Commerce 9/6/2020

Class - XI

Chap - 3

Sources of Finance for A Joint Stock Company.

(*vi*) Shareholders are not required to pay income tax on dividends received from the company.

Disadvantages of Equity Shares

From Company's Point of View

1. Manipulation of control. Equity shares carry full voting rights. This gives rise to many undesirable practices by persons who seek to gain control over the company. Often there is cornering of votes and manipulation of control by cliques of shareholders to their own advantage.

2. Danger of over-capitalisation. Capital raised through equity shares is not refundable during the life time of the company. Mistakes in estimation of financial requirements or overenthusiasm may lead to overcapitalisation resulting in lower rate of earnings and dividends. Financial structure becomes inflexible.

3. No trading on equity. When the entire share capital is raised through equity shares, the benefit of trading on equity is not available.

4. Costly. The cost of issuing equity shares is higher than the cost of issuing other types of securities. Underwriting commission, brokerage and other issue expenses are very high for equity capital.

5. Inflexible. A company can not issue shares in excess of its authorised capital as stated in the Memorandum of Association.

From investors'/shareholders point of view

1. Perpetuation of control by a few. Any new issue of equity shares has to be first offered to the existing shareholders. As a result the company comes to be managed by a handful of persons. Ordinary and small shareholders remain owners in name only.

2. High risk. Equity shareholders sink or swim with the company. Dividend and refund of capital are both uncertain. The right to declare dividend lies with the Board of Directors. Shareholders cannot increase the rate of dividend recommended by the Board of Directors. Prices of shares keep on fluctuating.

3. Unhealthy Speculation. Very often there is unhealthy speculation in the prices of equity shares. This is more so during boom when the prices are rising. Directors and officers of the company may also indulge in speculation on the basis of inside knowledge about the company. Innocent and ignorant investors suffer.

Equity Shares at a Glance

No.	*Advantages*	*Disadvantages*
1.	No burden on earnings	Interference in management
2.	Permanent capital	Over-capitalisation
3.	No charge on assets	No trading on equity
4.	Source of strength	High risk
5.	Wide appeal	Unhealthy speculation

(*iii*) **Legal formalities:** Redemption of preference shares involves several legal restrictions.

(*iv*) **Low appeal:** Preference shares have little appeal to investors. Cautious and conservative investors prefer debentures. Risk taking investors prefer equity shares. Therefore, a company can raise limited funds through preference shares.

From the Viewpoint of Shareholders

(*i*) Lack of voting rights: Preference shares do not carry voting rights in the normal course. When the company's earnings rise rapidly, holders of such shares do not get a share in the prosperity of the company except in case of participating preference shares.

(*ii*) Fear of being shown the door: Holders of redeemable preference shares have to face yet another unpleasant prospect. The company raises capital from them when it is badly in need of funds. But once its purpose is served, it bids good-bye to them by paying back their money.

(*iii*) No capital appreciation: Preference shareholders do not get the benefit of appreciation in their investment. They do not share in the prosperity of the company during boom period.

(*iv*) No guarantee of dividends: Payment of dividend on preference shares is not guaranteed. Rate of dividend is generally modest. Price fluctuations of preference shares is greater than that of debentures. These shares are less easily saleable on stock exchanges than equity shares.

PREFERENCE SHARES AT A GLANCE

No.	*Advantages*	*Disadvantages*
1.	Appeal to caution investors	Limited appeal due to uncertain returns
2.	No charge on assets	Fixed liability
3.	No burden on profits	Lack of voting rights
4.	No interference in management	Fearing of showing the door
5.	Trading on equity	
6.	Flexibility	

Preference shares are unpopular due to low rate of return, uncertainty as to its payment and absence of a voice in the management of the company. However, preference shares may be a useful source of capital for a company under the following conditions.

(1) When the assets are not acceptable as sufficient collateral security for issuing debentures.

(2) When higher interest will have to be paid by issuing debentures against assets which are already mortgaged.

(3) When the company's promoters want to retain control without creating fixed obligation as to payment.

(4) When the company needs funds for medium-term it can issue redeemable preference shares.

Preference shares can be issued as a bonus for increasing the sale of other shares.

3.3. PREFERENCE SHARES

Features : Preference shares are the shares which carry certain privileges or prefere rights — both regarding the dividend and the return of capital. ***First***, dividend at a fi rate must be paid on preference shares before any dividend is paid on equity sha *Secondly*, in the event of winding up of the company, preference shareholders must paid back their capital before equity shareholders. Generally, preference shares do carry any voting rights except when dividend is outstanding for more than two years (th years in case of non-cumulative preference shares).

Thus, preference shares are a hybrid security comprising features of both eq shares and debentures. Like equity shares, dividend on preference shares is payable o when there are profits. Like debentures, preference shares carry a fixed rate of divid and enjoy priority over equity shares but no voting rights.

Types : Preference shares can be of the following types:

1. ***Cumulative and non-cumulative preference shares.*** In the case of cumula preference shares dividends not paid in a particular year are carried forward to the s year. Such unpaid dividends go on accumulating and become payable out of the profits subsequent years. Such arrears of dividend must be paid before dividend is paid on a other class of shares. Unless otherwise stated preference shares are cumulative.

On ***non-cumulative*** preference shares dividends do not accumulate. In case the co pany does not have sufficient profits in any year, the right to dividend in respect of t year is lost for ever. The dividend claim is not carried to subsequent years. Sharehold cannot claim arrears of dividend in subsequent years.

2. ***Participating and non-participating preference shares.*** Participating prefere shares give the holder the right to share in the profits left after the payment of dividend preference and equity shareholders. Holders of participating preference shares are enti to participate in the surplus profits of the company in addition to their normal fixed rate dividend. On the contrary, the holders of non-participating preference shares do not en the right to share in the surplus profits. They get only the fixed dividend.

3. ***Convertible and non-convertible preference shares.*** Holders of convertible pre ence shares can get such shares converted into equity shares after a fixed period. On t other hand, preference shares which cannot be converted into equity shares are known non-convertible preference shares.

4. ***Redeemable and irredeemable preference shares.*** The holders of redeemab preference shares can be refunded their capital after the expiry of a specified period or the discretion of the company as stated in the Articles of Association. Only a compa limited by shares can issue redeemable preference shares. The intention to return mor should be made clear when the shares are issued. The Companies Act lays down seve conditions for the redemption of preference shares. Non-redeemable preference sha cannot be redeemed before the winding up of the company. However, the Compan Amendment Act 1996 lays down that preference shares cannot be issued for a period more than twenty years. Therefore, a company cannot issue irredeemable preference shar

Advantage of Preferen

From Company's Point o

1. **Appeal to cautiou** who look for reasonable s that obtainable on debent

2. **No burden on pr** dividends are payable on

3. **No interference** ing rights. Therefore, pro preference shares to outs

4. **No charge on a** or charge on the assets o used for raising loans in

5. **Trading on equ** company's earnings rise, ers. Preference shares ar is usually low.

6. **Flexibility.** In ca when the company does n to attract investors who share capital is consider of a company.

From Investors/Sharel

(*i*) Investors get dividend. Rat

(*ii*) The risk inv payable befo

(*iii*) Preference sh time period l twenty years

(*iv*) In case of cu and are paya

Disadvantages of P

. **From the Viewpoint o**

(*i*) **Costly sourc** than that of e

(*ii*) **Permanent** rate before a loss the burd shares.

paid after paying dividend on preference shares. In the event of winding up of the company equity shareholders are paid after all other claims are paid. Thus, equity shareholders bear the maximum risk. But they enjoy full voting rights and control over the management of the company. They are also entitled to all the residual profits of the company.

Features of Equity Shares

(i) Equity shares are issued prior to preference shares and debentures

(ii) These shares carry no preferential rights in the payment of dividend. Dividend is payable only after it is proposed by the Board of Directors and approved by the equity shareholders in the Annual General Meeting of the company.

(iii) Equity share capital is repaid in the last in the event of winding up of the company.

(iv) Holders of equity shares generally enjoy voting rights. They are also entitled to the residual profits of the company.

Advantages of Equity Shares

From company's point of view

1. **No burden on earnings.** Equity shares impose no burden on the company's resources because the dividend on such shares is payable only at the discretion of the management, subject to the availability of adequate profits. The company is under no obligation to pay a fixed rate of dividend on equity shares.

2. **Permanent capital.** Equity share capital is refunded only at the time of winding up of the company. Therefore, equity capital, remains with the company for ever. There is no liability as to repayment. Even at the time of winding up equity capital is paid back in the last and that too if any surplus is left after meeting all other liabilities.

3. **No charge on assets.** Equity shares do not create any charge or mortgage on the assets of the company. The company is free to use its property for raising loans.

4. **Source of strength.** A company with substantial equity capital commands prestige in the investment market. Its ability to borrow is high due to high credit worthiness.

5. **Small nominal value.** The face value of an equity share is generally very low. As a result equity shares have a wide appeal and even persons belonging to low income groups can buy them. A company can mobilise savings of large sections of society due to features of limited liability, transferability and perpetual succession.

6. **Unlimited source.** Any amount of capital can be raised through equity shares.

From investors'/shareholders' point of view

(i) Equity shareholders enjoy voting rights and controlling power over the company.

(ii) The liability of equity shareholders is limited to the face value of shares subscribed by them.

(iii) In case of successful business, the rate of dividend can be very high. For example Hero Honda motors has paid 900% dividend on equity shares in the year 2002-2003.

(iv) Equity shareholders have the pre-emptive right to subscribe to new shares issued by the company. Such shares are called 'Right Shares'.

(v) The value of investment in equity shares may increase manifold during boom and prosperity of the company-holders of these shares earn capital gains.

SOURCES OF FUNDS

Long-term Finance

1. Equity shares
2. Preference shares
3. Retained Earnings
4. Debentures
5. Loans from Commercial Banks
6. Loans from Financial Institutions

Short-term Finance

1. Public Deposits
2. Commerical Banks
3. Trade Credit
4. Customer Advances
5. Factoring
6. Inter-Corporate Deposits
7. Instalment Credit

Fig. 1 Long term and Short-term Sources of Finance

Both long term and short term funds can be raised from two types of sources (*a*) owned funds, and (*b*) borrowed funds. or Loan capital. Owned funds consist of equity shares preference shares and retained earnings. These funds belong to the owners. On the other hand, borrowed funds belong to the creditors or lenders. Debentures public deposits, trade credit, installment credit, loans, etc. constitute the borrowed funds. These funds are repayable after a specified time period.

3.2. EQUITY SHARES

Issue of shares is the most important method of raising long term funds. Shares are the ownership securities and share capital represents the ownership capital. Funds raised through shares provide a financial base to the company.

The capital of a company is divided into a number of equal parts known as shares. Thus, the term share means the interest of a shareholder in the company measured by a sum of money. According to the companies Act, "a share is a share in the share capital of a company, and includes stock except where a distinction between stock and shares is express or implied".

Share refers to a share in the share capital of a company. It is one of the units into which the share capital of a company can be divided. It indicates the interest in the assets and profits of a company. According to Justice Farewell, "A share is the interest of the shareholders in the company measured by a sum of money for the purpose of liability and of interest (dividend). It also consists of other rights given by the Articles of Association". A share is, thus, one of the equal parts into which the capital of a company is divided. Each share has a distinct number and a face value. It confers certain rights on its holder as specified in the articles of association of the company.

A public company limited by shares can issue two types of shares:

1. Preference shares
2. Equity shares

Shares which carry no preference rights or priority in the payment of dividend and in the repayment of capital are called equity shares or ordinary shares. Equity shares are issued prior to other securities and repaid in the last. Dividend on such shares is payable only when there are profits and the company declares dividend. Dividend on equity shares is

Advantage of Preference Shares

From Company's Point of View

1. **Appeal to cautious investors.** Preference shares greatly appeal to those inventors who look for reasonable safety of their capital along with a fixed but higher return than that obtainable on debentures.

2. **No burden on profits.** Preference shares do not put a fixed burden on finances as dividends are payable only out of profits. The cost of finance is also less.

3. **No interference in management.** Generally, preference shares do not carry voting rights. Therefore, promoters can retain exclusive control over the company by issuing preference shares to outsiders. There is no dilution of control.

4. **No charge on assets.** Issue of preference shares does not involve any mortgage or charge on the assets of the company. The company can keep its fixed assets free to be used for raising loans in future.

5. **Trading on equity.** Rate of dividend on preference shares is fixed. When the company's earnings rise, the company can pay higher rates of dividend to equity shareholders. Preference shares are an economical source of finance because the rate of dividend is usually low.

6. **Flexibility.** In case of redeemable preference shares the amount can be repaid as and when the company does not need it. Participating or convertible preference shares can be issued to attract investors who want to share in the growing prosperity of the company. Preference share capital is considered a part of networth. It therefore, increases the credit worthiness of a company.

From Investors/Shareholders' Point of View

(i) Investors get a more stable and regular dividend before payment of equity dividend. Rate of dividend is fixed.

(ii) The risk involved is comparatively less because preference share capital is payable before equity share capital on the winding up of the company.

(iii) Preference shareholders can expect to get back their investment after a certain time period but preference shares cannot be issued for a period of more than twenty years.

(iv) In case of cumulative preference shares the arrears of dividend also accumulate and are payable in future.

Disadvantages of Preference Shares

From the Viewpoint of Company

(i) **Costly source:** The cost of raising finance through preference shares is greater than that of debentures. Preference dividend is not deductible for tax purposes.

(ii) **Permanent burden:** Dividend on preference shares has to be paid at a fixed rate before any dividend is paid an equity shares. When the company incurs loss the burden of dividend is high especially in cas[illegible]ulative preference shares.

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4th

Class - XII

9/6/2020

Subject - Commerce

Chap - 3. (Sources of Finance for A Joint Stock Company)

Questions:

Q.1. What is Equity Share? Write four features of Equity Shares.

Q.2. Discuss the advantages ~~and disadvantages~~ of Equity Shares from Company's point of view.

Q.3. Discuss the advantages of Equity Shares from investor's / Shareholders point of view.

Q.4. Discuss the disadvantages of Equity Shares from Company's point of view.

Q.5. Discuss the disadvantages of Equity Shares from investors' / Shareholders' point of view.

Q.6. What is Preference Share? Discuss the various types of Preference Shares

Q.7. Discuss the advantages Preference Shares from the Company's point of view.

Q.8. Discuss the advantages of Preference Shares from the Investors' / Shareholders' point of view.

Q.9. Discuss the disadvantages of Preference Shares from the viewpoint of Company.

Q.10 Discuss the disadvantages of Preference Shares from the viewpoint of shareholders.