III. Long Answer Type Questions

Question 1. Explain different types of preference shares which can be issued by a company.
Answer: Different types of preference shares are discussed below:

1. Cumulative and Non-cumulative: The preference shares which enjoy the right
to accumulate unpaid dividends in future years if it is not paid during a year are termed as cumulative preference shares. On the contrary, a non-cumulative preference share is one in which dividend is not accumulated if it is not paid in the particular year. .
2. Participating and Non-participating Preference Shares: Those preference shares which have a right to participate in further surplus of a company's shares which after dividend at certain rate has been paid on equity shares are called participating preference shares. Those preference shares which do not have a right to participate in further surplus of a company's shares which after dividend at certain rate has been paid on equity shares are called non-participating preference shares.
3. Convertible and Non-convertible Preference Shares: Those preference shares which can be converted into equity shares within a specified period of time are called convertible preference shares. On the contrary, preference shares which cannot be converted into equity shares within a specified period of time are called non-convertible preference shares.

Question 2. Describe in brief the features of equity shares.
Answer: Equity shares are the most important sources of raising long term capital by a company. They represent the ownership of a company and therefore, the capital raised by issue of these shares is called owner's funds. Features of equity shares:

- Voting Rights: They have voting rights and hence they are the owners of the business.
- Participation in Management: Using their voting rights, equity shares holders get a right to participate in company's management.
- Return: These shareholders do not get a fixed dividend. They get according to the earnings of the company. They receive what is left after all other claims on the company's income and assets have been settled.
- Risk: They enjoy the reward and also bear the risk of ownership. Therefore, it is also called risk capital.
- Permanent Capital: Equity capital serves as permanent capital as it is to be repaid only at the time of liquidation of a company.
- No charge on assets of the company:Funds can be raised though equity issue without creating any charge on the assets of a company. The assets of a company are therefore, free to be mortgaged for the purpose of borrowings, if the need be.
- More Costly: The cost of equity shares is generally more as compared to the cost of raising funds through other sources.

Question 3. Differentiate between a share and a debenture.

Answer: Following are the main differences between a debenture and a share:

1. Debenture holder is a creditor of the company and cannot take part in the management of the company while a shareholder is the owner of the company. It is the basic distinction between a debenture and a share.
2. Debenture holders will get interest on debentures and will be paid in all circumstances, whether there is profit or loss will not affect the payment of interest on debentures. Shareholder will get a portion of the profits called dividend which is dependent on the profits of the company. It can be declared by the directors of the company out of profits only.
3. Shares cannot be converted into debentures whereas debentures can be converted into shares.
4. Debentures will get priority in getting the money back as compared to shareholder in case of liquidation of a company.
5. There are no restrictions on the issue of debentures at a discount, whereas shares at discount can be issued only after observing certain legal formalities.
6. Convertible debentures which can be converted into shares at the option of debenture holder can be issued whereas shares convertible into debentures cannot be issued.
7. There can be mortgage debentures i.e. assets of the company can be mortgaged in favor of debenture holders. But there can be no mortgage shares. Assets of the company cannot be mortgaged in favor of shareholders.

Question 4. What are retained profits? Discuss their advantages and disadvantages.
Answer: Retained Profits: For any company, the amount of earnings retained within the business has a direct impact on the amount of dividends. Profit re-invested as retained earnings is profit that could have been paid as a dividend. The management of many companies believes that retained earnings are funds which do not cost anything, although this is not true. However, it is true that the use of retained earnings as a source of funds does not lead to a payment of cash. The dividend policy of the company is in practice determined by the directors. From their standpoint, retained earnings are an attractive source of finance because investment projects can be undertaken without involving either the shareholders or any outsiders. The use of retained earnings as opposed to new shares or debentures avoids issue costs. The use of retained earnings avoids the possibility of a change in control resulting from an issue of new shares. Another factor that may be of importance is the financial and taxation position of the company's shareholders. For example, because of taxation considerations, they would rather make a capital profit (which will only be taxed when shares are sold) than receive current income, and then finance through retained earnings would be preferred to other methods.
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Disadvantages of Retained Earnings

- A company must restrict its self-financing through retained profits because shareholders should be paid a reasonable dividend, in line with realistic expectations, even if the directors would rather keep the funds for re-investing.
- At the same time, a company that is looking for extra funds will not be expected by investors (such as banks) to pay generous dividends, nor over-generous salaries to owner-directors.
- Scope of retained earnings is limited by amount of profits. A loss incurring firm has no source called retained earnings.

Question 5. Write a note on international sources of finance.
Answer:

- Commercial banks: Commercial banks all over the world extend foreign currency loans for business purposes. For e.g. Standard Chartered emerged as a major source of foreign currency loans to the Indian industry. The types of loans and services provided by banks vary from country to country.
- International agencies and Development banks: These bodies provide long and medium term loans and grants to promote the development of economically backward areas in the world. The more notable among them include International Finance Corporation(IFC), EXIM Bank and Asian Development Bank.
- International Capital Markets: Modern organizations including multinational companies depend upon sizeable borrowing in rupees as well as in foreign currency Prominent financial instruments used for this purpose are:
  1. Global Depository Receipts (GDR's)
  2. American Depository Receipts (ADR's)
  3. Foreign Currency Convertible Bonds (FCCB's)

Question 6. Explain in detail the types of debenture a company can issue.
Answer: Different types of debentures that a company can issue are described below:

1. Convertible and Non-convertible Debenture: Convertible debentures are those debentures that can be converted into equity shares after the expiry of a specified period. On the other hand, non-convertible debentures are those which cannot be converted into equity shares.
2. Registered and Bearer: Registered debentures are those which are duly recorded in the register of debentures holders maintained by the company. These can be transferred only through a regular instrument of transfer. In contrast the debentures which are transferable by more delivery are called bearer debentures.
3. Secured and Unsecured: Secured debentures are such which create a charge on the assets of the company, thereby mortgaging the assets of the company. Unsecured debentures on the other hand do not carry any charge or security on the assets of the company.
4. First and Second: Debentures that are rapid before other debentures are known as first debentures. The second

debentures are those which are paid after the first debentures have been paid back.

Question 7. Describe briefly the factors responsible for selecting a source of finance.
Answer: Following factors responsible for selecting a source of finance:

- Cost: There are two types of cost viz., the cost of procurement of funds and cost of utilizing the funds. Both these costs should be taken into account while deciding about the source of funds that will be used by an organisation.
- Form of organisation and legal status: The form of business organisation and status influences the choice of a source for raising money. A partnership firm cannot raise money by issue of equity shares as these can be issued only by a joint stock company.
- Risk Profile: Business should evaluate each of the sources in terms of risk. For example, equity shares are to be repaid only at the time of liquidation of the company. While debentures need to be repaid on maturity date along with interest every six months or annually. Moreover, dividends are to be paid only if there are profits while interest is to be paid in case of loss as well.
- Financial Strength and Operational Stability: When the earnings of an organization are not stable, fixed charged funds like preference shares and debentures should be carefully chosen as they add to the fixed financial commitments of an organization.
- Purpose and Time Period: Business should select a source of finance according to time period for which funds are required. If funds are needed for short term, then we can make use of trade credit, commercial papers, bank loan, public deposits, etc but if funds are needed for long run then debentures, preference shares etc. are better.
- Control: A particular source of fund may affect the control and power of the owners of management of a firm. For example, equity shares dilute the control as they have voting power while other sources do not have voting power but loans from financial institutions, loans from commercial banks and issue of debentures get mortgaged on assets of the company. It dilutes power in different ways.
- Effect on Credit Worthiness: While choosing a source of finance, am organization also needs to consider its effect on credit worthiness. For example, if the company issues secured debentures then it affects the credit worthiness of company for unsecured debentures of the company. Their willingness to extend further loans as credit to the company gets adversely affected.
- Tax Benefits: Various sources of finance may also be evaluated in terms of their tax benefits. For example, interest on debentures is tax deductible while divided on preference shares is not tax deductible. Therefore those organizations which are seeking tax advantage may prefer debentures to preference shares.
- Flexibility and Ease: Another factor which determines the choice of a source of finance is how easily it is available i.e. how less the paper formalities are and how flexible it is i.e. how easily its amount and terms can be modified.

Question 8. What is lease financing? Discuss its merits and demerits.
Answer: A lease is a contractual agreement, in which the owner of the asset grants the other party the right to use the asset in return for a periodic payment, but retains the title over the property. The owner of the asset is called lessor and the party who uses the assets is called lessee.

Lessee pays a fixed periodic amount to the lessor. It is called lease rent. When period of lease expires, the asset is returned to the lessor. It is used more frequently with items like computers and electronic items which become obsolete soon. Leasing company (lessor) owns the equipment and hires it out to the customers (lessee pays rental income to hire assets). It is a medium term fund. New companies need expensive equipments to run the business: office, equipment leasing from larger companies like Apple.
Merits of Lease financing

- It allows the lessee to acquire the asset with lesser investment.
- Simple documentations makes it easier to finance assets.
- Lease rentals get tax advantage as they are deductible for computing taxable profits.
- It reduces initial capital for (new) businesses.
- It provides added service: maintenance and upgrading.
- It makes funds available without diluting the ownership of business.
- The lease agreement does not bring any change in raising capacity of an organization.
- The risk of obsolesce is borne by the lessor.

Demerits of Lease Financing

- A lessee agreement imposes restrictions on usage of assets. For example, alternation and modification in assets may not be allowed.
- The normal business operations may be affected if lease is not renewed.
- It may result in higher payout obligations in case the equipment is not found useful and the lessee chooses for premature termination of the lease contact.
- It never makes lessee the owner of the asset.

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