5th

Commerce

class - XII

Chap - 3.

18/6/2020

Distinction between Equity Shares and Preference Shares

Point of distinction	*Preference shares*	*Equity shares*
1. Nominal value	Generally high	Generally low.
2. Degree of risk	Comparatively low. A fixed rate of dividend assures regular and steady income.	Very high risk. Sink and swim with the company.
3. Right to dividend	Prior to dividend on equity shares	After dividend on preference shares.
4. Rate of dividend	Generally fixed	Varies with the company's profits
5. Refund of capital	Prior to refund of equity capital	Repayment after all other obligations are refunded
6. Voting rights	Limited voting rights, when dividend remains unpaid for a certain period or when matters directly affecting them are involved.	Full voting rights
7. Appeal	Appeal to cautious and conservative investors	Appeal to bold and adventurous investors
8. Redemption	Redeemable during the life time of the company	Not redeemable during the life time of the company
9. Convertibility	May be convertible into equity shares	Not convertible into preference shares
10. Arrears of dividend	May accumulate	Never accumulate
11. Order of refund	Before equity shares are paid	After preference shares are paid
12. Further issue of shares	Not entitled to issue of right shares and bonus shares	Entitled to issue of right shares and bonus shares

3.4 BONUS SHARES OR BONUS ISSUE

Sometimes, a company may have large undistributed profits which it wants to distribute among its shareholders. Instead of distributing these profits as dividend, the company issues fully paid shares to them free of charge in proportion to their existing shareholdings. These shares are called **Bonus shares**. Issue of bonus shares is also known as **Bonus Issue or capitalisation of the undistributed profits** of the company.

A company must comply with the following conditions before issuing bonus shares:

(*i*) Articles of Association of the company must permit the issue of bonus shares.

(*ii*) Board of Directors of the Company must pass a resolution for making the bonus issue.

(*iii*) If the articles of Association so require approval of shareholders through a resolution in general meeting must be taken.

(*iv*) There should be adequate undistributed profits.

(*v*) SEBI guidelines must be followed in case a bonus issue is to be made by a listed company.

3. **Cash**	Rights shares bring cash to the company's coffers.	Bonus shares are free and hence do not add anything to the company's cash box.
4. **To be paid for.**	Rights shares are to be paid for existing shareholders.	Bonus shares are absolutely free for the existing shareholders.
5. **Minimum subscription**	Rights issue must comply with the minimum subscription requirement as per which 90% of the minimum subscription must be received within 60 days of the close of the issues failing which, the company must return the entire amount.	Bonus issue does not need to comply with this requirement.
6. **Separate Bank Account**	Till the concerned stock exchange approves the allotment money must be kept in a separate bank account in a scheduled bank.	This is not relevant for a bonus issue as no money is to be received by the company.
7. **Right of Renunciation**	An existing shareholder has the right to renounce all or part of the shares offered to him as Rights Shares, in favour of his nominee.	No such facility is available in case of bonus shares.
8. **Purpose of issue**	Rights issue is made for raising fund to meet the growth and diversification needs of the company.	Bonus issue is made to capitalise undistributed profits.
9. **Guidelines**	The Companies Act 1956 through its section 81 regulates the issue of Rights Shares. SEBI guidelines also apply.	There is no section in the Companies Act which regulates the issue of bonus shares. They are essentially regulated by the Articles of Association of the company and detailed guidelines issued by SEBI.

3.6 EMPLOYEE STOCK OPTION PLANS (ESOP)

An employee stock option plan is a scheme under which an employee of the company is given a right to purchase a specified number of its shares at a stipulated price (usually below the market price) during a given period of time. Only those employees are given this right who fulfil the specified eligibility conditions (e.g. minimum period of service in the company). The employees who exercise the option may be allowed to pay the money in instalments or by way of deduction from his/her monthly salary.

Merits : The merits of stock option scheme are :

(*i*) This scheme can link compensation package closely to performance.

3.5 RIGHTS SHARES OR RIGHTS ISSUE

A public company limited by shares may at anytime, increase its subscribed cap issuing new shares. But the directors of the company cannot offer the new shares persons at their discretion. Section 81 of the Companies Act 1956 provides that wh a company proposes to increase its subscribed capital through a further issue of it should offer such shares to the existing members of the company, if the issue is made (*a*) at any time after the expiry of two years from the formation of the comp (*b*) at any time after the expiry of one year from the first allotment of shares, whic is earlier. The shares which are so offered to the existing members are called Right and the right of members to be so offered is called Right of Pre-Emption. In other right shares are the shares offered to the existing shareholders at a discount to the price through a letter of offer.

The offer of right shares shall be made by notice specifying the number of offered. The notice shall give at least 15 days for the acceptance of the offer. If the is not accepted within this period, it shall be deemed to have been declined.

The shareholders have the right to renounce all or any of the shares offered to in favour of their nominees. After the expiry of the time specified in the notice receiving intimation of decline of the offer, the Board of Directors are free to dispo the shares in such manner as they think is most beneficial for the company.

A company need not offer further shares to the existing shareholders in the fo ing cases.

(*i*) When an issue is being made, within two years of formation or within year of first allotment of shares which ever is earlier.

(*ii*) Where a **special resolution** is passed by the company in a general me providing that shares need not be offered to existing equity shareholde

(*iii*) Where the company passes an **ordinary resolution** and gets the appro the Central Government, for not offering the further shares to existing shareholders. The Central Government will give its approval to the pro only if it is satisfied that it is most beneficial to the company.

(*iv*) Where all existing shareholders decline the offer.

Distinction Between Rights Shares and Bonus Shares

Basis	*Rights Shares*	*Bonus Shares*
1. Meaning	Whenever a company. comes out with a further issue of shares which is after 2 years of formation or one year of first allotment, they must be offered to existing shareholders first. Such shares are called Rights Shares.	When companies having undistributed profits issue paid-up shares to their exis shareholders. free of ch in proportion to their exis shareholdings they are kno as Bonus Shares.
2. Fully paid-up	The Rights shares may be partly paid-up.	Bonus shares are always paid-up

3. Cash	
4. To be paid for.	
5. Minimum subscription	
6. Separate Bank Account	
7. Right of Renunciation	
8. Purpose of issue	
9. Guidelines	

3.6 EMPLOYEE

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The amount of retained earnings in a company depends on several factors. Generally, more are the net profits of a company, greater is the capacity to plough back profits. *Secondly,* dividend policy of the company determines the extent to which profits can be retained for reinvestment in business. A company which follows a policy of paying liberal and regular dividend every year may not be able to retain as much profits as a company following a conservative dividend policy. *Thirdly,* the age of the company affects the practice of self-financing. New companies generally do not retain much profits due to their desire to satisfy the shareholders. On the other hand, an old company may distribute only a small part of the profits among shareholders and may retain the major part for ploughing back. *Lastly,* the future plans of the company regarding modernisation and expansion also have an influence on retained earnings.

Ploughing back of Profits at a Glance

No.	*Merits*	*Demerits*
1.	Convenience	Danger of over-capitalisation
2.	Economical	Dissatisfaction among shareholders
3.	No charge on assets	Speculation
4.	No interference	Unbalanced growth
5.	Goodwill	
6.	Tax benefits	

Merits (Advantages) to the Company

Ploughing back of profits offers the following **benefits:** (*i*) It is the most convenient and economical method of finance. No legal formalities are involved and no negotiations are to be made. No return is to be paid on retained earnings and no fixed obligations are created. (*ii*) The financial-structure of the company remains fully flexible. No charge is created against the assets and no restrictions are put on the freedom of management to raise further finance by floating new securities in the market. (*iii*) Ploughing back of profits adds to the financial strength and creditworthiness of the company. A company with large reserves can face unforeseen contingencies and trade cycles with ease and economy. Retained earnings increase the borrowing capacity of the company. (*iv*) Retained earnings can be used to redeem debts and to replace obsolete assets. A company with large reserves can take advantage of business opportunities. (*v*) Reserves created by ploughing back of profits can be used to stabilise the rate of dividend on equity shares. Regular dividends help, to improve, relations with shareholders. (*vi*) Use of retained earnings-does not disturb the voting control of the company. (*vii*) The company can undertake its plans for expansion, growth and modernisation without bothering about conditions in the capital market.

Advantages to Shareholders

(*i*) Shareholders of a company having large reserves and surplus get the benefit of safety of investment.

(*ii*) Shareholders will receive regular dividends as deficiency of one year will be made good out of the undistributed profits of previous years.

(ii) This scheme enables the companies to retain efficient employees with the pany, thereby reducing employee turnover.

(iii) It encourages the employees to work even better.

(iv) It inculcates a sense of ownership and responsibility among employees.

(v) This scheme boosts morale and team effort among employees.

(vi) When the market price of company's share rise the employee can becom millionaire.

Limitations : The limitations of the scheme are :

(i) This scheme can be used by only the profit-making companies.

(ii) Share prices do not always reflect fundamentals.

(iii) Falling share prices result in los to employees.

(iv) Unsound stock market conditions cause inconvenience to employees in ena ing their investment.

(v) Lack of transparency can earn accusations of favouritism.

3.7 SWEAT EQUITY SHARES

Sweat Equity shares are the shares issued by a company under Section 79A of the C panies Act, 1956 to employees or directors (*i*) at a discount (to the market price) or for consideration other than cash, or (*iii*) for providing know-how or making avai property right. Following conditions are prescribed for issue of Sweat Equity :

(i) There must be of a class of shares already issued.

(ii) At least one year must have lapsed since company commenced business.

(iii) The issue must be authorised by a special resolution.

(iv) The shares must be issued as per SEBI (Issue of Sweat Equity) Regulati 2002 (in case of listed companies) and as per Unlisted Companies (Issu Sweat Equity Shares) Rules, 2003 incase of unlisted companies.

Valuation of intellectual property and the pricing of sweat equity shall be made as the method given in the respective regulations. The sweat equity shares shall be locke for a period of three years.

Sweat equity shares are issued under a formal scheme and not at any time. The p pose of sweat equity shares is to retain talent as these shares cannot be sold by emplo before the expiry of three years from the date of issue. Employees who are offered sw equity shares have the option to reject these and receive their remuneration in cash.

3.8 RETAINED EARNINGS

Measuring : Retained earnings or Ploughing back of profits refers to the process retaining a part of the net profit year after year and reinvesting the same in busin Well-established companies often use undistributed profits to meet a part of their finan requirements. This source is also called 'self financing' as it is an internal method finance. Retained earnings are a popular source of capital for modernisation and expans of business.

(*iii*) Ploughing back of profits will add to the profitability and earning capacity the company. Shareholders will benefit from the prosperity of the company.

Advantages to the Society

(*i*) Corporate savings accelerate the rate of capital formation in the country.

(*ii*) Surplus makes the economy more stable. The rate of corporate failure is redu due to greater capacity of enterprises to absorb depression and other crises.

(*iii*) Companies can adopt modernisation and rationalisation schemes. These add industrial productivity and flexibility.

(*iv*) Business enterprises can produce better quality goods at lower costs. Society large would be the beneficiary of an increased standard of living.

Demerits (Disadvantages)

Excessive ploughing back of profits may result in the following **drawbacks**: (*i*) T management of a company may not always use the retained earnings in the best inter of shareholders. It may invest them in unprofitable fields or may spend them wasteful (*ii*) Too much dependence on retained earnings may tempt the management to issue bo shares to the equity shareholders. Frequent capitalisation of profits may result in ov capitalisation. (*iii*) The practice of ploughing back of profits may be used to manipul share prices on the stock exchange. Vested interests may speculate in the compan shares to deceive genuine and uninformed investors. (*iv*) Heavy reinvestment of earni year after year may cause dissatisfaction among shareholders as they get low dividen (*v*) Indiscriminate use of retained earnings may result in monopoly and concentration economic power in a few hands. (*vi*) It is an unstable source as profits may not rem the same in future years. (*vii*) Ploughing back of profits may lead to unbalanced industr growth because profits which might have been invested outside in other industries a reinvested in the same industry. The natural growth of the capital market is hindered.

3.9. DEBENTURES

Meaning : Debentures denote borrowing by a company and represent its loan capit Debentureholders are creditors of the company. A debenture is a document or certific issued by a company as proof of the money lent to it by the holder. It is an acknowledgme of debt as well as an undertaking to repay the specified sum with interest on or before t prescribed date. A debenture is a certificate issued by a company under its common se as acknowledgement of debt with or without a charge on the company's assets. Inter on debentures is paid at a fixed rate and it is payable periodically until the maturity a repayment of debentures. Debentures carry no voting rights but they generally involve charge on the company's assets.

According to Evelyn Thomas, "a debenture is a document under the compan seal, which provides for the payment of a principal sum and interest thereon at regul intervals, which is usually secured by a fixed or floating change on the company's propert or undertaking and which acknowledges a loan to the company".

Characteristics: The main features of debentures are as follows:

1. Debentures represent borrowed funds.
2. Interest on debentures is paid at a fixed rate.

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Difference between Shares and Debentures

	Point of Difference	Shares	Debentures
1.	Status	Owners	Creditors
2.	Yield	Fluctuating dividend out of profits	Fixed interest irrespective of profit
3.	Order of repayment	Unsecured, after debenture holders	Usually secured always before shareholders
4.	Voting rights	Full voting rights	No voting rights
5.	Terms of repayment	Usually irredeemable	Usually redeemable
6.	Risk to holders	No security, high risk	Generally secured low risk
7.	Redemption	Not redeemable except redeemable preference shares	Redeemable after a certain period
8.	Restrictions on issue	Certain restrictions	No restrictions
9.	Convertibility	Not convertible	May be convertible

Kinds of Debentures

Debentures issued by a company can be of the following types:

1. Naked and mortgage debentures. Naked or simple debentures are not secured as no property is pledged or mortgaged on their issue. They are more promises to pay. In case of default the debentureholders can merely sue the company for recovering their money. On the other hand, mortgage or secured debentures are issued by creating a fixed or floating charge on the company's assets. In case, the company makes a default in payment, the debentureholders can recover their dues from the mortgaged property.

A *fixed charge* is created on specific and existing assets of the company. The company cannot dispose off these assets without the consent of the debentureholders. On the other hand, *a floating charge* is created on both the existing and future assets of the company. The company can use these assets in the ordinary course of business. The charge keeps on fluctuating and becomes fixed when the company goes into liquidation or makes default in payment. Any change created by a company in the form of debentureholders must be registered.

2. Redeemable and irredeemable debentures. Redeemable or callable debentures are repayable on a predetermined date or at any time prior to their maturity at the option of the company. But irredeemable or perpetual debentures are repayable only at the time of winding up of the company.

3. Bearer and registered debentures. Bearer debentures can be transferred by mere delivery as no record of such debentures is kept in the Register of Debentureholders. Interest is paid on the production of coupons attached to such debentures. No legal formalities are required for their transfer and no formal notice or intimation to the company is necessary. But registered debentures are recorded in the Register of Debentureholders. Interest is payable only to the registered holders. Such debentures can be transferred only by transfer deed or intimation to the company and not mere delivery.

4. Convertible and no
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4. Convertible and non-convertible debentures. In case of convertible debentures, the debentureholders are given the option to convert their debentures into equity shares after a specified period and on certain conditions. This serves as an incentive to the debentureholders who can in course of time participate in the profits and management of the company. Non-convertible debentures do not carry any right to be converted into equity shares.

Advantages of Debentures

Debentures are an important source of raising long-term finance. The main advantages of debentures are as follows:

From the Viewpoint of Debentureholders

1. Appeal to cautious Investors. Large amount of finance can be raised by issue of debentures from cautious and orthodox investors who prefer safety of investment and a fixed return. In tight money conditions, debentures are the best source of finance.

2. Regular return. Debentureholders are paid interest at a fixed rate and at periodical intervals, irrespective of profits. Therefore, debentureholders are free from risk of fluctuations in the company's earnings.

3. Safety of investment. Debentures are usually secured by a charge on the company's assets. Therefore their repayment is assured.

From the Viewpoint of the Company

4. Economical source. A company can raise funds through debentures at a relatively low cost. This is because investors consider debentures a safe investment. Debentures can be sold more easily than shares. Underwriting commission, brokerage and other expenses of issue are lesser.

5. Freedom of management. Debentures do not carry voting rights. Therefore, a company can raise funds without diluting or weakening the control of the existing members. The management retains its independence as there is no interference from debentureholders.

6. Trading on equity. Interest on debentures is paid at a fixed rate. After payment of interest, the remaining profits are available to shareholders. When the earnings of the company increase, the rate of dividend on equity shares can be increased. This is known as trading on equity.

7. Flexibility. A company can repay the funds raised through debentures when it does not require the funds any more. The facility of redemption avoids the danger of overcapitalisation and keeps the financial structure flexible. Funds are available for a fairly long period and can be repaid out of earnings.

8. Tax relief. Interest paid on debentures is allowed a deduction while calculating taxable income. It results in saving in income tax liability.

Disadvantages of Debentures

Debentures suffer from the following disadvantages:

From the Viewpoint of the Company

1. Permanent burden of interest. Interest on debentures has to be paid every year irrespective of profits. During periods of depression, it becomes a heavy burden on the company's earnings.

2. Reduction in credit standing. The credit-worthiness of a company w issued a large amount of debentures is low. Borrowing from banks and financial in becomes difficult.

3. Charge on assets. Debentures usually involve mortgage of fixed assets. A c cannot raise funds easily through debentures unless it has enough fixed assets. periods of depression, the company may not be able to repay the amount. Debentur may attach the pledged assets which may paralyze business.

4. Reduction in dividend. During times of low earnings, very little profit m left after payment of interest on debentures. The company may not be able to pay dividends and the market value of its shares may go down.

From the Viewpoint of Debentureholders

5. No voting rights. Debentureholders have no voting rights in the manage a company. Therefore, they remain at the mercy of the shareholders. Debenture have little appeal to investors who want a share in the prosperity of the company.

6. High unit price. The unit price of debentures is generally higher than shares. Therefore, small investors may not be able to purchase debentures.

7. Unattractive. Enterprising investors who want high return and apprecia capital find debentures unattractive. Debentures of new companies do not appeal investors.

Debentures at a Glance

No.	*Advantages*	*Disadvantages*
1.	Trading on equity	Fixed burden on profits
2.	Low cost	Loss of prestige
3.	Appeal to cautious investors	Charge on assets
4.	Flexibility	Limited appeal
5.	Tax benefit	
6.	No interference in management	

3.10 LOANS FROM COMMERCIAL BANKS

Commercial banks usually provide short term finance because most of their depos short term deposits. However, in some cases commercial banks also provide term for medium and long periods especially to small scale and medium enterprises (SS

Meaning : Under a term loan, a banks advances a fixed amount in lump sum borrower for a specified period. The Interest is changed at a fixed rate on the sanc amount. The loan is advanced against the security of some assets or on the pe guarantee of the borrower.

Advantages : (*i*) Funds are available for the specified period (*ii*) Loans commercial banks provide the benefit of trading on equity (*iii*). Relationship with a re bank is beneficial for the borrower (*iv*) Repayment can be made out of future ear (*v*) Interest paid on bank loan is deductible for determining taxable profits.