# 12

# LONG-TERM SOURCES OF BUSINESS FINANCE

In the previous lesson we discussed about the various sources of short term finance. The funds that are invested in business for a long period of time, that is more than one year are known as long term finance. In this chapter we will learn more about it.

## LEARNING OUTCOMES

- state the meaning, nature and need of long-term finance;
- identifies the different sources of long-term finance, both internal and external ;
- explains the various sources of long-term finance;
- outline the merits and demerits of the various sources of raising long-term finance; and
- understand the factors affecting choice of source of funds.

## 12.1 LONG-TERM FINANCE

The funds which are not to be paid back within a period of one year are referred to as Long-term sources of finance. Certain long-term finance options directly form a part of the permanent capital of the firm. In such cases, the repayment obligation does not even arise.The long-term finance is also known as fixed capital.

### 12.1.1 NEED FOR LONG-TERM FINANCE

1) Long-term finance covers the requirements of fixed assets like land, building, plant, machinery, equipment, technical collaboration fee etc.

2) It is also required for major corporate restructuring including mergers, acquisitions, takeovers, modernisation etc.

3) Long-term finance is required to invest in R&D (Research and Development) operations.

4) It is required for designing marketing strategy or increasing facilities.

5) It also covers a component of working capital requirement which is non-fluctuating part of working capital.

## 12.2 SOURCES OF LONG-TERM FINANCE

The long-term financing could be done internally, i.e. from within the organisation or externally, i.e. from outside the organisation.

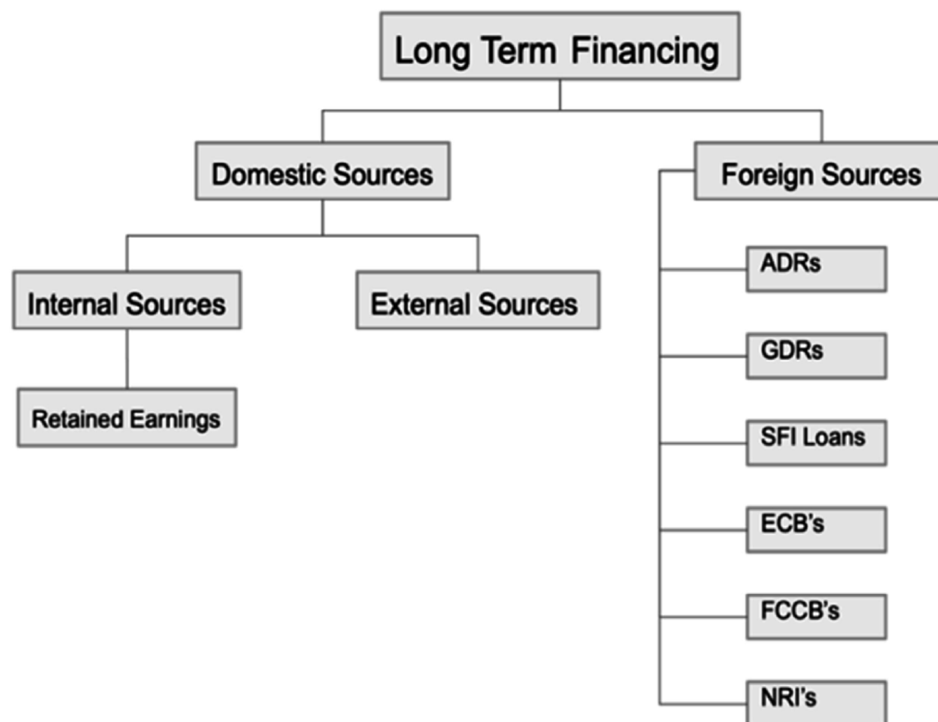


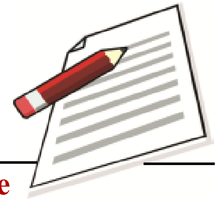

Fig. 12.1 Sources of Long-Term Finance

### 12.2.1 DOMESTIC SOURCES

Long-term finances may be domestically raised either internally i.e. from within the business, or externally i.e. from outside the business. External sources of long-term financing are discussed extensively later in the lesson. The key internal source - retained earnings - is discussed first.

**A. Internal Source - Retained Earnings**

Like an individual, companies also set aside a part of their profits to meet future requirements of capital. **The portion of the profits, which is not distributed among the shareholders but is retained and reinvested in business, is called retained earnings or ploughing back of profits.** As per The Companies Act 2013, companies




are required to transfer a part of their profits in reserves like General Reserve, Debenture Redemption Reserve and Dividend Equalisation Reserve etc. These reserves can be used to meet long-term financial requirements like purchase of fixed assets, renovation and modernisations etc. This method of financing long-term financial requirement is also called as Retention of Profit.

**Merits**

Following are the benefits of retention of profit:

1. **Cheap Source of Capital:** No expenses are incurred when capital is available from this source. There is no obligation on the part of the company either to pay interest or pay back the money. It can safely be used for expansion and modernisation of business.

2. **Bring Financial Stability:** A company which has enough reserves can face ups and downs in business. Such companies can continue with their business even in depression, thus building up their goodwill.

3. **Benefits to the Shareholders:** Shareholders are assured of a stable dividend. When the company does not earn enough profit it can draw upon its reserves for payment of dividends. Not only that, their holding size can improve with issue of bonus shares. Due to reserves, there is capital appreciation, i.e., the value of shares may go up in the share market.

**Demerits**

Following are the limitations of retention of profit:

1. **Only Possible in Case of High Profits:** This method of financing is possible only when the company earns huge profits and that too for many years.

2. **May Cause Dissatisfaction among Shareholders Expecting Dividends:** Accumulation of profits often leads to low dividend payment by companies. Not only that, the companies may not utilise it for issue of bonus shares to avoid higher dividend payment. This may create dissatisfaction among the shareholders.

3. **May result in Mismanagement of Funds by the Management:** Capital accumulated through retained earnings encourages management to be less careful with utilisation of funds which may lead to low profitability. It is not in the long-term interest of the shareholders.

## B. EXTERNAL SOURCES

You have already learnt about the purpose for which long-term finance is required by the business. In small organisations the long-term finances are generally provided by the owners. But for large organisations like joint stock companies there are various options available to raise the long-term finance externally. Following are the most commonly used methods of long-term finance from External Sources.

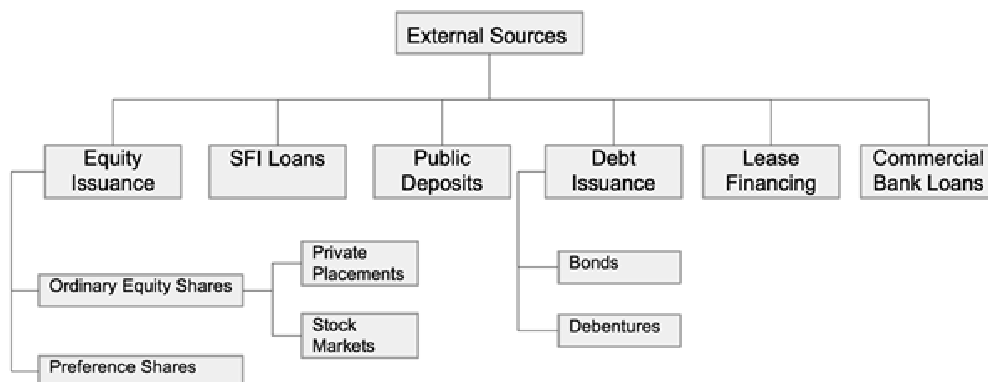



Fig. 12.2 External Sources of Long-term Financing

Let us now discuss about these in detail.

### I. Equity Issuance

Share is the smallest unit into which the total capital of the company is divided. For example, when a company decides to raise Rs. 50 crores of capital from the public by issuing shares, then it can divide its capital into units of a definite value, say Rs. 10/- or Rs. 100/- each. These individual units are called as its shares. After deciding the value of each share and number of shares to be issued, the company then invites the public to buy the shares. The investing public then buys the shares as per their capabilities. The investors who have purchased the shares or invested money in the shares are called the shareholders. They get dividend as return on their investment.

You know that investors are of different habits and temperaments. Some want to take lesser risk and are interested in a regular income. While others are ready to take greater risk in anticipation of huge profits in the future. In order to tap the savings of different types of people, a company can issue two types of shares, viz. (a) Ordinary Equity, and (b) Preference shares.

#### (a) Ordinary Equity Shares

Equity shares are shares which do not enjoy any preferential right in the

matter of claim of dividend or repayment of capital. The equity shareholders get dividend only after making the payment of dividend on preference shares. There is no fixed rate of dividend for equity shareholders. The rate of dividend depends upon the surplus profits. In case there are good profits, the company pays dividend to the equity shareholders at a higher rate. Again in case of winding up of a company, the equity share capital is refunded only after refunding the claims of others. In fact they are regarded as the owners of the company who exercise their authority through the voting rights they enjoy. The money raised by issuing such shares is known as equity share capital. It is also called as ownership capital or owners' fund.

**Merits of Equity Shares**

**From Shareholders' point of view**

- The equity shareholders are the owners of the company.
- It is suitable for those who want to take risk for higher return.
- The value of equity shares goes up in the stock market with the increase in profits of the concern.
- Equity shares can be easily sold in the stock market.
- The liability is limited to the nominal value of shares.
- Equity shareholders have a say in the management of a company as they are conferred with voting rights.

**From Management's point of view**

- A company can raise capital by issuing equity shares without creating any charge in its fixed assets.
- The capital raised by issuing equity shares is not required to be paid back during the lifetime of the company. It will be paid back only when the company is winding up.
- There is no binding on the company to pay dividend on equity shares. The company may declare dividend only if there are enough profits.
- If a company raises more capital by issuing equity shares, it leads to greater confidence among the creditors.

### Demerits of Equity Shares

#### From Shareholders' point of view

- Equity shareholders get dividend only when the company earns sufficient profits. The decision to declare dividend lies with the Board of Directors of the company.
- There is high speculation in equity shares. This is particularly so in the time of boom when profitability of the companies is high.
- Equity shareholders bear a very high degree of risk. In case of losses they do not get dividend, and in case of winding up of a company, they are the last to get the refund of their money invested. Equity shares actually swim and sink with the fate of the company.

#### From Management's point of view

- It requires more formalities and procedural delay to raise funds by issuing equity shares. Also the cost of raising capital through equity share is more as compared to debt.
- As the equity shareholders carry voting rights, groups are formed to influence the votes and grab the control of the company. This may lead to conflict of interests, which is harmful for the smooth functioning of a company.

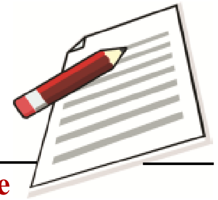
### Issuance of Equity Shares

#### Stock Markets

Equity Shares may be issued either on domestic stock markets, like NSE and BSE. However, to be able to issue equity on stock markets, the issuing company is required to be a certain size and at a certain stage of growth. Moreover, issuance on stock markets is a fairly complex process which is time-consuming and expensive.

#### Private Placements

Sometimes, to avoid the complexities and restrictions of equity issuance on stock markets, companies may decide to issue fresh equity through private means. This process is called Private Placement of Equity. Private Placements may be done to different entities like Angel Investors, Venture Capitalists or Private Equity Investors. These entities typically invest for long-term in growth-stage companies, which would otherwise find it difficult to raise capital through stock markets and bank financing. These investors bring equity capital to high-risk companies that may have a high possibility of failure.




Thus when shares are issued to privately known individuals or institutions, it is known as private placement of shares.

**(b) Preference Shares:** Preference Shares are those shares which carry preferential rights in respect of dividend and return of capital. Before any dividend is paid to the equity shares, the dividend at a fixed rate must be paid on the preference shares. However, this dividend is payable only if there are profits. Again at the time of winding up, the holder of the preference shares will get the return of their capital before anything is paid to the equity shareholders. The holders of the preference shares do not have any voting right. So, they cannot take part in the management of the company. It is not compulsory on the part of the company to issue preference shares.

**Types of Preference Shares**

A company has the option to issue different types of preference shares. Let us look at different types of preference shares a company can issue.

(i) **Convertible and Non-convertible Preference Shares:** The preference shares which can be converted into equity shares after a specified period of time are known as convertible preference shares. Otherwise, they are known as non-convertible preference shares.

(ii) **Cumulative and Non-cumulative Preference Shares:** In cumulative preference shares, the unpaid dividends are accumulated and carried forward for payment in future years. On the other hand, in non-cumulative preference shares, the dividend is not accumulated if it is not paid out of the current year's profit.

(iii) **Participating and Non-participating Preference Shares:** Participating preference shares have a right to share the profit after making payment of dividend at a pre-decided rate to the equity shares. The non-participating preference shares do not enjoy such a right.

(iv) **Redeemable and Irredeemable Preference Shares:** Preference shares having a fixed date of maturity are called redeemable preference shares. Here, the company undertakes to return the amount to the preference shareholders immediately after the expiry of a fixed period. On the other hand, where the amount of the preference shares is refunded only at the time of liquidation, those are known an irredeemable preference shares.

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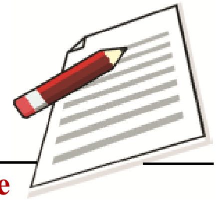
**Difference between Equity Shares and Preference Shares**

We have already learnt the meaning and features of equity and preference shares. Now let us find out the differences between these two.

| BASIS FOR COMPARISON | EQUITY SHARES | PREFERENCE SHARES |
|---|---|---|
| **Meaning** | Equity shares are the ordinary shares of the company representing the part ownership of the shareholder in the company. | Preference shares are the shares that carry preferential rights on the matters of payment of dividend and repayment of capital. |
| **Payment of dividend** | The dividend is paid after the payment of all liabilities. | Priority in payment of dividend over equity shareholders. |
| **Repayment of capital** | In the event of winding up of the company, equity shares are repaid at the end. | In the event of winding up of the company, preference shares are repaid before equity shares. |
| **Rate of dividend** | Fluctuating | Fixed |
| **Redemption** | No | Yes |
| **Voting rights** | Equity shares carry voting rights. | Normally, preference shares do not carry voting rights. However, in special circumstances, they get voting rights. |
| **Convertibility** | Equity shares can never be converted. | Preference shares can be converted into equity shares. |
| **Arrears of Dividend** | Equity shareholders have no rights to get arrears of the dividend for the previous years. | Preference shareholders generally get the arrears of dividend along with the present year's dividend, if not paid in the previousyear(s), except in the case of non-cumulative preference shares. |




## II. Debt Issuance

### (a) Debentures

The companies can raise long-term funds by issuing debentures that carry assured rate of return for investors in the form of a fixed rate of interest. It is known as debt capital or borrowed capital of the company. The debenture is a written acknowledgement of money borrowed. It specifies the terms and conditions, such as rate of interest, time of repayment, security offered, etc. These are offered to the public to subscribe in the same manner as is done in the case of shares.

The debentureholders are the creditors of the company and are entitled to get interest irrespective of profit earned by the company. They do not have any voting right. So they do not interfere in the day-to-day management of the business. Ordinarily, debentures are fully secured. In case the company fails to pay interest on debentures or repay the principal amount, the debentureholders can recover it from sale of its assets.

### Merits of Debentures

(a) Debentures are secured loans. On winding up of the company, they are repayable before making any payment to the equity and preference shareholders.

(b) The debentureholders get assured return irrespective of profit.

(c) Issue of debentures enables the company to provide high return to equity shareholders when the earnings of the company are good. This is called Trading on Equity.

(d) Debentureholders have no right either to vote or take part in the management of the company. So, by issuing debentures, the company raises additional capital without diluting control over its management.

(e) Interest paid on debentures is treated as an expense and is charged to the profits of the company. The company thus, saves income tax.

### Demerits of Debentures

(a) If the earnings of the company are uncertain and unpredictable, issue of debentures may pose serious problems due to fixed obligation to pay interest and repay the principal. So, when the company expects good and stable income, then only it should issue debentures.

(b) The company, which issues debentures, creates a charge on its assets in favour of debentureholders. So a company not having enough fixed assets cannot borrow money by issuing debentures.

(c) The assets of the company once mortgaged cannot be used for further borrowing. So, issue of debentures reduces the borrowing capacity of the company.

**Types of Debentures**

Debentures may be classified as:

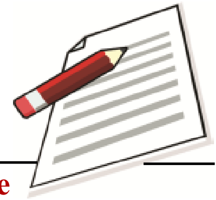
**(i) Redeemable and Irredeemable Debentures:** The debentures which are repayable on a specified date, are called redeemable debentures. On the other hand, there is no fixed time by which the company is bound to pay back the money in case of irredeemable debentures. These debenture holders cannot demand to get back their money as long as the company does not make any default in payment of interest. So these debentures are also called perpetual debentures.

**(ii) Convertible and Non-convertible Debentures:** The holders of convertible debentures are given the option to convert their debentures into equity shares. But incase of non-convertible debentures the company does not give any such option.

**(iii) Secured and Unsecured Debentures:** Secured debentures are issued with a charge on the assets of the company as security. This charge may be fixed i.e., on specified asset, or it may be floating. Secured debentures are also known as mortgaged debentures. On the other hand, unsecured debentures are issued with merely a promise of payment without having any charge on any assets as security. So these debentures are also known as naked or simple debentures. Now-a- days debentures are invariably issued as secured debentures.

**(iv) Registered and Bearer Debentures:** For registered debentures the issuing company maintains a record of the debenture holders. Any sale or transfer of such debentures must be registered with the company. On the other hand, bearer debentures are just like negotiable instruments and transferable by mere delivery. The company keeps no record of such debenture-holders. Interest coupons are attached to them and anybody can produce the coupon to get the interest.

After having some idea about shares and debentures let us find out the difference between them.



Note

Difference between Shares and Debenture

| BASIS | SHARES | DEBENTURES |
|---|---|---|
| **1. Status** | Shareholders are the owners of the company. They provide ownership capital which is not refundable unless the company is liquidated. | Debentureholders are the creditors of the company. They provide loans generally for a fixed period, which are to be paid back. |
| **2. Nature of return on investment** | Shareholders get dividends. Its amount is not fixed as it depends on the profit of the company. | Interest is paid on debentures at a fixed rate. Interest is payable even if the company is running at a loss. |
| **3. Rights** | Shareholders are the real owners of the company. They have the right to vote and determine the policies of the company. | Debentureholders do not have the right to attend meetings of the company. So they have no say in the management of the company. |
| **4. Security** | No security is required to issue shares. | Generally debentures are secured. So, sufficient fixed assets are required when debentures are to be issued. |
| **5. Order of repayment** | Share capital is paid back only after paying the debentureholders and creditors. | Debentureholders have the priority of repayment over shareholders. |
| **6. Risk** | Risk is high due to uncertainty of returns. | Little risk due to certainty of return. |

## INTEXT QUESTIONS 12.1

1. Complete the following chart that compares equity shares and preference shares:

| BASIS FOR DIFFERENCE | EQUITY SHARES | PREFERENCE SHARES |
|---|---|---|
| (1) Payment of dividend on shares | Dividend paid after paying dividend on preference shares | (a) ................................ ................................... |
| (2) Repayment of capital | (b) ........................... ........................... | Capital is refunded in preference over the equity shares. |
| (3) Voting rights | (c) ........................... ........................... | Do not carry voting rights |
| (4) Accumulation of Dividend | Dividend is not accumulated and therefore cannot be carried forward | (d) ................................ ................................... |

2. Some of the features of the different methods of raising long-term capital are given below. Identify the features that relate to equity shares, preference shares and debentures and write it in brackets.

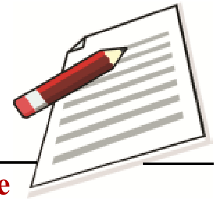
   (i) In case of winding up of the company, the capital is refunded after payment of debentures but before payment to equity shareholders. ( )

   (ii) Their holders are creditors of the company for a fixed period. ( )

   (iii) Their holders are the owners of the company and enjoy voting rights.( )

   (iv) They bear high degree of risk-in case of losses they do not get dividend and in case of winding up of the company, they are the last to get a refund of their invested money. ( )

   (v) Their holders have no say in the management of the company and they do not have the right to attend the company's meetings. ( )



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3. Mention the difference between shares and Debentures, on the basis of the criteria listed below:

| BASIS | SHARES | DEBENTURES |
|---|---|---|
| 1. Status | | |
| 2. Rights | | |
| 3. Security | | |
| 4. Risk | | |

### III. Loan from Domestic Special Financial Institutions (SFIs)

After independence a large number of financial institutions have been established in India with the primary objective to provide medium and long-term financial assistance to industrial enterprises. Institutions like Industrial Finance Corporation of India (IFCIs), Industrial Reconstruction Bank of India, State Financial Corporation (SFCs), State Industrial Development Corporation (SIDCs) have been established to provide financial support to set up new enterprises as well expansion and modernisation of the existing enterprises.

These financial institutions grant loans for a maximum period of 25 years. These loans are covered by mortgage of company's property and/or hypothecation of stocks/ shares etc. The major benefit derived from such loans are:

(i) The rate of interest payable is lower than the market rate and

(ii) The amount of loan is large.

However, it involves a number of legal and technical formalities and also the negotiation period is usually long. The financial institutions often nominate one or two directors to have some degree of control over the utilisation of funds and the functioning of the company.

### IV. Borrowing From Commercial Banks

Commercial banks in India may grant loans for a period of 3 to 5 years. These loans may be accessed by the companies for a variety of uses including capital expenditure. These may be issued against or without a collateral - depending on the company's credit standing.

**Merits**

The merits of long-term borrowing from banks are as follows:

1. It is a flexible source of finance as loan amount can be increased as per the business need and can be returned in advance when funds are not needed.
2. Banks keep the financial operations of their clients' secret.
3. Time and cost involved are lower as compared to issue of shares, debentures, etc.
4. Banks do not interfere in the internal affairs of the borrowing concern.
5. Loans can be paid back in easy instalments.
6. In case of small-scale industries and for industries in villages and backward areas, the interest charged is very low.

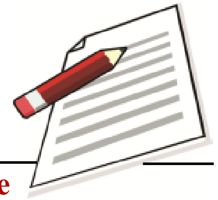
**Demerits:**

Following are the limitations of long-term borrowing from commercial banks:

1. Banks require personal guarantee or pledge of assets while granting loans. So the business cannot raise further loans on these assets. Thus, it reduces the borrowing capacity of the borrowers.
2. In case the short-term loans are extended again and again, there is always uncertainty about their continuity.
3. Too many formalities are to be fulfilled for getting term-loans from banks. These formalities make the borrowings from banks time consuming and inconvenient.

**V. Public Deposits**

It is a very old method of finance practised in India. When commercial banks were not there, people used to deposit their savings with business concerns of good repute. Even today it is a very popular and convenient method of raising short and medium term finance. Under this method companies can raise funds by inviting their shareholders, employees and the general public to deposit their savings with the company. To attract the public, the company usually offers a higher rate of interest than the interest on bank deposit. The period for which companies accept public deposits ranges between six months to sixty months.




**Merits**

Following are the merits of public deposits.

1. **Simple and Easy:** The method of borrowing money through public deposit is very simple. It does not require many legal formalities. It has to be advertised in the newspapers and a receipt is to be issued.

2. **No charge on Assets:** Public deposits are not secure. They do not have any charge on the fixed assets of the company.

3. **Economical :** Expenses incurred on borrowing through public deposits are much less than expenses on other methods like issue of shares and debentures.

4. **Flexibility :** Public deposits bring flexibility in the capital structure of the company. These can be raised when needed and refunded when not required.

**Demerits**

Following are the limitations of public deposits.

1. **Uncertainty:** A concern should be of high repute and have a high credit rating to attract public to deposit their savings. There may be sudden withdrawals of deposits, which may create financial problems. Depositors are regarded as fair weather friends.

2. **Insecurity:** Public deposits do not have any charge on the assets of the concern. It may not always be safe to deposit savings with companies particularly those, which are not very sound financially.

3. **Limits on the Amount Raised :** There are limits on the amount that can be raised through public deposit

**VI. Lease Financing**

Lease is a contract whereby one can use the assets of the other with due permission of the owner on payment of rent without purchasing them. The owner of the asset is called 'lessor' and the user is called 'lessee'. The period of use is called the lease period after which the lessee may opt for purchase of the asset.

So leasing is an arrangement that enables a business enterprise to use and exercise complete control over the assets without owning it. The owner gets rent in return and at any time as per the terms of the contract he can cancel the agreement. This system helps the business to use the plants and machinery and other fixed assets for a long period of time without investing a large amount of money in purchasing them. At the

Note

end of the lease period the asset goes back to the owner. The owner of the assets also has the option of selling it to the user at a reduced price. Sometimes the user company may request the leasing company to purchase its existing assets and allow them to use the same assets on lease basis. This enables the company to save the long-term funds that can be utilised for other purposes. This is known as 'sale and lease back' system.

**Merits:**

The important merits of lease financing are:

1. It enables the lessee to acquire the asset with a lower investment.
2. Simple documentation makes it easier to finance assets.
3. Lease rentals paid by the lessee are deductible for computing taxable profits
4. It provides finance without diluting the ownership or control of business.
5. The lease agreement does not affect the debt raising capacity of an enterprise.
6. The risk of obsolescence is borne by the lesser. This allows greater flexibility to the Lessee to replace the asset.

**Demerits:**

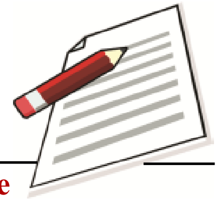
The limitations of leasing finance are given below

1. A lease agreement may impose certain restrictions on the use of assets.For example, it may not allow the lessee to make any alteration or modification in the asset.
2. The normal business operations may be affected in case the lease is not renewed.
3. It may result in higher payout obligation in case the equipment is not found useful and the lessee opts for premature termination of the lease agreement.
4. The lessee never becomes the owner of the asset. It deprives him of the residual value of the asset.

### 12.2.2 FOREIGN SOURCES

**(i) American Depository Receipts (ADRs)**

The depository receipts which are issued by a USA-based bank for trading only in American Stock markets are known as American Depository Receipts (ADR). The ADRs are issued only to the American citizens.




**(ii) Global Depository Receipts (GDRs)**

The issue of Global Depository Receipts (GDRs) and American Depository Receipts (ADRs) are different methods of raising funds from foreign sources. Under this method the shares of Indian companies are issued in the form of depository receipts (Global or American) that are traded on the foreign markets.

Under GDR, shares of the company are first converted into depository receipts by an international banks. These depository receipts are denominated in US dollars. Then these depository receipts are offered for sale globally through foreign stock exchanges. The holder of GDRs are entitled for dividend just like shareholders. But they do not enjoy the voting rights. Many Indian companies like ICICI, Wipro etc. have raised foreign capital through issue of GDRs.

**(iii) Loans from multinational Special Financial Institutions (SFIs)**

Sometimes, companies may also take loan from international financial institutions like The World Bank and the International Finance Corporation (IFC), either directly or by way of refinancing. This funding is especially common in financing of infrastructure products and businesses operating in priority sectors.

**(iv) External Commercial Borrowings (ECBs)**

Sometimes, to take advantage of lower interest rates applicable on borrowings on foreign currencies, companies may also seek to avail long-term foreign currency borrowings from foreign banks. These borrowings are called External Commercial Borrowings. While the pricing of these borrowings may turn out to be lower than that of local borrowings, the borrowers of ECBs may be exposed to adverse currency fluctuations.

**(v) Foreign Currency Convertible Bonds(FCCBs)**

These are equity linked debt securities that are to be converted into equity or depository receipts after a specific period.Thus, a holder of FCCB has the option of either converting them into equity shares at a predetermined price or exchange rate, or retaining the bonds. The FCCBs are issued in a foreign currency and carry a fixed interest rate which is lower than the rate of any other similar non-convertible debt instrument. FCCBs are listed and traded in foreign stock exchanges. They are very similar to convertible debentures issued in India.

**(vi) Non-Resident Indians Financing (NRIs financing)**

The sale of shares to the persons of Indian origin and nationality, living abroad

(Non- Resident Indians or NRIs) is another method of raising long-term funds of business. A non-resident Indian or a company controlled by non-resident Indians can invest within the prescribed limits of the paid up capital of an Indian company.

## 12.3 FACTORS AFFECTING CHOICE OF SOURCE OF FUNDS

Financial needs of a business are of different types-long-term, short-term, fixed and fluctuating. Therefore business firms resort to different types of sources for raising funds.

Each source of funds has its own merits and limitations, it is advisable to use a combination of sources, instead of relying only on a single source of fund. The factors that affect the choice of the source of finance are discussed below:

1. **Cost:** There aretwo types of cost viz.,the cost of procurement of funds and cost of utilising of funds.Both these costs should be taken into account while deciding about the source of funds that will be used by an organisation.

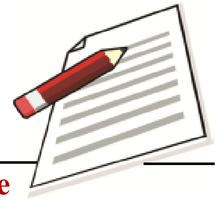
2. **Financial Strength and Stability of Operations :** The financial strength of a business is a key determinant in the choice of sources of funds. Business should be in a sound financial position to repay the principal amount and interest on the borrowed amount.

3. **Form of Organisation and Legal Status:** The form of business organisation and status influences the choice of source for raising money. A partnership firm for example cannot raise money by issue of equity shares as these can be issued only by a joint stock company.

4. **Purpose and Time Period:** Business should plan according to the time period for which the funds are required.Similarly the purpose for which funds are required need to be considered so that the source is matched with the use.

   For example, a long-term business expansion plan should not be financed by a bank overdraft which will be required to be repaid in the short term.

5. **Risk Profile:** Business should evaluate each of the source of finance in terms of risk involved. For example there is least risk in equity as share capital is to be repaid back only at the time of winding up and need not be paid if no profits are available. A loan on the other hand has a repayment schedule for both the principal and the interest.




6. **Control:** A particular source of funds may affect the control and power of the owners on the management of a firm.For example, issue of equity shares may mean dilution of the control, as equity shareholders enjoy voting rights. Financial institutions may take control of the assets or impose conditions as part of the loan agreement. Thus business firm should choose a source keeping in mind the extent to which they are willing to share their control over business.

7. **Effect on Credit-worthiness:** The dependence of business on certain sources may affect its credit-worthiness in the market. For example, issue of secured debentures may affect the interest of unsecured creditors of the company and may adversely affect their willingness to extend further loans as credit to the company.

8. **Flexibility and ease of obtaining funds:** Restrictive provisions, detailed investigation and documentation in case of borrowings from banks and financial institutions for example may be the reason that a business organisation may not prefer it, if other options are readily available.

9. **Tax benefits:** Various sources may also be weighed in terms of their tax benefits. For example, while the dividend on preference shares is not tax deductible and may not be preferred by organisations seeking tax advantage. For seeking tax benefit,fixed charged securities (debt) are preferred.

## INTEXT QUESTIONS 12.2

I. Give the full form of the following abbreviations:

(a) IFCI

(b) SFC

(c) ADR

(d) GDR

(e) FDI

II. Which method of long-term financing, Public Deposit or Retention of Profits, are being referred to, in each of the following statements:

(a) Management is less careful about funds utilization by this method. ( )

(b) To raise funds through this method, an advertisement is generally given through the newspapers. ( )

(c) They offer flexibility and the funds can be refunded when not required. ( )

(d) They offer benefit to shareholders as company may draw upon them to pay dividend to them. ( )

(e) No obligation on the company to pay interest on it or repay the money. ( )

III. (a) How are funds raised through lease financing? Explain briefly, in your own words.

(b) List any two limitations of long-term borrowings from Commercial Banks.

## TERMINAL EXERCISE

**Very Short Answer Questions**

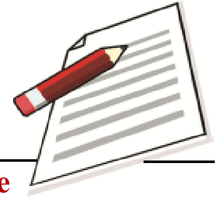
1. What is meant by lease financing?
2. State the meaning of 'Preference shares'.

**Short Answer Questions**

1. Distinguish between GDR and ADR.
2. 'Finance is considered as the life-line of the business, especially in the modern day'. Give reasons for the same.
3. Give two merits and two limitations of equity shares, from the point of view of the management.
4. Explain the four types of preference shares that a company can issue.

**Long Answer Questions**

1. What are 'Debentures'? Describe three merits and three limitations of debentures as a source of long-term finance for a company.
2. Differentiate between 'Shares' and 'Debentures' as sources of long-term finance.
3. What is meant by Special Financial Institutions (SFIs)? Explain two merits and two demerits of taking loans from SFIs as a source of long-term funds.
4. Write explanatory notes on: (a) Retention of Profits; and (b) Public Deposits, as methods of Long-term finance.



## ANSWERS TO INTEXT QUESTIONS

12.1

I. (a) Dividend is paid on these shares in preference to the equity shares.

(b) Share capital refunded only after the refund of preference share capital.

(c) Shareholders enjoy voting rights.

(d) Unpaid dividends are accumulated and are carried forward to the future years, in case of cumulative preference shares.

II. (i) Preference shares

(ii) Debentures

(iii) Equity shares

(iv) Equity Shares

(v) Debentures

III.

| BASIS | SHARES | DEBENTURES |
|---|---|---|
| 1. Status | Owners of the company | Creditors of the company. |
| 2. Rights | Right to vote and determine policies of the company. | No right to attend company's meetings. No say in company's management. |
| 3. Security | Not required | Generally secured. So sufficient fixed assets required to issue debentures. |
| 4. Risk | High | Little risk |

12.2

I. (a) Industrial Finance Corporation of India

(b) State Financial Corporation

(c) American Depository Receipt

(d) Global Depository Receipt

(e) Foreign Direct Investment

II. (a) Retained Earnings

(b) Public Deposit

(c) Public Deposit

(d) Retained Earnings

(e) Retained Earnings

(f) Retained Earnings

## WHAT HAVE YOU LEARNT