SOS POLITICAL SCIENCE AND PUBLIC ADMINISTRATION

MBA FA 202

SUBJECT NAME: FUNDAMENTALS OF FINANCIAL MANAGEMENT

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TOPIC NAME: SOURCES OF LONG TERM FINANCE SHARES & DEBENTURES

SORCES OF LONG TERM FINANCE
SHARES AND DEBENTURES

Introduction

As we are aware, finance is the life blood of business and is of vital significance for modern business which requires huge capital. Funds required for a business maybe classified as long term and short term. Long term finance is required for purchasing fixed assets like land and building, machinery etc. The amount of long term capital depends upon the scale of business and nature of business.

Long Term Finance – Its meaning and purpose

- A business requires funds to purchase fixed assets like land and building, plant and machinery, furniture etc. These assets may be regarded as the foundation of business. The capital required for these assets is called: fixed capital
- A part of the working capital is also of a permanent nature. Funds required for this part of the working capital and for fixed capital is called long term finance.

Purpose of long term finance:

1. **Finance fixed assets**:

- Business requires fixed assets like machines, Building, furniture etc. Finance required to buy these assets is for a long period, because such assets can be used for a long period and are not for resale.

2. **To finance the permanent part of working capital:**

- Business is a continuing activity. It must have a certain amount of working capital which would be needed again and again. This part of working capital is of a fixed or permanent nature. This requirement is also met from long term funds.

3. **To finance growth and expansion of business:**

- Expansion of business requires investment of a huge amount of capital permanently or for a long period.

Factors determining long-term financial requirements

- The amount required to meet the long term capital needs of a company depend upon many factors. These are :

(a) Nature of Business:

The nature and character of a business determines the amount of fixed capital. A manufacturing company requires land, building, machines etc. So it has to invest a large amount of capital for a long period. But abrading concern dealing in, say, washing machines will require a smaller amount of long term fund because it does not have to buy building or machines.

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(b**) Nature of goods produced**:

- If a business is engaged in manufacturing small and simple articles it will require a smaller amount of fixed capital as compared tone manufacturing heavy machines or heavy consumer items like cars, refrigerators etc. which will require more fixed capital.

(c) **Technology used**:

- In heavy industries like steel the fixed capital investment is larger than in the case of a business producing plastic jars using simple technology or producing goods using labour intensive technique.

Sources of long term finance

The main sources of long term finance are as follows:

1. **Shares**: These are issued to the general public. These may be of two types: (i)Equity & (ii)Preference. The holders of shares are the owners of the business.

2. **Debentures**: These are also issued to the general public. The holders of debentures are the creditors of the company.

3. **Public Deposits** :General public also like to deposit their savings with popular and well established company which can pay interest periodically and pay-back the deposit when due.

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4. Retained earnings:

The company may not distribute the whole of its profits among its shareholders. It may retain a part of the profits and utilize it as capital

5**. Term loans from banks:**

Many industrial development banks, cooperative banks and commercial banks grant medium term loans for a period of three to five years.

6. **Loan from financial institutions:**

There are many specialized financial institutions established by the Central and State governments which give long term loans at reasonable rate of interest. Some of these institutions are: Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI),Industrial Credit and Investment Corporation of India (ICICI), Unit Trust of India(UTI), State Finance Corporations etc.

Shares

Issue of shares is the main source of long term finance. Shares are issued by joint stock companies to the public. A company divides its capital into units of a definite face value, say of Rs. 10 each or Rs. 100 each. Each unit is called a share. A person holding shares is called a shareholder.

Investors are of different habits and temperaments. Some want to take lesser risk and are interested in a regular income. There are others who may take greater risking anticipation of huge profits in future. In order to tap the savings of different types of people, a company may issue different types of shares. These are:

1.Preference shares, and 2. Equity Shares.

Preference Shares

- Preference Shares are the shares which carry preferential rights over the equity shares. These rights are(a) receiving dividends at a fixed rate,(b) getting back the capital in case the company is wound-up.
- Investment in these shares are safe, and a preference shareholder also gets dividend regularly.

Equity Shares

- Equity shares are shares which do not enjoy any preferential right in the matter of payment of dividend or repayment of capital. The equity shareholder gets dividend only after the payment of dividends to the preference shares. There is no fixed rate of dividend for equity shareholders. The rate of dividend depends upon the surplus profits. In case of winding up of a company, the equity share capital is refunded only after refunding the preference share capital. Equity shareholders have the right to take part in the management of the company. However, equity shares also carry more risk.

MERITS :To the shareholders

1. In case there are good profits, the company pays dividend to the equity shareholders at a higher rate.
2. The value of equity shares goes up in the stock market with the increase in profits of the concern.
3. Equity shares can be easily sold in the stock market
4. Equity shareholders have greater say in the management of a company as they are conferred voting rights by the Articles of Association.

To the Management

1. A company can raise fixed capital by issuing equity shares without creating any charge on its fixed assets.
2. The capital raised by issuing equity shares is not required to be paid back during the life time of the company. It will be paid back only if the company is wound up.
3. There is no liability on the company regarding payment of dividend on equity shares. The company may declare dividend only if there are enough profits.
4. If a company raises more capital by issuing equity shares, it leads to greater confidence among the investors and creditors.

Characteristics of shares

- The main characteristics of shares are following:

1. It is a unit of capital of the company.
2. Each share is of a definite face value.
3. A share certificate is issued to a shareholder indicating the number of shares and the amount.
4. Each share has a distinct number.
5. The face value of a share indicates the interest of a person in the company and the extent of his liability.
6. Shares are transferable units.

Debentures

Whenever a company wants to borrow a large amount of fund for a long but fixed period, it can borrow from the general public by issuing loan certificates called Debentures. The total amount to be borrowed is divided into units of fixed amount say of Rs.100 each. These units are called Debentures. These are offered to the public to subscribe in the same manner as isdone in the case of shares. A debenture is issued under the common seal of the company. It is a written acknowledgement of money borrowed. It specifies the terms and conditions, such as rate of interest, time repayment, security offered, etc.

Characteristics of Debenture

- Following are the characteristics of Debentures
  1)Debenture holders are the creditors of the company. They are entitled to periodic payment of interest at a fixed rate.

2) Debentures are repayable after a fixed period of time, say five years or seven years as per agreed terms.

3) Debenture holders do not carry voting rights.

4) Ordinarily, debentures are secured. In case the company fails to pay interest on debentures or repay the principal amount, the debenture holders can recover it from the sale of the assets of the company.

Types of Debentures

- **Debentures may be classified as:**

a) Redeemable Debentures and Irredeemable Debentures

b) Convertible Debentures and Non-convertible Debentures.

- **Redeemable Debentures** :

  These are debentures repayable on a pre-determined date or at any time prior to their maturity, provided the company so desires and gives a notice to that effect.

- **Irredeemable Debentures** :

  These are also called perpetual debentures. Accompany is not bound to repay the amount during its life time. If the issuing company fails to pay the interest, it has to redeem such debentures.

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- **Convertible Debentures :**

  The holders of these debentures are given the option to convert their debentures into equity shares at a time and in a ratio as decided by the company.

- **Non-convertible Debentures**:

  These debentures cannot be converted into shares.

Retained Earnings

- Like an individual, companies also set aside a part of their profits to meet future requirements of capital. Companies keep these savings in various accounts such as General Reserve, Debenture Redemption Reserve and Dividend Equalization Reserve etc. These reserves can be used to meet long term financial requirements. The portion of the profits which is not distributed among the shareholders but is retained and is used in business is called retained earnings or ploughing back of profits. As per Indian Companies Act., companies are required to transfer a part of their profits in reserves. The amount so kept in reserve may be used to buy fixed assets. This is called internal financing.

Merits :

Following are the benefits of retained earnings:

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 modernization of business.

2. 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 its goodwill.

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3. Benefits to the shareholders:

Shareholders may get dividend out of reserves even if the company does not earn enough profit. Due to reserves, there is capital appreciation, i.e. the value of shares go up in the share market .

Limitation

Following are the limitations of Retained Earnings:

1. Huge Profit :

This method of financing is possible only when there are huge profits and that too for many years.

2. Dissatisfaction among shareholders :

- When funds accumulate in reserves, bonus shares are issued to the shareholders to capitalize such funds. Hence the company has to pay more dividends. By retained earnings the real capital does not increase while the liability increases. In case bonus shares are not issued, it may create a situation of under–capitalisation because the rate of dividend will be much higher as compared to other companies.

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3. Fear of monopoly :

Through ploughing back of profits, companies increase their financial strength. Companies may throw out their competitors from the market and monopolize their position.

4**. Mis-management of funds :**

Capital accumulated through retained earnings encourages management to spend carelessly.

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