficient to cover fully the cost of the equipment and hence full amortisation of the cost of asset is not possible. At the end of the life of the lease, the asset reverts back to the lessor. Computers, vehicles, office equipments etc. are common assets which are leased under operating lease arrangements.

Differences between Financial Lease and Operating Lease :

We know that leases are classified broadly into two types – Financial Lease and Operating Lease. The differences between these two types of leases may be stated as follows :

Points of Difference	Financial Lease	Operating Lease
1. Nature	1. Financial lease is basically a form of borrowing. The lessee has to decide whether to lease or borrow and buy the asset.	1. An operating lease is basically a rental agreement. The lesseehas to decide whether to lease or buy the asset.
2. Role of lessor	2. The lessor takes the role of a financier. They cannot render specialised service in connection with the asset.	2. The lessor is specialised in handling and operating the particular asset and generally provides specialised services.
3. Purchase of asset	3. The lessor buys the asset which is identified by the lessee as per his requirement i.e., the leased asset is use-specific.	3. The lessor buys the asset of common-use activity and leases it out to different lessees successively.

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Points of Difference	Financial Lease	Operating Lease
4. Coverage period	4. Financial lease covers the full useful economic life of the assets or a period that is close to the economic life.	4. Operating lease covers significantly less than the useful economic life of the asset. It is a short-term lease.
5. Cancellability	5. It is generally a non-cancellable contractual obligation.	5. The lease is usually cancellable at short notice.
6. Risk and rewards	6. Financial lease transfers substantially all the risks and rewards of ownership to the lessee. The lessor only remains the legal owner of the asset.	6. Under this lease agreement lessee is given only the right to use the asset for a certain period of time. Hence, the risks and rewards associated with the ownership remain with the lessor.
7. Risk of obsolescence and maintenance	7. As the equipment is chosen by the lessee, the risk of obsolescence and the liability for repair, maintenance and insurance of the equipment rests with the lessee.	7. Operating leases normally include the maintenance clause requiring the lessor to maintain the leased asset and also to bear the risk of obsolescence.
8. Number of lessees	8. As the lease period covers most the economic life of the asset, the lessor relies on a single lessee to recover his investment.	8. Since the lease period is shorter than the expected life of the asset, the lessor does not rely on the single lessee for the recovery of his investments. So, the number of lessee should be at least two or more than two.
9. Amortisation of the cost of the asset	9. The lessors' capital outlay is fully amortised during the primary lease period. The lessor recovers through the lease rentals the cost of the leased asset along with interest and profit. Hence, it is called *full-pay-out lease*.	9. Since the lease periods are shorter, the lease rentals are not sufficient to totally amortize the cost of the assets. Hence, it is called a *non-payment lease*.
10. Types of assets	10. This type of lease is generally suitable for equipment which is tailor made and does not have ready resale or re-lease market. e.g., Heavy machines.	10. This type of lease is suitable for equipment having longer economic life and ready resale or re-lease market. e.g., Automobiles, Computers, Office-equipments etc.
11. Classification	11. On the basis of how the lessee acquires the asset, financial lease may be of different types.	11. There is no such classification in respect of an operating lease.
12. Purchase of the asset by the lessee	12. A finance lease may provide a right or option, to the lessee, to purchase the equipment at a future date.	12. Under the operating lease, no such right is given to the lessee.

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Advantages of Lease Financing :

Lease financing brings actual benefit for both the lessor and the lessee. These benefits can be summarised as follows :

To the lessor :

The lessor can be benefitted out of lease financing in the following ways :

(1) **Ownership :** The lessor retains ownership of the assets and the asset reverts back to the lessor at the end of the lease period. Moreover, the lessor can take repossession of the asset in the event of any default on the part of lessee.

(2) **Security :** As the lessor retains full ownership of the asset, his interest is fully secured. The lessor can take back the asset leased at the end of the lease period or in case of default payment, conveniently realise an asset secured against a loan payment.

(3) **Depreciation :** As the lessor is the actual owner of the asset, he can charge depreciation on the asset leased. Under the existing provisions of the Income Tax Act, the owner can charge depreciation on the basis of diminishing method and in respect of ships, straight line depreciation is permissible.

(4) **Tax relief :** Depreciation is a charge against profit and hence the lessor can take the benefit of tax relief by way of charging depreciation on leased assets to a great extent.

(5) **Lease rentals :** Lessor gets a fixed amount of lease rentals regularly which is a steady source of income over the lease period.

(6) **Cash inflow :** When the asset is reverted back to the lessor, he can sell the asset in the market which enables inflow of cash.

(7) **High profitability :** Generally, lease rentals received by the lessor is higher than the interest paid by them on the amount of borrowings. The difference between these two amounts shows a positive figure which signifies profitability.

(8) **Growth potentiality :** Lease financing is regarded as a more convenient form of financing than debt financing. Every year many companies are coming up. Leasing maintains the economic growth even during a period of depression as the lessee can get the benefit of economic use of the asset without actually purchasing the asset during a recession. Thus, there is a potentiality of a very large growing market for leasing companies in India.

To the lessee :

The benefits which arises to the lessee are :

(1) **Capital outlay :** The lessee is not required to incur any capital expenditure for purchase of fixed assets, such as, land, building, plant, machinery, heavy equipments etc. So, the lessee can start his business without making any initial investment to acquire fixed assets.

(2) **Convenience :** Lease financing is regarded as a more convenient form of financing than debt financing. Borrowing from banks and financial institutions involve a long and complicated procedure. In comparison, leases are less restrictive and can be negotiated faster.

(3) **Short period lease :** Buying of an asset for a short period is inconvenient, costly and time consuming because arrangements have to be made to resell the asset. In such a case, it is better to take the asset under the lease arrangement.

(4) **Tax shield :** Leasing can provide the tax advantages to the lessee if the lessee is a tax paying entity. When a company acquires an asset on lease, the full amount of lease rentals is deductible for tax purposes.

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(5) **Cost of repairs, maintenance, insurance etc. :** Under lease agreement, a lessee may be able to pass on a number of 'nuisance costs' to the lessor, such as, legal fees, taxes, insurance, repairs and maintenance etc.

(6) **Off-balance sheet financing :** The lease is considered as a hidden source of financing or off-balance sheet financing as the lessee is not required to show the assets acquired on lease in the balance sheet as the other debts and loan appear. Thus, window dressing of balance sheet is possible which mislead the investor regarding the financial leverage of the firm.

(7) **Borrowing capacity :** As the lease does not appear in the balance sheet as debt, the firm's borrowing capacity remains intact. In otherwords it may be argued that the lease enhances the real borrowing capacity of the firm.

(8) **Risk of obsolescence :** Risk of obsolescence can be averted under the lease arrangement. The chances of technological obsolescence is highly associated with assets, such as computers, electronic goods etc. Under the lease arrangement, the lessee can transfer the risk of obsolescence to the manufacturer-lessor.

(9) **Specialised services :** With a full service lease, the lessee can get the advantage of specialised services from the lessor at a lower cost for assets like computers.

(10) **Dilution of control :** Dilution of control is not possible from the lessee's view point under the lease agreement. Sometimes, financial institutions, while lending funds to the borrower may insist for conversion of loan into equity or may nominate directors on the board. Such dilution of control is not possible under lease financing.

(11) **Costly assets :** Lease financing is very much effective for the assets which are very costly. Under this arrangement, a lessee can get the benefit of the same without going to purchase it.

(12) **Testing of assets :** Sometimes, it may become essential to test the asset before actually going to purchase the same. Lease arrangement provides this facility to the prospective buyer of the asset.

(13) **Flexibility in lease rentals :** The lease rentals are structured in such a way that it is convenient for the lessee to pay the rentals from the funds generated from operations. Not only that, the lease period is chosen in such a way so as to enable the lessee to pay rentals conveniently.

Disadvantages of Lease Financing :

Like other sources of financing, it is also not free from demerits. The disadvantages of lease financing are noted below :

To the lessor :

The disadvantages from the point of view of the lessor are :

(1) **Cost of repairs, maintenance etc. :** In lease financing the lessor has to bear a number of nuisance costs that usually accompany ownership including legal fees, insurance, repair, maintenance etc.

(2) **Taxes :** The lease rentals received by the lessor is fully taxable in the hands of lessor.

(3) **Control :** Lessor cannot impose any power of control on the lessee's business which may be possible in the case of direct loan given to a borrower firm by nominating a director on the board or by imposing a condition of convertibility of loan into equity capital.

(4) **Risk of obsolescence :** The lessor has also to bear the risk of technological obsolescence in the near future in case of assets such as computers, electronic goods etc.

(5) **Sales tax :** Sales tax may be charged twice in case of a lease financing transaction. The lessor has to pay sales tax at the time of buying the asset and again it has to be paid at the time of leasing the asset to the lessee. However, in case of VAT (Value Added Tax), the lessor gets an input tax credit.

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To the lessee :

The disadvantages from the point of view of lessee are :

(1) **Restriction on use :** The lessor may impose, as the owner of the asset, certain restrictions on use of the asset. Again, lessee cannot make any additions or alterations with the leased asset to fit his requirements.

(2) **Default :** If the lessee defaults in making payment of lease rentals or in complying with any terms and conditions of the lease agreement, the lessor can take back the leased asset.

(3) **Technological changes :** In case of technological changes, an upgradation of the asset is required to maintain efficiency. But, the lessor may not allow such upgradation or alteration or modification being the owner of the asset or the lessee may not even want to invest in making the changes.

(4) **Understatement of asset :** As the lessee does not show the leased asset in the balance sheet, it may lead to underestimation of the asset. But it has to be mentioned as a foot note to the balance sheet.

(5) **Higher payout obligation :** In case of finance lease if the lessee opts for premature termination of the lease agreement because of any reason, he may have to pay higher rentals.

(6) **Residual value :** The lessee cannot enjoy the residual value of the assets which may increase due to inflation because of his non-ownership of the asset.

The growth of equipment leasing is of recent origin and its volume in India is quite modest. Many private sector non-bank financial companies are engaged in lease financing. Some of them are Infrastructure Leasing and Financial Services Ltd. (IL & FS), ICICI, IFC, LIC, NDFC, IRBI etc. whereas the lessee companies include many leading corporations in both public and private sectors and small manufacturing companies.

3.3.6. Hire Purchase

Hire purchase involves a system under which term loans for purchase of goods and services are advanced to be liquidated in stages through a contractual obligation. Hire purchase credit may be provided by the seller himself or by any financial institution.

Under the hire purchase system the customer called the *hire purchaser,* gets the possession of the goods immediately, can use it and pay the price in instalments. However, the ownership of the goods remain with the seller who is called the *hire vendor* and passes to the hire purchaser only after the payment of last instalment. Usually, a certain amount is paid at the time of delivery and the balance amount is paid together with interest on the unpaid amount in different instalments. Each instalment paid by the hire purchaser is treated as the hire charges for using the asset. In case of default in payment of any instalment, the seller can repossess the assets without compensating the hire purchaser.

In India the Hire Purchase Act, 1972 was promulgated to govern hire purchase agreements. Though the Act was passed by the parliament and had got the assent of the President it did not become operational. Hire purchase agreements are rather being governed by the laws of contracts.

Section 2(C) of the Hire Purchase Act has defined a hire purchase agreement as *an agreement under which goods are let out on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement and includes the agreement under which :*

(i) Possession of goods is delivered by the owner thereof to a person on condition that such person pays the agreed amount in periodical instalment ;

(ii) The property in the goods is to pass to such a person on payment of the last instalment ; and

(iii) Such a person has right to terminate the agreement at any time before the property passes.

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AS-19 which deals with the leases is also applicable to Hire Purchase agreement. Para-4 of AS-19 states that *the definition of a lease includes agreements for the hire of an asset which contains a provision giving the hirer an option to acquire title to the asset upon the fulfillment of agreed condition. These agreements are commonly known as hire purchase agreements. Hire purchase agreements include agreements under which the property in the asset is to pass to the hirer on the payment of the last instalment and the hirer has a right to terminate the agreement at any time before the property so passes.*

The hire purchaser shows the assets in his balance sheet and can charge depreciation on such assets. The amount of interest which is included in the payment of different instalments are eligible for deduction from the taxable income.

Features of Hire Purchase System :

The essential features of hire purchase system are :

(1) **Possession :** The hire vendor transfers only the possession of goods to the hire purchaser immediately after signing the hire purchase contract.

(2) **Use of the asset :** The hire purchaser is entitled to start using the goods immediately after receiving the possession.

(3) **Payments made :** On signing the agreement the hire purchaser may pay a certain initial amount which is called "Down Payment". The balance amount along with interest is paid in different instalments at a regular interval for a specific period of time.

(4) **Hire purchase price :** Hire purchase price is the total amount which is to be paid as per the hire purchase agreement. It includes the down payment and all the instalments together with the amount of interest.

(5) **Title of the goods :** Title or ownership of the goods passes to the buyer only after the payment of the last instalment.

(6) **Termination :** The hire purchaser has the right to terminate the agreement at any time before the title of the goods passes to the hire purchaser.

(7) **Default in payment :** The hire vendor has the right to repossess the goods without making any compensation in case of default in payment of any instalment. Even if only the last instalment is not paid, the seller can take back the goods from the buyer.

- Difference between Hire Purchase and Lease Financing : Now, we can indicate some of the differences between the procedures of hire purchase and lease financing. These are as follows :

Points of Difference	Hire purchase	Lease financing
1. Ownership	1. According to the hire purchase agreement, the hire purchaser gets the ownership of assets after the payment of last instalment.	1. According to the lease contract, the lessee does not get the ownership of the assets even after the completion of the lease period.
2. Salvage value of the asset	2. The hire purchaser also owns the salvage value of the asset after the completion of hire purchase agreement period.	2. The lessee, however does not own the salvage value of the asset after the completion of lease period.

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Points of Difference	Hire purchase	Lease financing
3. Depreciation cost	3. The hire purchaser can charge depreciation on the asset.	3. The lessee, however, does not have any right to charge depreciation on the assets.
4. Tax concessions	4. The hire purchaser enjoys tax concessions only on 'interest' amount paid in the instalments.	4. The lessee enjoys tax concessions on the whole amount of lease rental paid to the lessor.
5. Reflections of transaction in the balance sheet	5. This transaction is relfected in the balance sheet of the 'hire purchaser'	5. This transaction, however, is not reflected in the balance sheet of the "lessee".

3.3.7. Commercial Banks (i.e., Bank Financing)

The commercial banks have rendered great service to Indian business in meeting its need of current financial and short-term capital. The major portion of working capital loans are provided by commercial banks. They provide a wide variety of loans to meet the specific requirements of a concern. Commercial banks provide loans and advances in the following forms :

(i) Loans

(ii) Cash credits

(iii) Overdrafts

(iv) Discounting of bills

(i) **Loans :** When a bank makes an advance in lump sum with or without security, the whole of which is withdrawn in cash immediately by the borrower who undertakes to repay it in instalments, is called a loan. The entire amount of loan is paid to the borrower either in cash or by credit to his deposit account. Loans are sanctioned for definite purpose and periods. The borrower is required to pay the interest at an agreed rate on the whole amount from the date of sanction whether he draws the full amount from the loan account or not. Repayments of loan may be made in instalments or at the expiry of a certain period. The rate of interest on loan is generally lower than the rate of interest on cash credits or bank overdrafts. Commercial banks usually provide short-term loans up to a period of one year for meeting working capital requirements of business firms. But term loans may also be provided for medium-term (which is repayable within 1 to 5 years) and long-term (which is repayable after 5 years). There is an another type of loan sanctioned by the commercial banks, viz. *demand loan*. Demand loan is a loan which is to be payable on demand.

(ii) **Cash credits :** Cash credit is the most popular method of financing by commercial banks. It is an arrangement under which a borrower is allowed an advance up to a certain limit against the security of tangible assets or guarantees. The borrower need not borrow the entire amount of advance at one time, rather he can draw as often as required provided the limit of cash credit is not exceeded. It is also known as *secured credit*. But if the cash credit is not backed by any security, it is known as clean cash credit. The borrower gives a promissory note which is signed by two or more sureties in case of *clean cash credit*. Interest on cash credit is not charged on the full amount of the advance but on the amount actually availed of by the borrower. The Reserve Bank of India issued a directive to all scheduled commercial banks on 28th March, 1970, prescribing a

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commitment charge which banks should levy on the unutilised portion of the credit limits. The borrower also enjoys the facility of repaying the amount, partially or fully, as and when he desires. These accounts are repayable on demand, but banks usually do not recall such advances, unless they are compelled to do so by adverse factors. Cash credit operate against the security of inventory and accounts receivables in the form of hypothecation/pledge.

(iii) **Overdrafts :** Under this arrangement, the commercial bank allows its customer to overdraw his current account upto a certain limit so that it shows a debit balance. So, opening of an overdraft account requires that a current account will have to be formally opened. Any business concern can enter into this arrangement to tide over a temporary shortage of funds. The customer is charged interest on daily overdrawn balances and not on the limit sanctioned. Overdraft accounts can either be clean overdraft, partly secured or fully secured. The security in an overdraft account may be shares, debentures and government securities. In special cases, life insurance policies and fixed deposit receipts are also accepted. So, there is no difference as such between overdrafts and cash credit. The main difference between these two is that overdraft is allowed for a shorter period and it is a temporary arrangement whereas the cash credit is allowed for a longer period of time.

(iv) **Discounting of bills /purchase of bills :** Bill arises out of trade transactions. The seller of goods draws the bill on the purchaser. The bill may be either clean or documentary, i.e., supported by a document of title to goods like a railway receipt, and may be payable on demand or after a period not exceeding 90 days.

Commercial banks finance the business concern by discounting their bills at a price lower than their face value. The bankers however, collect the full amount on maturity. The difference between these two amounts represent the earnings of the bankers for the period. This item of income is called a 'discount'. In case the bill discounted is dishonoured by non-payments, the bank recovers the full amount of the bill from the customer along with expenses in that connection.

Bills are sometimes purchased from approved customers. Although the term 'bills purchased' gives the impression that the bank becomes the owner of such bills, in actual practice the bank holds the bill only as a security for the advance. A bank has to be very cautious and grant advances against the purchase or discount of a bill only to those customers who are creditworthy and have established a steady relationship with the bank.

There may be some other form of advances which are granted by the commercial banks, such as :

(v) **Advances against goods :** The term goods include all forms of movables, such as agricultural commodities, industrial raw materials or partly finished goods etc. A banker accepts them as security and allows advances against them.

(vi) **Advance against documents of title to good :** These documents include a bill of lading, dock warehouse keeper's certificate, railway receipt etc. An advance against the pledge of such documents is equivalent to an advance against the pledge of goods themselves.

(vii) **Advances against supply-bills :** Advances may be granted by banks against bills for supply of goods to government or semi government departments which is obtained against an order after the acceptance of a tender. Again, advances against bills from contractors for work executed either wholly or partially, entered into with the government agencies also come under this category.

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3.3.8. Public Deposits

Public deposits are the fixed deposits accepted by the public companies directly from the public popularly it is a source of short-term and medium-term finance. After the commencement of Companies Act, 2013, no company shall invite, accept or renew deposits from the public except in a manner provided in Section 73, 74, 75 and 76 of this Act. However, these sections do not apply to a banking company and non-banking financial company as defined in the Reserve Bank of India Act, 1934 and to such other company as the Central Government may, after consultation with Reserve Bank of India, specify.

Features of Public Deposits :

The important *features* of public deposit are :

(1) **Advertisements :** While inviting deposits the company must issue an advertisement (which indicates its financial position) in a leading english newspaper and also in a vernacular newspaper circulating in the state in which the registered office of the company is situated.

(2) **Form of application :** No company can accept or renew any deposit unless an application is made by the intending depositor for the acceptance of such deposits.

(3) **Ceiling on deposits :** Deposits from the general public must not exceed 25% of the aggregate of the paid-up share capital and free reserves. But it is 10% as against unsecured debentures or any deposits from its shareholders or any deposits guaranteed by its directors.

(4) **Maturity period :** The minimum period for acceptance of deposits is normally 6 months and the maximum period is 36 months. However, for meeting short-term requirement of funds, a company may accept deposits for a period of 3 months, the total amount of which should not exceed 10% of share capital and free reserves.

(5) **Repayability :** No company shall accept any deposit which is repayable on demand. Once a deposit is accepted for a certain period, the company cannot repay the same before the expiry of six months.

(6) **Receipts to depositors :** It is necessary for every company to give receipts for the amount received by them to the depositors or their agents for accepting or renewing any deposit.

(7) **Register :** A register should be maintained by every company mentioning the names and addresses of the depositors, amount of deposit, date of deposit, maturity date, rate of interest and the date of interest payment etc.

(8) **Interest :** The rate of interest may vary from 8% to 12% depending upon the tenure of deposit.

(9) **Return :** Companies accepting public deposit must regularly file return giving detailed information regarding such deposits to the Registrar of Companies. A copy of return is also required to be furnished to the Reserve Bank of India.

(10) **Brokerage :** For mobilising deposits, companies may require to pay brokerage to the brokers, managers or consultants which is usually 1% of such deposit.

(11) **Liquid assets :** Companies must maintain a part of assets in a liquid state. Companies should deposit or invest by the 30th day of April every year, a sum which shall not be less than 10% of deposits maturing during the year ending on 31st March next year in a scheduled bank or in government securities or in trust securities. The amount so set aside should be utilised for the purpose of repayment of deposits only.

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(12) **Penalty on default :** If a company fails to repay any deposit or a part thereof, the Company Law Board may direct the company by order to make the repayment forthwith or within a stipulated time. If the company fails to comply with the order of the Company Law Board, it shall be punishable with imprisonment upto 3 years and shall be liable to pay a fine of not less than ₹ 50 for every day during which such non-compliance continues.

Advantages of Public Deposits :

The merits of borrowing by public deposits are as follows :

From the company's point of view :

Public deposits offer the following advantages to the company :

(1) **Simple Procedure :** Financing through public deposit is simple without much complicated formalities.

(2) **Less costly :** It is beneficial for the company since it receives funds on lower rates of interest than charged by banks and financial institutions.

(3) **Cost of collection :** The cost of collecting deposits from the public is less too.

(4) **Security :** The public deposits are usually not backed by any security or assets of the company. So, the company can use its assets as security for raising capital from other sources.

(5) **Flexibility :** Public deposits introduce flexibility in the financial planning. These can be repaid when they are not required.

(6) **Tax benefit :** As the interest paid on public deposits is a charge against profit, the company can have tax benefit on such interest.

(7) **Dilution of control :** The depositors do not have any right to interfere with the internal management of the company. Thus, there is no dilution of control of shareholders.

(8) **Trading on equity :** It helps in trading on equity if the company is earning more than the rate of interest paid on public deposits. Thus, the shareholders can get higher rate of dividend.

From the investor's point of view :

The investors also find certain advantages in public deposits, which are :

(1) **Rate of interest :** The rate of interest is usually higher than several alternative sources, such as, banks, post offices etc.

(2) **Maturity period :** As the maturity period is short ranging from 6 months to 36 months, investors are in a position to utilise their money in different alternative sources, if necessary, just after a maximum of a 3 year time period.

Disadvantages of Public Deposits :

Inspite of many advantages, the following are the demerits of public deposits :

From the company's point of view :

The disadvantages of public deposit from the company's point of view are :

(1) **Dependability :** Raising funds through public deposits is not a reliable and dependable source of finance. It is difficult to predict whether public deposits would be forthcoming to the desired extent. The depositors may not respond when the conditions in the company are uncertain. Therefore, such deposits are termed as 'fair weather friends'.

(2) **New companies :** New companies and companies with uncertain earnings cannot raise finance through public deposits.

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(3) **Limitation of amount :** The amount that can be raised through public deposit is limited as per the Sections 73 to 76 of the Companies Act, 2013. Maximum of 25% of the paid up capital and reserves can be raised from the general public, whereas the percentage is only 10 if it is raised from shareholders, directors etc.

(4) **Short maturity period :** The maturity period of public deposit is relatively short though they can be renewed, but it is not a wise thing to depend on them for long-term financing.

(5) **Unhealthy trend in capital market :** There are numerous rates of interest offered by different companies which create unhealthy trends in the capital market and this is detrimental to the development of the capital market too.

From the investor's point of view :

The disadvantages from the investor's point of view are :

(1) **Security :** Investors do not get any security for their deposits. Money deposited by them may be used by the management in any way it likes. So, the risk of investment in public deposit is much higher.

(2) **Taxability :** Interest income on public deposit is not exempted from tax. Hence, many investors do not like to invest in public deposits.

(3) **No guarantee :** Public deposits are neither covered by any insurance nor guaranteed by the government as opposed to bank deposits. Inspite of many safeguards, there is a danger of losing money to the mismanaged companies.

(4) **Liquidity :** Public deposits are not very liquid assets. It is possible for an investor to withdraw his deposit from a bank easily but not from a company.

(5) **Narrowed the investment market :** The method has narrowed the investment market by restricting the supply of good securities such as shares and debentures to an ordinary investor.

3.3.9. Inter-corporate Deposits

A company can borrow funds for a short period upto 6 months from other companies which have surplus liquidity. Such borrowings are known as inter-corporate deposits. Inter-corporate deposits can be of three types : (*i*) call deposit, (*ii*) three-months deposits and (*iii*) six-months deposit.

A deposit is said to be a ***call deposit*** if it is withdrawable by the lendor any time by giving a day's notice. But the time requirement to mobilise the process is at least 3 days.

To overcome short-term requirement generated out of dividend payment, excessive import, unplanned capital expenditure etc., a company can take deposits for 3 months from the other companies. This deposit is known as ***three-months deposit***. In practice this inter-corporate deposit is more popular.

If a company receives deposits for a period upto 6 months from the another company, it is known as ***six months deposit***. Lending companies cannot extend deposits beyond this time limit.

The rate of interest on inter-corporate deposits varies depending upon the amount involved and the time period. Since 1973, the market for these deposits have been expanding in India as the restrictions on working capital finances were imposed by the Reserve Bank of India in that year. There are no limits on borrowings for inter-corporate deposits made for short term.

Inter-corporate deposit transactions are very easy as there are neither any legal restrictions nor any rules and regulations binding such transactions. This transaction can be done secretly, so that there will be no chance of unhealthy competition and/or any possibility of undercutting rates of interest. Sometimes inter-corporate deposit transactions are made based on personal contacts.

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3.3.10. Commercial Paper

An emerging source of financing working capital requirements of the corporate enterprises is the Commercial Paper (CP). It is an unsecured promissory note issued by the large listed joint stock companies to raise short-term funds under the approval of the Reserve Bank of India with a fixed maturity.

Commercial Paper was first introduced in the Indian money market in the year 1990 on the recommendations of the Working Group on Money Market (Vaghul Committee, 1988) and the Reserve Bank of India's announcement in its credit policy statement dated March 27, 1989.

The companies which issue a commercial paper must have a minimum tangible net worth of ₹ 5 crore as per the latest audited accounts, sound financial health and should enjoy a high credit rating. A credit rating agency called CRISIL (Credit Rating Institution Services of India Limited) has been set up in India by ICICI and UTI which has been approved by the RBI to rate commercial papers.

Commercial paper has a fixed maturity period mostly ranging from 91 to 180 days. But it can also be issued for a maximum period of one year and a minimum period of 15 days. It has to be issued in multiples of ₹ 5 lakhs and the minimum size of an issue to a single investor is of the face value of ₹ 25 lakhs, though it can be issued at a discounted value too. The face value of a commercial paper issued by any company should not exceed 30 per cent of its working capital limit and the company should have a minimum current ratio of 1·33 as per the latest audited balance sheet.

Government companies, companies governed by FERA with prior approval of the government and Non-resident Indians (NRIs) are also eligible to issue commercial papers. The participants or the investors of commercial paper can be corporate bodies, banks, UTI, LIC, GIC etc.

A commercial paper is a cheaper source of raising short-term finance as compared to the bank credit and proves to be effective even during a period of tight bank credit. It provides a diversified source of capital to the lender. It cannot be redeemed before the period of maturity even if the issuing firm has surplus funds to pay back.

3.3.11. Factoring

Another method of raising short-term capital is through account receivable credit offered by factors. *A 'factor' is a financial institution that manages the collection of bills receivables of business enterprises.* Factoring is a unique financial innovation. Factoring service is an arrangement between the seller of goods and a financial institution, called the 'factor' under which the later takes over the credit collection, purchase and recovery function of the former. Being a financial service it is designed to help business firms on the management of receivables. A businessman or a firm can obtain cash for invoices he sends to his customers in respect of supply of goods and services to them through factoring. Thus, factoring is also termed as 'Invoice Discounting'. In a nutshell, factoring is the collection and finance service designed to improve the cash flow position of the sellers by converting sales invoices into ready cash. Hence, funds can be obtained under this arrangement at the moment of sales in respect of credit sales. The factor works between the seller and the buyer for realisation of credit sales, once a sale transaction is completed. Factors provide all these services against a charge which is worth paying as compared to the other sources of finance.

The procedure of factoring starts when the seller makes an agreement with the factor. After signing an agreement regarding the terms and conditions, the client passes all credit sales to the factor and informs their customers that the payment has to be made to the factor. The factor purchases the invoices and makes the advances, generally upto 80% of the invoice amount. Once the customer makes payment to the factor, the balance amount due to the client is paid by the factor. The factor also

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