UNIT 5 METHODS OF RAISING FINANCE

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5.0 'OBJECTIVES

After going through this unit, you will be able to:

- explain the need for finance
- classify types of financial needs
- distinguish between ownership capital and borrowed capital
- explain the concept of capital structure and identify the factors determining it
- describe different methods of raising finance
- evaluate the advantages and limitations of different methods of raising finance

5.1 INTRODUCTION

In Unit 4 you have learnt about various steps taken by promoters before setting up any business venture. One of the important steps is of arrangement of finance for the business. No one can start a business unless adequate capital is available. In this unit you will learn why finance is needed, what the sources of finance are and the methods of raising finance to meet capital requirements of the business.

5.2 NEED FOR AND IMPORTANCE OF FINANCE

We all know that every business activity requires money to run it. Take the case of manufacturers. They must have a place to produce goods. They must buy machinery and raw materials, engage workers and managers, pay for electricity and water supply, and incur expenses for delivery of goods to their customers. Similarly, take the case of traders. They must buy goods and have godown to keep them. They have to arrange for the delivery of the goods to their customers. They must employ people for loading and unloading of goods, for keeping accounts as well as for bill collection. Take another example of goods transportation business, The transporters must buy trucks, must engage drivers and helpers, incur expenses on diesel, repairs and servicing of the vehicle, and so on. All these can be undertaken only with the help of finance. Thus, money is required for all types of business activities be it manufacturing or trading or transportation or any other kind. It is true that income is earned by business when goods are sold and services have been rendered. But this takes place afterwards. Goods must be produced or purchased before they can be sold. Arrangement of finance is therefore necessary much before any income can be earned. It costs money to build a factory, to buy machinery and raw materials, to hire a place for the business office, to pay rent, wages and salaries, and to meet to day expenses. So no one can run a business without first raising adequate finance, of course this is done in anticipation of future income, on the assumption that customers will buy the goods and services offered to them.

To run a business, besides finance, we also require men, materials, machinery and management. But finance may be regarded as the most important requirements of business. Men, materials, machinery and managers can be brought together and engaged in business when you have adequate finance. Many business firms are known to have failed mainly due to shortage of finance. The importance of finance has increased in modern times for two reasons. Firstly, the business activities are now undertaken on a much larger scale than in the past. Even if a business is started initially on a small scale, it grows in course of time. There is increasing need for finance with enlargement of business. Secondly, the manufacturing process have become more complex than in the past. Factory production requires expensive machinery, equipment and tools, and many men. It requires large quantities of materials to be procured and kept in stock. The products must be widely advertised. Distribution of the products must be arranged through wholesalers, dealers and salesmen. Thus, with the growth in size and volume of business and with the increasing complexity of production and trade, there is a growing need for finance. In an existing business on the one hand, money must be spent before money is realised from sales. On the other hand, cash realisation on account of sales over a certain period may not be equal to the amount of expenditure incurred during the same period. Finance should, therefore, be available in adequate amount as and when needed. To anticipate what amount of finance will have to be arranged at what point of time is not an easy task. This is because business conditions may change from time to time.

5.3 TYPES OF FINANCIAL NEEDS

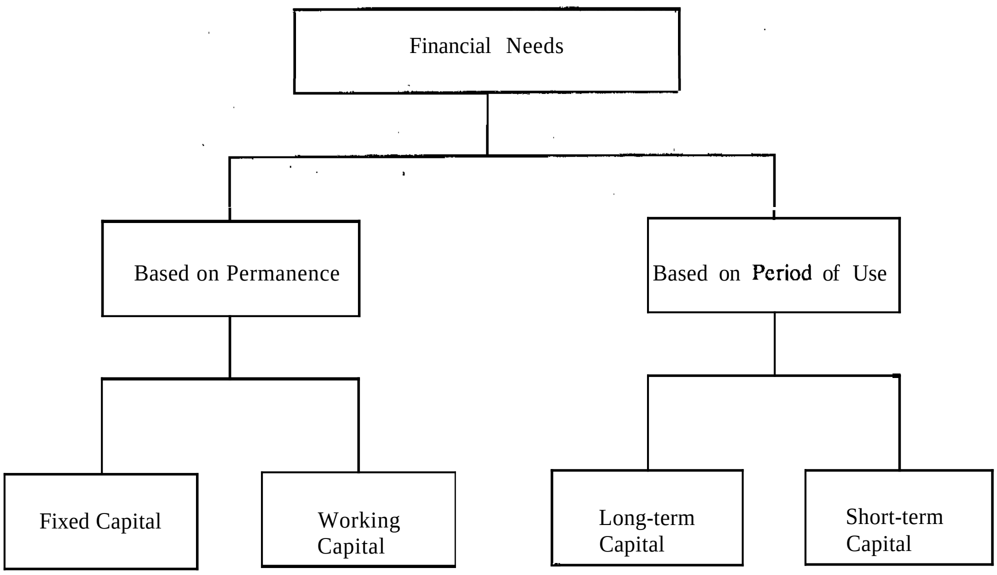
Broadly speaking, there are two ways of classifying the financial needs of the business. i) On the basis of the extent of permanence, we can classify the financial needs into: a) fixed capital, and b) working capital. ii) On the basis of the period of use, we can classify the financial needs into: a) long-term capital, and b) short-term capital. Look at Figure 5.1 for the classification of financial needs.

5.3.1 Fixed Capital and Working Capital

Fixed Capital: In every business concern money has to be invested in some fixed or durable assets like land, buildings, machinery, equipment, furniture, etc. These assets are required for permanent use, that is, for a long period of time. Funds required to purchase these assets is known as fixed capital or long-term capital. The nature and size of the business generally determines the amount of fixed capital needed. Manufacturing activities, particularly those engaged in heavy engineering, electrical, transport, shipping and ship building, electric supply, iron and steel manufacture, automobiles, etc. require large investments in plant and machinery, equipment, factory buildings, warehouses, etc. On the other hand, trading concerns need relatively lesser investment in fixed assets.

Investment in fixed assets involves a commitment for a longer period of time. These fixed assets continue to generate income and profits over an extended period of time. Moreover, funds which are once invested in fixed assets cannot be withdrawn and put to some other use.

Figure 5.1
Classification of Financial Needs



Working Capital: In business you require finance for purchase of raw material, payment of wages and salaries, rent, fuel, electricity and water, repairs and maintenance of machinery, advertising, etc. Requirements of finance for these purposes arise at short intervals. In course of business activities, it is also necessary to hold stocks of materials, spare parts, and finished goods. This involves investment in short-term assets or current assets in the form of stocks of raw materials, spare parts, stores, finished goods, etc. Besides, sale of goods on credit leads to the holding of debtors balances and bills receivable, which may also be regarded as current assets.

Money invested in current assets like stock of raw materials, finished goods, etc., and book debts (that is debtors balances as well as bills receivable) is known as Working Capital. It is sometimes known as Circulating Capital or Revolving Capital. That is because funds invested in current assets are continuously recovered through realisation of cash, and again reinvested in current assets. The amount keeps on circulating or revolving from cash to current assets and back again to cash. Although this takes place at short intervals, the amount is needed again and again. Hence part of the funds required for this purpose is of a permanent nature. It is known as the 'fixed or permanent' part of the working capital, The permanent part of working capital should accordingly be regarded as long term capital. The other part of working capital may vary due to the rise or fall in the volume of business. Hence it is known as the 'fluctuating' or 'variable' part of the working capital. Therefore, strictly speaking, only the fluctuating part of the working capital is regarded as short-term capital, the funds required are for less than a year. The amount of working capital required depends mainly on the nature of the business, the time required for completing the manufacturing process, and the terms on which materials are purchased and goods are sold. For instance, trading companies require more working capital than manufacturing companies. This is because the trading business requires large quantities of goods to be held in stock, and also carry large debtors' balances. Construction companies also require relatively larger amounts of working capital than manufacturing concerns. In both these types of business, the value of current assets is about 80% to 90% of the value of total assets. The investment in current assets is relatively smaller in the case of hotels and restaurants because they mostly have cash sales, and only small amounts of debtors balances.

Working capital requirements vary among manufacturing industries because of differences in the time involved in the production process i.e., time that passes between the purchase of raw materials and the production of finished goods. Longer the processing time, the more is the amount of working capital required. For example, heavy engineering industry needs relatively more working capital than a rice mill or a cotton spinning mill or a steel rolling mill.

Another factor that determines the amount of working capital relates to the terms of credit allowed to customers. For instance, a company may allow only 15 days' credit, while another may allow 90 days' credit. One may extend credit facilities liberally to all customers, while another in the same business may grant credit only to selected reliable customers. The amount of working capital required will 'naturally be more if the credit period is longer and credit facilities are extended to all customers. In both these cases, there will be larger debtors' balance which will demand more working capital. On the other hand, if supplies of materials are available on favourable terms of credit (i.e., payments can be made at longer intervals), working capital needs will be correspondingly smaller.

5.3.2 Long-term Capital and Short-term Capital

As stated earlier fixed assets should be financed with permanent long-term capital. This is mainly because fixed assets are meant for use over a fairly long period of time, generally for five years or more. Long term capital is also required to finance the permanent part of the working capital. On the other hand, to finance current assets and meeting day-to-day expenses, capital is needed generally for a short period i.e., less than a year. This is because stocks of materials and finished goods are normally used for as sold within a year, and dues from customers are usually realised within three to six months. The main difference between long-term capital and short-term capital is that the former is required for a longer pesiod, (five years or more) while the latter is required for a short period (less than a year). Besides these capital needs, business concerns often require funds for a period of 2 to 5 years known as **medium-term capital.** Medium-term capital is required for certain activities like renovation of building, modernisation of machinery, heavy expenditure on advertising, etc.

5.4 CAPITAL STRUCTURE

The funds raised to meet both the long-term and short-term capital requirements may take the form of ownership capital or borrowed capital. Let us first understand these two terms before we talk of capital structure.

5.4.1 Ownership Capital

The amount of capital invested in a business by its owners is known as Ownership **Capital.** It is on the basis of their investment that owners become entitled to the profits of the business. In a business under sole proprietorship, the individual owner normally invests capital from his own savings. In a partnership business, each partner contributes capital as mutually agreed among partners. Companies raise capital by issuing shares. Investors who contribute towards the share capital of a company become its owners by virtue of their share holding. They are entitled to receive dividend out of the profits earned by the company. The owners cannot claim to get any return on their investment unless there is profit. The rate of return on owners investment depends on the level of profits earned. If there is no profit, the owners go without any dividend. The risk of losses and of low rates of return are, thus, associated with ownership capital. Hence it is known as 'risk capital'.

Ownership capital may be used for financing fixed assets as well'as continuous investment in current assets. Ownership capital is generally used as permanent capital or long-term capital. As risk-bearers, owners do not have any assurance whether they will get adequate returns on their investment or not. But they receive high returns if the business is successful. Besides, owners have a right to participate in the management of the business. **A** sole proprietor as also the partners of a business play an active part in running the business. Shareholders of companies do not manage the business directly. They elect members of the Board of Directors who manage the affairs of the company on behalf of the shareholders.

5.4.2 Borrowed Capital

The financial requirements of the business are often met by raising loans. Loans carry a certain fixed rate of interest which must be paid at regular intervals, half-yearly or yearly. There is also a commitment that the principal'amount will be repaid in due course. Thus, if loan is raised for a period of 10, 15 or 20 years, its repayment may fall due at the end of that period or after stated intervals according to the tams on which the loan has been raised. Interest on loan is a fixed expense which has to be paid irrespective of the income. Thus, borrowing of money involves fixed obligation to pay interest and repay the principal amount as and when due.

Money may be borrowed for short-term and long-term purposes i.e., to finance fixed assets as well as current assets. In a sole proprietory business the proprietor can borrow money on his persona! security or on the security of his existing assets. A partnership firm can raise loans on the personal security of the individual partners whereby they become jointly and severally liable. Companies can also borrow either by issuing debentures or bonds, or raise direct loans.

If business income is stable and cash is realised from debtors regularly, raising of loan is not difficult. But if conditions are such that payment of interest is not possible as and when due, serious consequences may follow. There is loss of credit worthiness, that is, suppliers may not be prepared any more to supply materials on credit, further loans may not be forthcoming and lender's and creditors may even start legal action to recover their dues. Hence, borrowing money without the ability to meet the obligations of paying interest and repaying the principal is not desirable.

However, there are certain advantages of financing business activities with loans. If the business is profitable, interest being a fixed charge, the return on owners' investment is much higher. Suppose total investment in a business is Rs. 1 lakh out of which owners have contributed Rs. 40,000 and loans have been raised for the balance of Rs. 60,000 at 15% interest per annum. The profit earned during the year is Rs. 30,000. In this case, the total amount of interest payable is Rs. 9,000. So profits after interest payment will amount to Rs. 21,000. Let us assume that tax is payable on profits at the rate of 50%. So, tax to be paid amount to Rs. 10,500. Net profit after tax will thus be Rs. 10,500. What will be the return on owner's capital? It will be Rs. 10,500 on their investment of Rs. 40,000 that is, 26.25%. Would it be so high if the owners had invested Rs. 1 lakh and there was no borrowings? Obviously not. Let us examine. Since no interest would be payable, tax would amount to Rs. 15,900 (50% of Rs. 30,000). The net profit after tax would amount to Rs. 15,000 (total profit of Rs. 30,000 minus Rs. 15,000 tax). The return on owners' capital would then be Rs. 15,000 on an investment of Rs. 1 lakh which works out to only 15%. You must have realised that owners got a higher rate of return when a part of the total investment was borrowed. If you examine all this carefully, you can notice two effects. Firstly, the amount of tax payable was less (Rs. 10,500 instead of Rs. 15,000). Secondly, the payment on account of interest was fixed. Although loans helped in the expansion of business, nothing more was to be paid to lenders. The remaining profit was entirely for the owners. Use of borrowed capital to derive the benefit of higher rates of return on owners' investment is known as 'Trading on Equity'.

5.4.3 What is Capital Structure?

You have noticed that borrowing is desirable when profits are high. But it may be dangerous to depend on loans when profits decline. Then what should be the amount of borrowing for financing business activities? The general principle is to maintain borrowed capital and owners' capital in proper proportions. For a very successful business in favourable conditions, borrowed capital may be twice or even thrice as large as owners' investment. But for a business which is suffering from declining profits, the proportion of borrowed capital should be as low as possible.

Since borrowing of funds has distinct advantages, you may expect promoters to raise as large an amount as possible through loans. But beyond a certain limit borrowing may be risky. This is because fluctuation in earning and inadequacy of available cash could lead to a situation where it may not be possible for the business to pay interest and repay the amount of loan. In that case, the financial position of the business is sure to be looked upon by suppliers and creditors as unreliable. They may stop extending credit, and in an extreme situation, the business may go bankrupt or insolvent. This danger arises basically on account of the fixed payments to be made on borrowed,capital irrespective of the earnings and the shortage of available cash.

The proportion of fixed interest bearing capital in the total capital is known as capital gearing. The capital is, thus, said to be highly geared if borrowed capital is proportionately very high in relation to the ownership capital. Correspondingly, low gearing of capital signifies a smaller proportion of borrowed capital compared with the ownership capital. The composition of the total capital consisting partly of long-term funds with fixed charge and partly of ownership funds is known as the capital structure. Thus, capital structure refers to the relative proportion in which various sources of long-term finance are used to meet the total financial requirements, like debentures and long-term loans, preference share capital, and equity capital (including reserves and surplus).

5.4.4 Factors Determining The Capital Structure

To what extent long-term funds should be raised from different sources so. as to determine the capital structure depends on a variety of factors. Let us now discuss about such factors.

1 Nature of the business: If a company is engaged in business activities in which sales are subject to wide fluctuations, it is desirable to have a smaller proportion of borrowed funds. Companies manufacturing televisions, refrigerators, machine tools and capital goods are normally subject to fluctuations in sales from time to time. If these companies have high debt ratios, they run the risk of facing financial distress during lean business due to their inability to discharge the fixed obligations. On the other hand, companies dealing in essential consumer goods of daily use dr products having inelastic demand generally have stable earnings, and thus may depend to a greater extent on borrowed capital.

Competitiveness among companies is also another aspect of business which may affect the level of earnings. For instance in the ready-made garment industry, competition among the firms is based on styles which are subject to frequent changes and mostly unpredictable. Hence, these firms rely less on borrowed capital and more on equity finance.

2 Characteristics of the company: The size of a company as well as its credit standing also determines the extent to which equity or debt capital should be raised. Small firms have to depend more on owners' funds as it is difficult for them to raise long-term loans. This is because investors consider lending to small firms to be more risky. In contrast, large companies must make use of different sources of raising funds as no single source can meet their total financial requirements. Normally investors prefer to lend money to large companies as they believe that their money is safe and the risk is less with big business firms. Similarly, firms which enjoy high credit standing among investors and lenders are in a better position to raise long-term finance from different sources.

3 Management control: Promoters who had major share holding and control the management of the company take into account the probable effect of raising funds through the issue of equity shares. Equity shareholders having voting rights can influence the policy decisions of the company or the selection of directors. But the persons whd give loans do not have any right to elect directors or to participate in the management of the company. Hence the existing management group, in order to retain their control over management, prefer to raise additional finance through the issue of debentures and preference shares.

4 Cost **of finance:** Since interest paid on borrowings is chargeable to profits before tax calculation, the cost of debt financing is inevitably lower than the expected rate of earnings (i.e. profitability) on equity capital. Hence, it is always beneficial to raise part of the total financial requirement through long-term loans. With lower cost of debt financing, the overall (average) cost of financing is reduced, and the return on equity capital is higher. This is one of the important determinants of the capital structure.

5 **Effect** of debt financing on the earnings per equity **share:** We have already explained how the rate of return on equity share capital increases if borrowed

capital is used. The effect of debt on the rate of return on equity (or earning per share) is known as 'trading on equity' or 'leverage effect', Thus in business ventures with assured prospect of rising income, there is greater emphasis on debt capital in the capital structure.

6 Expected earning in relation to interest charges: Another factor determining debt-equity ratio is the estimated coverage of interest by profits. If the average earnings of the company are expected to be three to four times the amount of interest payable on borrowed capital, it may be considered safe to raise long-term loans rather than equity capital. Three to four times coverage of interest by earnings is regarded as a reasonable assurance that interest payment would be possible even if profits decline substantially.

7 Availability of cash (cash flow): The ability of a business to discharge its fixed obligations depends essentially on the availability of liquid cash. Profits earned may be adequate to cover the fixed charges arising out of debt, but the firm may not have sufficient cash to pay as the income gets continually invested in the form of more inventory, book debts or even purchase of equipment, particularly, if it is a growing concern. Hence, besides profitability, it is necessary to estimate the cash flows before deciding on the proportion of debt in the capital structure.

8 Flexibility of capital structure: The capital structure decision is usually made by management keeping in view their ability to adjust the sources of funds. The scope of changing the capital structure in future happens to be a basic consideration. For instance, in case additional funds are needed, a firm which is already financed with heavy debt may be forced to issue equity shares with a higher cost of finance involved. Or, again if funds raised are to be refunded on account of declining business, a firm may be unable to do so if it earlier relied heavily on equity capital. Indeed, to preserve operating flexibility, it is desirable that every firm should have unused debt raising capacity for future use. On the other hand, there should be a judicious mix of debt and equity capital so that refund of debt is possible when necessary.

The most suitable capital structure known as optimal capital structure is planned taking into account the effect of alternative sources of financing and the mix of debt and equity capital which will maximise the wealth of the firm.

Check Your Progress A

1 State which of the following statements are True or False.

i) There is increasing need for finance in business only because workers always demand higher wages.

ii) No one can run a business without finance.

iii) Fixed capital is required to finance the purchase of raw materials.

iv) Relatively more fixed capital is required by manufacturing companies than trading companies.

v) Long-term investment is required for financing fixed assets as well as current assets.

vi) High gearing of capital indicates more of debt financing.

vii) The permanent part of working capital may be regarded as long-term finance.

viii) Working capital is not required by traders who buy and sell goods on credit.

ix) In a profitable business, the return on owners' capital will be more if part of the total is borrowed,

2 Fill in the blanks with appropriate words,

i) Ownership capital is also known as .... capital.

ii) .... capital is sometimes called revolving or circulating capital.

iii) Funds required for 5 years or more is regarded as .... finance.

iv) Short-term finance is required for a period upto .... years.

v) Medium-term finance is required for a period of .... years.

vi) Trading companies need more working capital than .... capital.

vii) Investment in current assets generally means .... investment.

viii) Loans may be raised for long-term as well as .... purposes.

3 Match the items in Column A with those in Column B.

Column A	Column B
1) Fixed capital	i) Current assets
2) Long-term finance	ii) Short-term finance
3) Medium-term finance	iii) Risk capital
4) Capital structure	iv) Durable assets
5) Working capital	v) More than 5 years
6) Ownership capital	vi) Modernisation of machinery
7) Bills receivable	vii) Borrowed capital and equity capital

5.5 METHODS OF RAISING CAPITAL

You have learnt that there are different purposes for which funds have to be raised for periods ranging from very short to fairly long duration. The size and nature of business determine the total amount of financial needs. The scope of raising funds depends on the sources from which funds may be available. For a sole proprietor, there are limited opportunities for raising funds. He can finance his business by any of the following means:

1 Investment of own savings
2 Raising loans from friends and relatives
3 Arranging advances from commercial banks
4 Borrowing from finance companies

The same methods of financing are available to partnership firms also. In both these forms of business organisations, long-term capital is generally provided by the owners, i.e., sole proprietor or the partners.

Fixed capital can be raised by way of loans from friends and relatives on the personal security of owners. Generally short-term working capital needs are met partly by trade creditors (suppliers of materials and goods) and loans from finance companies. Another method of securing both long and short-term finance is the reinvestment of profits earned from time to time.

In the case of companies, there are a number of methods of raising finance. To raise long-term and medium-term capital, companies have the following options:

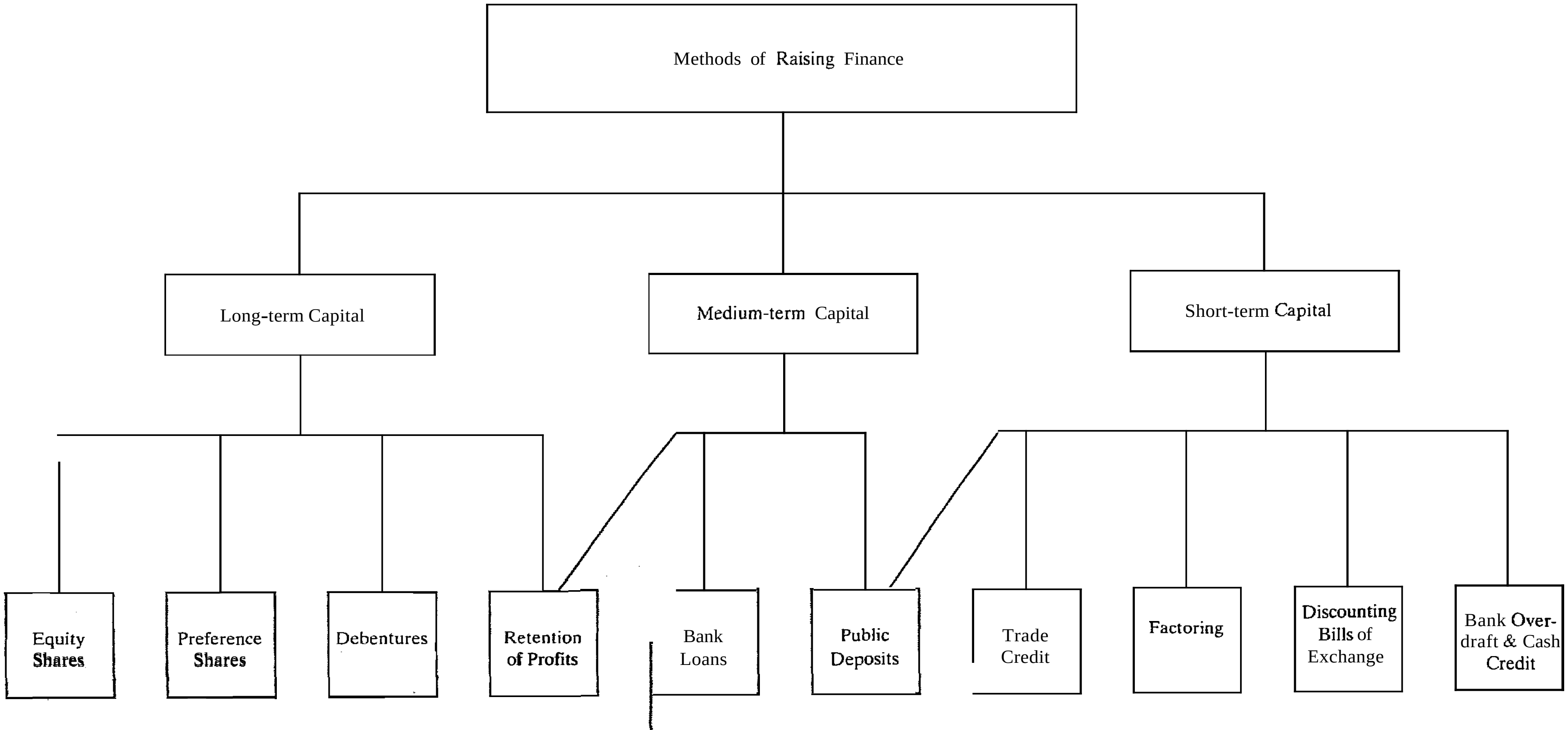
1 Issue of shares
2 Issue of debentures
3 Loans from financial institutions
4 Loans from commercial banks
5 Public deposits
6 Retention of profits

The following methods may be used to finance short-term capital:

I Trade credit
2 Factoring
3 Discounting bills of exchange
4 Bank overdraft and cash credit
5 Public deposits

Look at Figure 5.2 for various methods adopted by companies for raising finance.

Figure 5.2 Methods of Raising Finance by Companies



Note: 1. Public deposits could be used for both medium-term as well as short-term purposes.
2. Retention of profits could be used for both Long-term as well as short-term capital purposes.

5.5.1 Issue of Shares

Issue of shares is the most important method of raising long-term capital for companies. There are two types of shares: i) equity shares and ii) preference shares. In the case of shares, the liability of shareholders is limited to the face value of shares, and also they are easily transferable. For these reasons investors prefer to invest their money in shares. Moreover, shares issued are generally of small face value viz., Rs. 10 or Rs. 100. So investment in shares is within the means of ordinary people. As you know, a private company cannot invite the general public to subscribe for its share capital. Private companies can issue shares to a limited number of persons not exceeding fifty. Also shares of private companies are not freely transferable. But for public limited companies there are no such restrictions.

Equity shares: There are several advantages of issuing equity shares to raise ownership capital. The rate of dividend on these shares depends on profits available and the discretion of directors. There is, therefore, no fixed burden on the company. The shareholders expect high rates of dividend in profitable years. But they also bear the risk associated with uncertainty of earnings of the company. Thus, risk capital is available by issuing these shares. Further, the amount raised by issue of equity shares can be used permanently. It is not required to be paid back so long as the company exists. Moreover, equity shares do not require mortgaging of the company's assets. Additional funds can be raised as loan on the security of assets.

However, excessive issue of equity shares may create problems for the promoters who may like to control the management of the company. Each equity share carries one vote for the holder. So holders of equity shares may form groups and vote against the existing directors of the company. This may not be always in the best interest of the company as a whole. Secondly exclusive dependence on equity share capital may not permit the company to take advantage of trading on equity. Besides, once equity shares are issued the amount become a permanent capital which at times may be more than what the company can use profitably. In that case, there is no way of reducing it unless detailed legal formalities are complied with. Also reduction of share capital damages the image of the company.

Preference shares: Issue of preference shares is another method of raising long-term capital. It has certain merits. Dividend is payable on preference shares at a fixed rate and is payable only if there are profits. Hence, there is no compulsory burden on the company's finances. Secondly, preference shareholders do not have voting right. So they cannot take part in the management of the company and thus are not a threat' to the promotkrs. Another advantage of preference shares is that the company can declare higher rates of dividend for equity shareholders in good years because the rate of preference dividend is fixed. Besides, permanent use of preference share capital is also not essential. A company may issue redeemable preference shares and have the flexibility of paying off the amount if necessary and replace it by some other type of capital.

Some investors subscribe to preference shares because of preferential rights as to the payment of dividend'and the return of capital. But others do not prefer it due to the fixed return as well as some risk of non-payment of dividend. Also they do not derive any benefit by way of rise in market price of the shares as is the case with equity shares.

5.5.2 Issue of Debentures

Companies generally have powers to borrow and raise loans by issuing debentures as securities of specified face value. The rate of interest payable on debentures is fixed at the time of issue, and they are recovered by a charge on the property or assets of the company, which provide the necessary security for payment. Debentures are mostly issued to finance the long-term requirements of business. There are certain advantages of issuing debentures.

i) Because of the fixed interest on debentures, companies with stable income can secure higher returns on equity capital by trading on equity.

ii) The rate of interest is usually lower than the expected rate of return on share capital. This is because debenture holders do not bear any risk.

iii) Debentures do not carry any voting right. Hence management by promoters or existing directors remains unaffected.

However, if the earnings of the company are uncertain or unpredictable, issue of debentures may pose serious problems for the company due to the fixed obligation to pay interest and repay the principal. The company is liable to pay interest even if there is no profit. If there is default in payment of interest or repayment of the principal, assets can be attached by order of the court. Trading companies which generally do not have large fixed assets, cannot provide adequate security for issue of debentures. Even for manufacturing companies the capacity to raise loans is limited by the value of their properties and assets.

5.5.3 Loans from Financial Institutions

Long-term and medium-term loans can be secured by companies from financial institutions like the Industrial Finance Corporatioh of India, Industrial Credit and Investment Corporation, State-level Industrial Development Corporations, etc. You will learn in detail about financial institutions in Unit 6. These financial institutions grant loans for a maximum period of 25 years against approved schemes or projects. Loans agreed to be sanctioned must be covered by securities by way of mortgage of the company's property or hypothecation or assignment of stocks, shares, gold, etc.

Usually the financial institutions nominate one or two directors to have some degree of control over the functioning of the company. These nominee directors may not allow decisions to be made by the Board of Directors affecting the interest of the lending institution. The loan agreement may also provide for conversion of loans into equity capital after a stated period if the lending institution so desires.

The most important advantage of this method of raising finance is that the rate of interest payable is lower than the market rate. But there is a close security of the investment project before loan is sanctioned. Preference is given to companies which submit projects in accordance with the priorities of industrial development laid down in the five year plan. The potential profitability of the project and the potential ability of the company to discharge its interest and repayment obligations are strictly evaluated. Also the companies are required to comply with a number of legal and technical formalities. Hence a long time is taken in the process of negotiating a loan from the financial institutions.

5.5.4 Loans from Commercial Banks

Medium-term loans can be raised by companies from commercial banks against the security of properties and assets. Thus, funds required for modernisation and renovation of assets can be borrowed from banks. Generally 50% to 75% of the value of industrial assets are granted as loan after the bank is satisfied about the earning capacity of the company and its ability to generate sufficient cash flows. The bank does not interfere with the management of the company. Also this method of financing does not require any legal formality except that of creating a mortgage on the assets. Besides, the loan can be repaid in parts and interest saved to that extent. Short-term loans can also be obtained from banks on the personal security of the directors of the company. These are known as **clean advances.**

5.5.5 Public Deposits

Companies often find it convenient and necessary to raise funds by inviting their shareholders, employees and the general public to deposit their savings with the company. The Companies Act permits such deposits to be received for a period up to **3** years at a time. Thus, public deposits can be raised by companies to meet their short-term and medium-term financial needs. It is a simple method of raising finance for which the company has only to advertise in the newspapers giving particulars about its financial position as prescribed by the Companies Act. The deposits are not required to be covered by mortgaging assets or by other securities. Moreover deposits can be invited by offering a higher rate of interest than the interest on bank deposits.

But companies are not permitted to raise unlimited amounts of fund through public deposits. The aggregate of all outstanding deposits cannot exceed 25% of the paid up capital and free reserves of the company. Interest to be allowed on deposits must also be in accordance with the rate fixed by the Government. Further, it is laid down in the Companies Act that at the beginning of each year, the company must deposit in a bank at least 10% of the deposits maturing during that year, or invest an equivalent amount in Government securities for repayment of deposits. Besides, the company has to file a return or statement every year with the Registrar of Companies giving all information relating to the deposits.

However, small scale industries (i.e. manufacturing companies with investment in plant and machinery not exceeding Rs. 35 lakhs) are exempted from the restrictions as to the maximum limit of deposits if the following conditions are satisfied.

i) The amount of deposit does not exceed Rs. 8 lakhs or the amount of paid up capital whicfiever is less.

ii) The paid up capital does not exceed Rs. 12 lakhs.

iii) The number of depositors is not more than 50%.

iv) There is no invitation to the public for deposits.

5.5.6 Retention of Profits

Profitable companies do not generally distribute the whole amount of profits as dividend. A certain proportion is transferred to reserves and utilised as additional capital. Thus the financial needs of a company can be met by retaining a part of the annual profits. This may be regarded as reinvestment of profits or **'ploughing back of** profits'. Since retained profits actually belong to the shareholders of the company, these are treated as a part of ownership capital, and may be used to meet long, medium and short-term financial needs. The main advantage is that there is no legal formality involved, nor does the company has to depend on external investors to raise capital. Retention of profit is a sort of self financing of business. However, only the on-going profitable companies can make use of this source of finance. For profitable companies transfer upto 10% of current profits is legally permitted. A company may transfer more than 10% of profits to reserves provided it fulfils certain conditions laid down in the rules framed under the Companies Act. In short, more than 10% of current profits can be retained only after declaring a minimum rate of dividend consistent with the dividend distributed in the past.

5.5.7 Trade Credit

Just as companies sell goods on credit, they also buy raw materials, components, stores and spare parts on credit from different suppliers. Hence, outstanding amounts payable to trade creditors as well as bills payable relating to credit purchases are regarded as sources of finance. Generally suppliers grant credit for a period of 3 to 6 months, and thus provit short-term finance to the company. Availability of this type of finance is closely connected with the volume of business. When the production and sale of goods increase, there is automatic increase in the volume of purchases, and more of trade credit is available. On the other hand, if sales decline there-is a corresponding decline in purchases of materials, and consequent decline in trade credit as a source of finance. Thus, creditors' balances (accounts payable) and bills payable help companies to finance current assets, i.e., stock of materials and finished goods as well as book debts. However, trade credit also involves loss of cash discount which could be earned if payments were made within 7 to 10 days from the date of purchase. This loss is regarded as the cost of trade credit.

5.5.8 Factoring

The amounts due to a company from customers on account of credit sale generally remain outstanding during the period of credit allowed i.e. till the dues are collected from the debtors. If necessary, book debts may be assigned to a bank and cash realised in advance from the bank. By this arrangement the responsibility of collecting the debtors' balances is taken over by the bank on payment of specified charges by the company. This is a method of raising short-term capital and known as **'factoring'.** It helps companies to secure finance against debtors' balances before the debts are due for realisation, and incidentally also helps in saving the effort of collecting the book debts. The bank charges payable for the purpose is treated as the cost of raising funds. Keeping in view the risk of bad debts, the amount to be made available by banks is calculated so as to provide for a margin for non-realisation of debts. The disadvantage of factoring is that customers who are in genuine difficulty do not get the facility of delaying payment which they might have otherwise got from the company.

5.5.9 Discounting Bills of Exchange

This method is widely used by companies for raising short-term finance. When goods are sold on credit, bills of exchange are generally drawn for acceptance by the buyers of goods. The bills so drawn are payable after **3** or 6 months depending on the prevailing practice among traders. Instead of holding the bills till the date of maturity, companies generally prefer to discount them with commercial banks on payment of a charge known as bank discount. Bills are endorsed in favour of the bank so as to enable it to realise the amount of the bill on maturity from concerned parties. The amount of discount is deducted from the value of bills at the time of discounting. The rate of discount to be charged by banks is prescribed by the Reserve Bank of India from lime to time. It really amounts to the interest for the period from the date of discounting to the date of maturity of the bill. If any bill is dishonoured on maturity, the bank returns it to the company which then becomes liable to pay the amount to the bank. The cost of raising finance by this method is the discount charged by the bank.

5.5.10 Bank Overdraft and Cash Credit

Arranging cash credit and overdraft with commercial banks is a common method adopted by companies for meeting short-term financial requirements. Cash credit refers to an arrangement on a continuing basis whereby the commercial bank allows money to be drawn as advance from time to time within a specified limit known as cash credit limit. This facility is granted against the security of goods in stock, or promissory notes bearing a second signature, or other marketable instruments like Government bonds. The company is allowed to draw whatever amount is required at different times within the limit agreed upon. The cash credit limit may bc revised according to the value of securities. The money drawn can be repaid as and when possible. Interest is charged on the actual amount withdrawn.

Overdraft is a temporary arrangement with the bank which permits the company to overdraw from its current deposit account with the bank upto a certain limit. The overdraft facility is also grantecl against securities as in the case of cash credit. Interest is charged only on the amount actually overdrawn.

The rate of interest charged on cash credit and overdraft is relatively much higher than the rate of interest on bank deposits. But this method of financing has the flexibility of allowing funds to be drawn for short-term purposes according to changing needs which depend on business conditions.

Check Your Progress B

1 Six methods of raising finance are mentioned below. Indicate by tick marks the methods which can be used for raising fixed capital.

i) Issue of equity shares
ii) Clean advance from banks
iii) Public deposits
iv) Loans from financial institutions
v) Discounting of bills
vi) Issue of preference shares

2 Which of the following methods can be used by a company for raising short-term finance? Put a tick mark against those methods only.

i) Issue of debentures
ii) Cash credit
iii) Public deposits
iv) Bank overdraft
v) Term loans from banks

3 Read the following statements and indicate which of them are True or False.

i) 'Trading on equity' is possible if a company issues preference shares and debentures for raising necessary capital.
ii) Fixed capital can be raised by issuing preference shares.
iii) Factoring means appointing a bank as collecting agent.
iv) Equity share capital can be used for investment in fixed assets as well as current assets.
v) Bills of exchange can be discounted with a bank on payment of interest in advance.
vi) Any amount of public deposits can be raised by a company.
vii) Issue of debentures must be covered by adequate security of assets.
viii) Cash credit is just like clean advance from banks.
ix) Term loans can be raised from commercial banks for long-term purposes.
x) Trade credit helps in financing short-term investments.

4 Fill in the blanks with appropriate words selected from the words given in the brackets.

i) Equity shares are issued for ....(investment in fixed assets, financing operating expenses, modernisation of plants)
ii) Short-term working capital is generally raised from ....(financial institutions, general public, commercial banks)
iii) Cash credit is granted against the security of ....(fixed assets, goods in stock, bank balance)
iv) The cost of trade credit is ....(loss of profit, loss of cash discount, loss of interest)
v) Amount due from customers on account of credit sale requires ....financing. (long-term, medium-term, short-term)
vi) Public deposits can be raised by companies for a maximum period of .... (2 years, 3 years, 4 years)

5.6 LET US SUM UP

Every business firm requires money or finance to run its activities. The importance of finance has increased in modern times for two reasons: (i) business activities are now undertaken on a much larger scale than in the past, and (ii) manufacturing processes have become more complex than before.

Broadly speaking, the financial requirements of a business are of two types: i) fixed capital and ii) working capital. Finance required to purchase fixed assets is known as fixed capital or long-term capital. Finance needed for investment in current assets is known as working capital or circulating capital. The nature of business and size of the business unit generally determine that amount of fixed capital needed. On the other hand, the amount of working capital depends upon the nature of business, the time required for completing the manufacturing process, and the terms on which materials are purchased or goods are sold.

Funds raised to meet the financial requirements of a business can be classified as ownership capitaland borrowed capital. The amount of capital invested in a business by its owners (proprietor, partners or shareholders) is known as ownership capital. Borrowed capital may be raised by way of direct loans, or by issue of debentures or bonds in the case of a company. Ownership capital is raised by companies by issuing shares. Borrowed capital is often used to derive the benefit of higher rates of return on owners' investment. This is known as 'trading on equity'.

'Capital structure' refers to the relative proportion in which different sources of long-term finance is used to meet the total requirements. The proportion of fixed interest bearing capital in the total capital is known as 'capital gearing'.

The main difference between long-term finance and short-term finance is that the former is required for use over a longer period, five years or more, while the later is required for a short period of less than a year. Finance required for a period of 2 to 5 years is known as medium-term finance.

Sole proprietorship concerns and partnership firms have limited opportunities of financing their business. They can use one or more of the following methods of raising funds: investment of own savings, raising loans from friends and relatives, advance from commercial banks and borrowings from finance companies, all against personal security or against the security of their own assets and properties.

A company may decide to use one or more of the following methods to meet the needs of long-term and medium-term finance: issue of shares, issue of debentures, loans from financial institutions, loans from commercial banks, public deposits and retention of profits.

To raise short-term finance, a company may use trade credits, factoring, discounting bills of exchange, arranging bank overdraft and cash credits, and raising public deposits. Each of these methods have certain advantages as well as disadvantages.

5.7 KEY WORDS

Borrowed Capital: Funds raised by way of loans or issue of debentures, which entitle the investors (i.e. lenders) to claim regular payment of interest and repayment of the loan when due.

Capital Gearing: The proportion of fixed interest-bearing capital in the total capital of a business.

Capital Structure: Proportion in which different sources of long-term finance are used to meet the total funds requirement, like shares, debentures, loans, retained profits, etc.

Factoring: Assignment of book debts to a bank and receiving cash in advance with the responsibility of collecting the debts taken over by the bank on payment of specified charges.

Fixed Capital: Funds required for purchase of fixed assets like land, building, plant and machinery, furniture, etc..

Long-term Finance: Finance required for use over a long period, five years or more, meant for purchase of fixed assets and continuous investment in a part of the current assets.

Mediutn-term Finance: Funds required for use over a period of 2 to 5 years, generally for renovation of building, modernisation of plant and machinery, etc.

Ownership Capital: Funds invested by owners of business for permanent use, which entitle them to decide how the business activities will be managed and what will be their share in the profits.

Public Deposits: Deposits raised from the public for medium or short-term financial needs.

Short-term Finance: Funds required for short periods, less than a year, meant for financing current assets which fluctuate due to changing volume of business.

Trade Credit: Outstanding amounts payable to suppliers of raw materials and consumable items and bills payable relating to credit purchases.

Trading on Equity: Use of borrowed capital to have a higher rate of return on equity capital.

Working Capital: Funds required for holding current assets like stock of raw materials; finished goods, book debts, bills receivable, etc.

5.8 SOME USEFUL BOOKS

Bhushan, Y.K. 1987. *Fundamentals of Business Organisation and Management,* Sultan Chand & Sons: New Delhi. (Part 8, Chapters 1 & 2)

Kuchhal, S.C. *Corporation Finance,* Chaitanya Publishigg House: Allahabad.

Paish, F.W. 1975. *Business Finance,* Pitman: London (Chapters 1-3)

Singh, B.P. and T.N. Chhabra. 1988. *Business Organisation & Management,* Kitab Mahal: Allahabad. (Chapters 16 & 17).

5.9 ANSWERS TO CHECK YOUR PROGRESS

A 1 i) False ii) True iii) False iv) True
v) True vi) True vii) True viii) False
ix) True

2 i) Fixed ii) Working iii) Long-term iv) One
v) 25. vi) Fixed vii) 'short-term viii) Short-term

3 1) iv 2) v 3) vi 4) vii 5) ii 6) iii 7) i

B 1 i, iv, vi

2 ii, iii, iv

3 i) False ii) True iii) False iv) True v) True
vi) False vii) True viii) False ix) False x) True

4 i) investment in fixed assets
ii) commercial banks
iii) goods in stock
iv) loss of cash discount
v) short-term finance
vi) 3 years

5.10 TERMINAL QUESTIONS

1 Discuss briefly the importance of finance in business. Distinguish between fixed capital and working capital.

2 State the purposes for which working capital is required.
Discuss the factors determining working capital needs.

3 What are the advantages of raising capital through borrowings?

4 What is meant by ownership capital? What are its merits and limitations?

5 State the methods of raising fixed capital.

6 What are the methods of raising short-term capital? Discuss.

7 Briefly explain the merits and demerits of issuing debentures. Compare it with equity shares as a method of raising fixed capital.

8 Compare the relative advantages and disadvantages of issuing equity shares and preference shares.

9 What are the advantages of raising finance through public deposits? What are the legal requirements to be fulfilled for raising public deposits?

10 Discuss briefly 'factoring' and 'discounting of bills of exchange' as methods of raising short-term finance.

11 What do you understand by overdraft and cash credit facilities? Mention the types of securities required for cash credit and overdraft.

12 What is meant by capital structure? What factors should management take into account while deciding on a capital structure?

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not send your answers to the university. They are for your practice.

UNIT 6 SOURCES OF LONG-TERM FINANCE AND UNDERWRITING

Structure

6.0 Objectives
6.1 Introduction
6.2 Nature and Importance of Long-term Finance
6.3 Sources of Long-term Finance
   6.3.1 Capital Market
   6.3.2 Special Financial institutions
   6.3.3 Leasing Companies
   6.3.4 Foreign Sources
   6.3.5 Retained Profits
6.4 Underwriting
6.5 Let Us Sum Up
6.6 Key Words
6.7 Some Useful Books
6.8 Answers to Check Your Progress
6.9 Terminal Questions

6.0 OBJECTIVES

After going through this Unit you will be able to':

- explain the nature and significance of long-term finance
- identify the various sources of long-term finance
- define underwriting
- explain the importance and limitations of underwriting
- recognise the legal restrictions on underwriting

6.1 INTRODUCTION

In Unit 5 you have learnt about the nature of financial needs of business and various methods of raising finance. You have also noted the distinction between long-term, medium-term and short-term finance. In this unit we shall examine in detail the nature and importance of long-term finance and the sources through which long-term finance may be raised by companies. We shall further discuss what is meant by underwriting, in what way it helps long-term financing, and the role of different agencies which undertake this function.

6.2 NATURE AND IMPORTANCE OF LONG-TERM FINANCE

You know every business unit requires some amount of money for investment in fixed assets besides the money required for day 'to day operations. The types of fixed assets required for business activities depends mainly upon the nature of business. For example, the fixed assets required by manufacturing companies generally include land and buildings, plant and machinery, furniture, etc. A trading company, on the other hand, may require'a godown, office-building, furniture and fixtures, etc. The proportion of capital to be invested in fixed assets is naturally more in the case of manufacturing companies than trading concerns.

Fixed assets are long-lived assets and, therefore, investment can be made only with long-term finance i.e., funds which will not have to be returned within five years. Actually, the useful life of assets like machinery and equipment, furniture and fixtures, etc. maybe 5 to 10 years. It may be as long as 50 years in-the case of steel plant, and more in the case of buildings. Hence, long-term finance is defined as finance required for a period of five years or more. As a result, profits earned on long-term investment in fixed assets invariably extend over a long period in the future. In other words, long-term finance is associated with long-term return on the investment. Since the future is always uncertain, long-term finance must be invested with care and estimation of the future prospects of business. Particularly, investment in plant and machinery requires careful consideration of the possibility of changes in production techniques which may necessitate replacement of the existing plant'. Another implication of long-term investment is that decisions once made cannot be reversed at short intervals. For example, if a company has installed plant and machinery with a production capacity of 10 lakh tonnes of cement per year, it cannot reduce the size of the plant just because there is a decline in the demand for cement. Moreover, it may be economical and profitable to instal plant and machinery with large production capacity involving a correspondingly heavy investment. This is true of certain industries like iron and steel, cement, basic chemicals, engineering goods, etc. Even otherwise, large scale production always leads to lower cost of production per unit.

The importance of long-term finance, therefore, lies in its necessity for investment in fixed assets which is essential particularly for manufacturing activities. At the same time, long-term finance involves long-term commitment of funds which cannot be withdrawn at short notice. And larger the business greater is the need for long-term finance.

check Your Progress **A**

1. Fill in the blanks.
   i) Long-term finance is required for investment in ....
   ii) The need for long-term finance is relatively more in ,case of .... companies than in .... companies.
   iii) Long-term investment decisions cannot be .... at short notice.
   iv) Funds invested in fixed assets cannot be .... within a short period.

2. Which of the following statements are True and which are False?
   i) Long-term finance isgenerally required for a period of 20 years or more.
   ii) Fixed assets are long-lived assets.
   iii) Plant and machinery once installed must be used continuously till the same are completely worn out.
   iv) Long-term finance is required in all types of business activities — manufacturing, trading as well as transport business.
   v) The amount of long-term investment required depends upon the nature and size of the business-unit.

6.3 SOURCES OF LONG-TERM FINANCE

Funds required for investment in fixed assets'are mainly provided by the promoters in the case of proprietory and partnership business. Friends and relatives of the proprietor or partners may also make long-term investment in the business on the personal security of the promoters. However, if large amounts of funds are required for any business venture, the promoters generally set up a company. This is because in the case of a company, there is greater scope of raising finance from different sources. Generally speaking', long-term finance may be raised by companies from , one or more of the following sources:

1 Capital market which consists of individual investors, financial institutions and investment companies
2 Special financial institutions consisting of development banks and institutional investors
3 Leasing companies
4 Foreign sources
5 Retained profits

Let us examine how long-term finance may be procured from these sources.

6.3.1 Capital Market

The meaning of capital market is not the same as or similar to that of a market place where goods are bought and sold. Capital market actually denotes the arrangements whereby transactions of money capital (not capital goods) are facilitated. In other words, transactions involving procurement of funds and supply of funds which take place among individuals and various organisations may be regarded as the capital market. Thus, the capital market is not located in a particular place. Nor there are fixed categories of investors and dealers in the capital market, that is, those who supply funds and those who procure funds for investment.

You may have heard or read about another type of market in connection with business finance, known as the money market. Money market refers to transactions involving borrowing and lending of money for short periods for which again there is not definite place set aside in a town. Thus, we can say that money market is the market for short-term funds.

Sometimes the term 'money market' is used in a broad sense to include the markets for short-term as well as long-term funds. Strictly speaking, money market refers only to the market for short-term funds. This distinction helps us in understanding the nature of money transactions which take place for financing business activities. But there is a close relation between the capital market and the money market. The same institutions often deal in both the markets. Companies borrow money for capital purposes. Many financial institutions lend money for short periods as also long periods. Apart from having common links, the two markets are mutually interdependent. The relative demand and supply of funds in the two markets are determined by changes in the rates of interest on short-term funds compared to the expected yield on long-term funds. Thus, if there is increase in interest rate in the money market, one expects an increase in demand for funds in the capital market. Or, a rise in the expected yield in the capital market may lead to a rise in demand for funds in the money market.

You have learnt that transactions involving the procurement and supply of long-term funds take place in the capital market. You also know that companies raise funds by issuing shares and debentures of different types. Individuals and institutions which contribute to the share capital of a company become its shareholders. They are also known as members of the company. Share certificates are issued to them by the company bearing the company's seal and indicating the number of shares allotted to the holders of the certificates. Similarly, debentures are issued by companies to raise long-term loans. Debenture bonds are issued to those who subscribe to the loans.

When long-term capital is initially raised by new companies or by existing companies by issuing additional shares or debentures, the transactions are said to have taken place in the market for new capital. Those who deal in newly floated shares or debentures of companies become a part of the capital market known as the market for new capital or **New Issue Market.** 'As you know, shares and debentures issued by public limited companies are freely transferable. Buying and selling of shares and debentures already issued by companies take place in another type of market, known as the **stock exchange,** which is also a part of the capital market. You will learn in detail about stock exchanges in Unit 7.

The New Issue Market for raising capital consists of arrangements which facilitate the procurement of long-term finance by companies issuing shares and debentures. Shares are issued by companies before the commencement of business and, if necessary, subsequently for expansion of business. Before shares are issued, the directors of the company have to decide on the following matters: the amount of capital which is to be raised by issue of shares, the types of shares (preference shares, equity shares, or both) which will be issued, and the time of issuing shares. No company can raise share capital exceeding the amount of authorised capital mentioned in the Memorandum of Association. What part of the authorised capital should'be raised initially or at any other point of time depends upon the purpose for which funds are needed and the alternative sources of raising capital which may be available (like borrowing, for instance). Next, the directors must decide the type or types of shares to be issued. If both equity and preference shares are to be issued, decisions have to be made as to the proportion in which they will be issued, the number and the face value of shares in each category and the rate of dividend on preference shares. The relative attractiveness of equity shares and preference shares is generally taken into account while deciding the above matters. The time of issue is decided by the directors taking into account the likely demand for shares in the capital market, the investors' mood, government policies with regard to money and credit control and taxation, as well as the prevailing business conditions. If it is desired that the shares to be issued should be listed in the stock exchange for official quotation, the directors must fulfil the conditions for that purpose.

Sometimes, the directors of a company along with their friends and relatives agree to take up a certain proportion of the shares. Similarly, the promoters may privately negotiate with Non-Resident Indians (Indians living abroad) and financial institutions to raise a part of the share capital. The arrangement whereby shares are, thus, decided to be allotted is known as private placement of shares. At the same time, the general public may be invited to subscribe to the share capital through advertisement and issue of prospectus. This is known as public issue of shares.

Where a company decides to issue additional shares at any time after two years of its formation or after one year of the first allotment of shares, whichever is earlier, it is required under law that such shares must be first offered to the existing shareholders of the company. If the offer is declined by the existing shareholders, only then the shares can be issued to the public. Such an issue is called '**rights** issue' and these shares are known as 'right shares'.

Besides issuing shares, most companies also raise long-term loans by issuing debentures to the public. A public company can simultaneously issue shares and debentures immediately after its incorporation. The company's indebtedness is acknowledged in the debenture bonds issued to the subscribers. The terms and conditions relating to the issue are also specified in the debenture bond. Debentures are usually repayable after a specified period and carry a fixed rate of interest payable at regular intervals. The company creates a mortgage or charge on its assets to secure the issue of debentures. Although debentures are usually repayable after a fixed period, companies may also issue debentures which are convertible into equity shares after a certain period. Such debentures are known as 'convertible debentures'.

The issue of convertible debentures by a company, which has bright prospects, makes it more attractive for investors. The reason is that, investors as debenture holders enjoy a fixed interest income during the initial stage and, later on, as equity shareholders they become entitled to share in the prosperity of the company through high dividend income as well as increase in share prices. However, approval of the Central Government is required where the holders of debentures are given the option to convert or not to convert the debentures into shares.

Control of **Capital Issues:** To ensure that investment made by companies are in accordance with the national development plans, and not used for wasteful purposes, Government controls the issues of shares and debentures under the Capital Issues (Control) Act, 1947. Let us study the main points in this connection.

I A company making public offer of shares and debentures must obtain the consent of the Controller of Capital Issues if the amount to be raised during a period of 12 months exceeds Rs. one crore. But public limited companies issuing shares (not debentures) are exempt from seeking consent provided the following conditions are Fulfilled:

a) The amount of debt (borrowings) of the company does not exceed twice that of the owners' investment (in the form of share capital and retained profits) i.e. the debt to equity ratio does not exceed 2:1.
b) The amount of equity (owners' investment) is less than three times that of preference share capital i.e. the equity-preference ratio is less than 3:1.
c) The rate of dividend on preference shares and interest on debentures do not exceed the maximum limit fixed from time to time by the Controller.
d) The shares issued to the public are eligible for being officially quoted on a recognised stock exchange.

2 Companies making fresh issue of shares (not debentures) are to file a statement of proposals for capital issue with the Controller at least 30 days before the date of the proposed offer of shares. The companies must also obtain a letter of acknowledgement from the Controller before making the public offer and make a statement to that effect in the prospectus or statement in lieu of prospectus.

3 Loans raised by companies from financial institutions do not require the Controller's approval.

4 Private limited companies are also subject to control over their capital issues if more than 20% of the amount is subscribed by one or more public limited companies, and the amount of capital issue involved exceeds Rs, one crore during a period of 12 months.

5 Companies must seek the consent of the Controller of Capital Issues for issue of debentures to the public.

6 The amount of debenture issue for working capital purposes is not to cxceed 20% of the gross current assets, loans and advances. For long-term investment projects, the amount will he considered on the basis of approval of the scheme of finance by the financial institutions or Government.

7 The debt-equity ratio, including the proposed debenture issue, must not cxceed 2:1. But this requirement may be relaxed in the case of industries like fertilisers, petrochemicals, cement, paper, shipping, etc., which require heavy investments.

8 The debentures shall carry rate of interest not exceeding the rate which may bc prescribed from time to time by the Controller.

Normally debentures shall not be redeemable before the expiry of the period of seven years. A company may have the option of redeeming the debentures from the fifth to the ninth year from the date of issue in such a way that the average period of redemption continues to be seven years. However, investors holding debentures of the face value of Rs. 5,000 or less must be paid in one instalment.

Check Your Progress B

1 Which of the following statements are True and which are False?

i) Companies can raise long-term finance from different sources.

ii) Public limited companies cannot issue shares and debentures simultaneously.

iii) There is no difference between the money market and capital rnarkct.

iv) The new Issue Market is a part of the capital markct.

v) If additional shares are issued by a company within two years of its formation, the shares must be offered only to the existing shareholders.

vi) All companies offering shares or tlebentures to the public must obtain the consent of the Controller of Capital Issues.

vii) The maximum rate of dividend which may be paid on preference shares is notified from time to time by the Controller.

viii) Debentures are permitted to be issued provided the debt-equity ratio does not exceed 2:1.

2 Fill in the blanks.

i) Loans raised by public limited companies from financial institutions do not require the consent of the ....

ii) .... funds are raised from the money market and .... funds from the capital market.

iii) Debentures are not normally redeemable before the expiry of .... years.

iv) Dehentures which can be exchanged for equity shares after a specified period are known as ....

v) When directors or their relatives and financial institutions agree to subscribe to a part of the share issue before they arc offered to the public, the arrangement is known as .... of shares.

vi) A public company can issue shares and debentures after its ....

3 Match the items in column **A** with those in column B.

Column **A**	Column B
1) New Issue Market	i) Existing shareholders
2) Issue of debentures	ii) 2:1
3) Right shares	iii) Fresh issue of shares and debentures
4) Capital market	iv) 3:1
5) Debt-equity ratio	v) Long-term funds
6) Equity-preference ratio	vi) Mortgage or charge on assets

6.3.2 Special Financial Institutions

After independence a large number of financial institutions have been established in India with the primary objective of providing long-term financial assistance to industrial enterprises. Some of these institutions have been set up on the initiative of the Central Government, while others have been set up in different states on the initiative of the concerned State Governments. Thus there are all-India institutions like Industrial Finance Corporation of India (IFCI), Industrial Credit and Investment Corporation of India (ICICT), Industrial Development Bank of India (IDBI), and Industrial Reconstruction Corporation of India (IRCI). They mainly provide long-term finance for large companies. On the other hand, at the state level there are State Financial Corporations (SFCs) and Industrial Development Corporations (SIDCs). These state level institutions mainly provide long-term finance to relatively smaller companies. These institutions (both national level and state level) are known as 'Development Banks' because their main objective is to provide financial assistance to industrial enterprises for investment projects, expansion or modernisation of plants in accordance with the priorities laid down in the Five Year Plans.

Besides the development banks, there are several other institutions known as investment companies or investment trusts which subscribe to the shares and debentures offered to the public by companies. For example, the Life Insurance Corporation of India (LIC), General Insurance Corporation of India (GIC), the Unit Trust of India (UTI), etc., come under this category. A brief account of the functions of some of these institutions is given in a subsequent section.

Now let us discuss about the functions of some of the major development banks and investment companies.

Development Banks

1 Industrial Finance Corporation **of** India (IFCI): This was set up in 1948 under the Industrial Finance Corporation Act, 1948. Its primary objective is to provide long-term and medium-term finance to large-scale industrial concerns particularly when bank loans were not suitable or funds could not be raised from the capital market by issue of shares. The IFCI deals only with industrial enterprises registered as limited companies or cooperative societies. Non-manufacturing concerns, private limited companies, partnership or sole traders cannot get assistance from this institution. It considers loan applications for amounts in excess of Rs. 30 lakh. It provides financial assistance for long-term investment in new industries or expansion or diversification of existing activities, or moderqisation and renovation of plant and equipment. The IFCI can grant loans or subscribe to debentures issued by companies repayable in not more than 25 years. It can also guarantee loans raised from other sources or debentures issued to the public. Further, companies can secure loans in foreign currency from the IFCI or get such loans guaranteed by the Corporation. IFCI takes up the underwriting of the public issue of shares and debentures by companies. You will learn in detail about 'underwriting' of shares and debentures later in this unit.

2 Industrial Credit and **Investment** Corporation **of** India **(ICICI):** It was incorporated under the Indian Companies Act in 1955. It provides financial assistance to companies in two ways: i) by providing long-term loans for a period upto 15 years, and ii) by subscribing to the shares and debentures issued by companies. However, proprietory and partnership concerns are also entitled to secure loans

from the ICICI. Loans are granted against proper securities. Like the IFCI, the ICICI also guarantees loans raised by companies from other sources, besides underwriting the issue of shares and debentures by companies. Foreign Currency Loans can also be secured by companies from the ICICI.

3 **Industrial Development Bank of India (IDBI):** This was set up by Government of India in 1964 and is a subsidiary of the Reserve Bank of India. It seeks to cover the gaps left by the various institutions in the field of industrial finance. The IDBI can provide financial assistance to all types of industrial enterprises which are registered under the Companies Act or any other law. There is no restriction on the types of finance and the amount of funds that may bc available from this institution. It has the unique role of not only providing financial assistance directly to industrial units, but also to refinance loans granted by other financial institutions. Further, it is required to coordinate the functions of all development banks, scheduled commercial banks and state cooperative banks as regards industrial financing. Thus, the functions of the IDBI include the following:

i) It refinances (a) term-loans to industrial concerns granted by IFCI and other financial institutions repayable between 3 and 25 years; (b) loans repayable between 3 and 10 years given by scheduled banks or state cooperative banks; (c) export credit granted by specified financial institutions maturing between 6 months and 10 years.

ii) It subscribes directly to the issue of shares and debentures made by industrial concerns.

iii) It grants loans and advances to companies repayable between 8 to 10 years.

iv) It guarantees loans raised by industrial concerns from the capital market or scheduled banks.

v) It accepts, discounts and rediscounts commercial bills of exchange and promissory notes of industrial enterprises.

vi) It undertakes underwriting of the public issue of shares and debentures made by companies.

vii) To meet the financial requirements of large enterprises, the IDBI also arranges joint financing by two or more financial institutions, particularly when the amount and the risk involved happen to be too heavy for any single institution to bear alone.

4 **State Financial Corporations (SFCs):** These institutions are set up in different states by the respective state governments under the provisions of the State Financial Corporation Act, 1951. All types of enterprises — proprietory and partnership concerns as well as limited companies — can seek financial assistance from the SFCs. The primary objective of these corporations is to accelerate the pace of industrial development in their respective states.

SFCs provide finances in the form of long-term loans or advances or through subscription of debenture issues repayable within 20 years. But the maximum amount of loan or advance granted to any single enterprise is not to exceed 10% of the paid up capital of the SFC or Rs. 10 lakhs, whichever is less. Loans raised by industrial concerns from other sources and repayable within 20 years can be guaranteed by the SFCs. SFCs also take up underwriting public issue of shares and debentures made by companies. They cannot directly subscribe to the shares issued by companies. If shares are required to be taken up as a result of the underwriting obligation, the same must be disposed of in the market within 7 years.

Investment Institutions

We have mentioned earlier about another category of institutions known as 'investment corporations' or 'investment trusts' or 'investment companies' which provide long-term finance. These institutions promote the savings habit among individuals and households with an assurance that the amount of savings entrusted to them would be invested in profitable channels and help in earning adequate return for the savers.

Investment Corporations: The most important investment corporations in India are: i) Life Insurance Corporation of India, and ii) General Insurance Corporation of

India. The Life Insurance Corporation of India (LIC) which undertakes life insurance business, guarantees payment of the amount of policy on the death of the insured person or on the expiry of a certain period. The amount of premium received from the policy-holders are invested by the LIC in different types of securities, e.g. Government bonds, shares and debentures of public limited companies, etc. Similarly, the General Insurance Corporation of India (GIC) invests its funds in Government securities, and shares and debentures of companies. As you know, the GIC undertakes general insurance business including fire, marine, accident, burglary and so on. Thus, the LIC and GIC may be regarded as sources of long-term finance for industrial enterprises.

Investment Companies: A number of investment companies registered under the Companies Act have been engaged in financing industrial concerns by subscribing to the shares and debentures of other companies. These investment companies issue their own shares and debentures to individuals, and borrow money from other institutions. The funds so raised are invested in the shares and debentures of other companies. Besides providing long term finance to industrial concerns, the investment companies also underwrite the issue of shares and debentures of other companies. However, financing of industrial companies by the investment companies is regulated by law (the Companies Act). They can invest in the shares of another company upto 10% of the subscribed capital of that other company, and the aggregate of investments made in all other companies should not exceed 30% of the subscribed capital of the investing company. Some of the well-known investment companies in India are: Investment Corporation of India Ltd., Sri Ram Investment Co. Ltd., Eastern Investment Ltd.. Shree Sun Investment and Trading Co. Ltd., Shree Rishav Investment Co. Ltd., etc.

Investment Trusts: Another category of investment institutions which provide long-term finance to companies is investment trusts. Investment trusts specifically refer to those investment companies which are established for the investment of funds obtained from individuals and institutions. The investors receive shares (or units) issued by the investment trusts. These investment trusts are also known as Unit Trusts. The Unit Trust of India (UTI) is the largest organisation of this type in our country. The UTI was set up under the Unit Trust Act of 1962, and started its operation in 1964. Its initial capital was subscribed by the Reserve Bank of India, LIC, State Bank of India and other financial institutions. Let us try to understand the working of the UTI in some more detail.

Briefly speaking, the UTI invests its funds in shares and debentures of different companies. The securities (shares and debentures) are held in trust by the management. Based on the value of the securities, the management offers 'units' to the public. Each unit having a specified face value is a kind of certificate of participation in the 'unit scheme'. Individuals can buy and sell units at any time. The management receives interest and dividend on the debentures and shares held by them. The income so realised is distributed among the unit-holders in proportion to the value of their holdings. Thus, small savers find it convenient to buy units with an assurance that the UTI will invest the savings in profitable companies, and give them a reasonable return by way of dividend on value of units. On the other hand, the investible funds of the UTI are available to industrial enterprises. You will study the working of financial institutions in detail in another course.

6.3.3 Leasing Companies

Manufacturing companies can secure long-term funds from leasing companies. For this purpose a lease agreement is made whereby plant and machinery and fixed assets may be purchased by the leasing company and allowed to be used by the manufacturing concern for a specified period on payment of an annual rental. At the end of the period the manufacturing company (lessee) may have the option of purchasing the asset at a reduced price. The ownership of the asset remains with the leasing company (lessor) during the lease period. To meet its financial requirements, a manufacturing company may also sell its existing fixed assets to a leasing company at the current market price on the condition that the leasing company would lease the assets back to the seller for a specified period. Such an arrangement is known as 'sale and lease back'. The manufacturing company in this case gets the fund immediately without having to part with the physical possession of the assets. It continues to use the assets on payment of periodical rent for the lease. In any type of lease agreement, the lease rent includes an element of interest besides expenses and profits of the leasing company. Actually, the leasing company makes an investment of its own funds and must earn an income as a return on its investment through the lease rents.

6.3.4 Foreign Sources

Funds can also be collected from foreign sources which usually consist of: i) foreign collaborator, ii) international financial institutions, and iii) non-resident Indians (NRIs)

Foreign Collaborators: If approved by the Government of India, large companies may be able to secure long term finance on the basis of collaboration agreements with companies abroad. Foreign collaboration may, thus, enable Indian companies to secure equity capital from abroad through the subscription of foreign collaborator to their share capital, or by way of supply of technical knowledge, patents, drawings and designs of plants or supply of machinery.

International Financial **Institutions:** There are a number of international financial institutions which provide long-term funds for industrial development all over the world. The most important among them are: i) The World Bank, and ii) International Finance Corporation.

The World Bank grants loans for specific industrial projects of high priority included in the national development plan. The loans have to be guaranteed by the Government of India, and may be given directly to an industrial concern, or through a Government agency, or may be given to the IOBI for refinancing to companies.

The International Finance Corporation (IFC) was established in 1956. It is an affiliate of the World Bank. As you know the World Bank grants loans only to governments of member-countries or private enterprises with guarantee of the concerned government and it does not provide risk capital to enterprises in member-countries. IFC was set up to assist the private undertakings without the guarantee of the member-countries. It also provides them risk capital. IFC grants loans to industrial firms for a period of 8 to 10 years. Such loans do not require Government guarantee. Industrial concerns with investment plans drawn in accordance with the priority laid down under the national development plans can secure long-term loans from the IFC. But the corporation considers loan applications involving large amounts of about $100,000 or more from organisations having total assets of the value of at least $500,000.

Non-resident Indians: Persons of Indian origin and nationality living abroad (Non-resident Indians) are also permitted to subscribe to the shares and debentures issued by companies in India. A non-resident or a company controlled by a non-resident can invest upto a maximum of 5% of the paid up equity capital of an Indian company. New issues of shares or debentures by an industrial company can be subscribed by non-resident Indians to the extent of 40% of the new issue subject to a quantity ceiling of Rs. 40 lakh if the non-resident wants to have the option of repatriating the investment i.e. sell the shares and debentures and get the amount remitted abroad. However, exceptions are allowed in the case of priority industries like industrial machinery, scientific instruments, fertilisers, chemicals, drugs, export industry, hotels, etc.

6.3.5 Retained Profits

An important source of long-term finance for ongoing profitable companies is the amount of profit which is accumulated as general reserve from year to year. To the extent profits are not distributed as dividend to the shareholders, the retained amount can be reinvested for expansion or diversification of business activities. It can also be used for renovation of assets or modernisation of plant and equipment. It may be interpreted that the existing shareholders provide the finance. Hence, the company must decide to reinvest profits only when the rate of return is comparable with that of other similar companies. Moreover, a part of the profits must be distributed as dividend keeping in mind shareholders' expectation and the effect of dividend rate on the market price of shares. Retained profit is an internal source of finance. Hence it does not involve any cost of floatation which has to be incurred to raise finance from external sources. Further, the company does not have to face the uncertainties of external financing. The only drawback of this source of long-term finance is that it depends on the availability of adequate profits for retention.

Look at Figure 6.1. It shows various sources through which companies raise long-term finance.

Check Your Progress **C**

1 Fill in the blanks with appropriate words.

i) IFCI is a .... bank.

ii) Companies can seek loans from the IFCI which are repayable in not more than .... years.

iii) Long-term loans are granted by ICICI for a period upto .... years.

iv) IDBI .... long-term loans granted to companies by other development banks.

v) The maximum amount of loan which a company can obtain from any SFC is Rs. .... lakhs or .... % of the paid up capital of .... whichever is less.

2 Which of the following statements are True and which are False?

i) LIC is an investment trust.

ii) UTI can invest its funds in shares and debentures of companies.

iii) An industrial concern can raise long-term finance from an investment company upto 20% of its subscribed capital.

iv) A partnership firm can get loans sanctioned by the IFCI.

v) SFCs grant loans to companies as well as proprietory and partnership concerns.

vi) Units issued by UTI can be purchased any time by the public at face value.

vii) Development banks are just like commercial banks.

viii) Companies can raise funds by issuing shares to investment companies.

3 Which of the following statements are True or False?

i) 'Sale and lease back' is based on an agreement between leasing company and a manufacturing concern.

ii) Assets which are used for sometime on lease must be invariably returned to the leasing company at the end of the lease period.

iii) Foreign companies can never subscribe to the issue of shares in India.

iv) The World Bank can give Ioans directly to an industrial firm without Government guarantee of its repayment.

v) The International Finance Corporation grants loans for a period of twenty years.

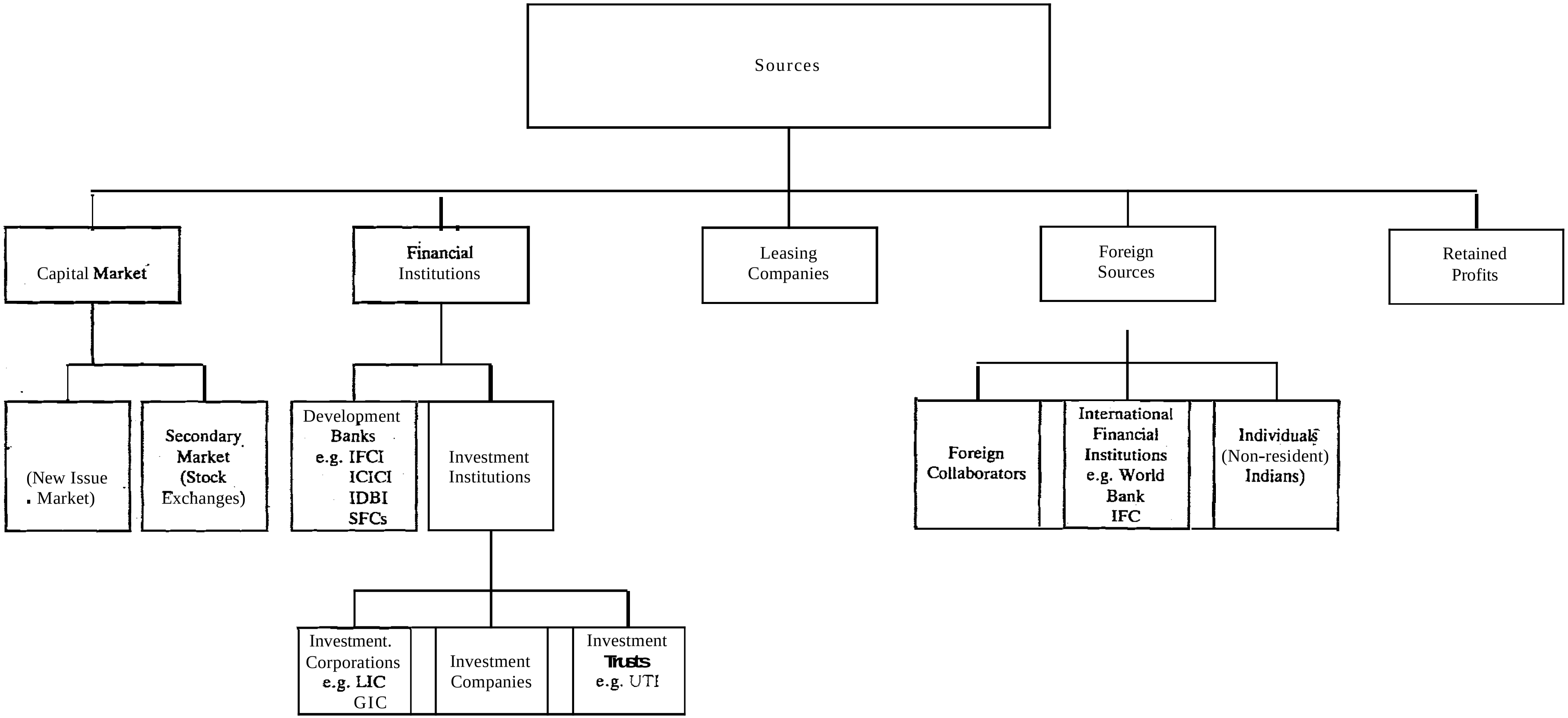
vi) Non-resident Indians can subscribe to the new issue of shares upto a maximum of 10% of the paid up equity capital of a company,

vii) A company need not pay dividend out of profits if the whole amount of profit can be reinvested for the expansion of business to earn higher level of profits.

6.4 UNDERWRITING

We have already mentioned that development banks and financial institutions underwrite the issue of shares and debentures of public limited companies. Besides, investment trusts, stock-brokers. issue houses and other similar organisations also underwrite the public issue of shares and debentures. Those who underwrite security issues are known as **Underwriters.** Let us study in detail about underwriting.

Figure 6.1 : Sources of Long-term Finance



What is Underwriting?

Before issuing the prospectus inviting public subscription for shares and debentures, the promoters of a company generally make arrangements whereby public response to the issue may be encouraging. Otherwise, the promoters cannot be sure that the shares or debentures would be fully or substantially subscribed by the public and ,necessary finance would be available. Similarly, when any existing company decides to raise additional finance by issuing shares or debentures, it has to be reasonably sure that there is adequate response to the issue.

Underwriting refers to an agreement between the promoters or directors of a company on the one hand, and an individual, firm or institution (known as underwriter) on the other, whereby the latter agrees to take up the whole or part of the shares or debentures issued which may not be subscribed by the public. In consideration of the undertaking given by the underwriter, the company agrees to pay a commission which is known as 'underwriting commission'. The commission agreed'upon is generally a percentage of the issue price of the shares or debentures underwritten.

Terms and Conditions **of** Underwriting

There is a written agreement between the company and the underwriter known as the 'Underwriting Agreement' (or Contract). Usually the following aspects are specified in this agreement.

i) The number of shares or debentures which are agreed to be underwritten.
ii) An undertaking by the underwriters to take up such of the shares or debentures as are not subscribed by the public.
iii) An undertaking by the company that the terms of issue given in the prospectus will not be changed without the consent of underwriters.
iv) Authority of the underwriters to the company to allot them the balance of shares or debentures not taken up by the public.
v) The rate of commission to be paid to the underwriters and the mode of payment.

The commission is payable as a percentage of the issue price of all the shares or debentures even if the issue is fully subscribed by the public.

Sometimes the underwriters want to subscribe to a block of shares or debentures even if the total issue is fully subscribed by the public. This is known as 'firm offer'. A clause to that effect is then included in the underwriting agreement. Thereby the underwriters are assured of allotment of the block of shares or debentures specified for which they have made a firm offer.

Legal Regulations

Regarding payment of underwriting commission, certain legal requirements, as prescribed under the Companies Act, must be fulfilled by the company. First, the payment of the commission must have been authorised by the Articles of Association of the company. Secondly, the commission agreed to be paid must not exceed 5% of the issue price of shares, and in the case of debentures it must not exceed 2.5% of the issue price. The amount or rate of commission agreed to be paid must be disclosed in the prospectus or statement in lieu of prospectus. The commission may be paid out of capital or out of profits.

Advantages and Limitations **of** Underwriting

To the promoters of a coinpany the most important advantage of underwriting is that the funds required for the enterprise become available whether or not there is adequate public response to the issue of shares and debentures. The underwriters ensure the availability of finance. A new company has to invariably enter into various contracts with different parties for purchase of fixed assets and other arrangements, before the commencement of business. The promoters can confidently prqceed with the preliminary steps after the underwriting agreement. They do not have to wait for the public response and actual subscription to the issue of shares and debentures. Thus, precious time may be saved and business activities started on a sound basis as a result of underwriting.

Another advantage of underwriting is that the company gets the benefit of expert advice from the underwriters. Every underwriter, before entering into an agreement, carefully examines the scheme of financing the business ventures prepared by the company. The underwriter signs the contract only when the scheme is sound. While examining the scheme, the underwriter may suggest improvements in the scheme and thus enable the company to avoid future setbacks. If a reputed firm has underwritten the issue of shares or debentures, it creates confidence in the public and helps the company to raise the necessary amount of finance from the public.

Underwriters usually have working arrangement with brokers and agents who secure public subscription on behalf of the company and earn commission for their services. Thus, public response to the issue of shares and debentures is not restricted to any particular area but secured from different areas. Members of the public who intend to invest their savings are also benefited as a result of underwriting of shares and debentures offered by a company. It is expected that the underwriters must have fully satisfied themselves about the soundness of the issue before underwriting the same. Hence, an investor runs much less risk when he subscribes to the issue which has been underwritten than otherwise.

The only disadvantage of underwriting is that it adds to the cost of raising finance. Thus, the rate of return on investment proposed to be made with the funds raised must be sufficiently high so as to absorb the additional cost of floating shares and debentures. But the significance of underwriting arrangement is such that even well-established profitable companies cannot avoid it while issuing additional shares or deberitures to the public. Smaller companies often find the cost involved quite heavy.

Underwriting Agencies and Institutions

We have stated before that any individual, partnership firm, company or financial institution may become an underwriter. They may be regarded as underwriting agencies or institutions. In India, the development banks, commercial banks, investment companies, investment trusts and stock brokers (share brokers) engage in underwriting business. Some of the well-known underwriting agencies in India are given below.

1	Development banks	IFCI, IDBI, ICICI, SFCs
2	Investment Institutions	LIC, GIC, UTI and Investment Companies
3	Commercial Banks	State Bank of India, Central Bank, Bank of India, Bank of Baroda, etc.
4	Others	Stock brokers and financiers like the Firm of Place, Siddens and Gough, etc.

Check Your Progress D

Put a tick mark against the appropriate answer.

a) Underwriting means
   i) promise to buy shares.
   ii) promise to buy debentures.
   iii) assuring public subscription to the issue of shares.
   iv) undertaking to subscribe to shares or debentures if public subscription is not adequate.

b) Underwriting commission is payable as a percentage of
   i) the face value of shares.
   ii) the market price of shares.
   iii) value of shares subscribed by the public.
   iv) issue price of all the shares offered to the public.

c) A company can pay underwriting commission upto a maximum rate of
   i) 2% on shares underwritten,
   ii) 4% on shares underwritten.
   iii) 5% on shares underwritten,

iv) 7.5% on shares underwritten.

d) Payment of underwriting commission must be authorised by

i) Board of Directors.
ii) Articles of Association.
iii) Memorandum of Association.
iv) Managing Director of the Company.

6.5 LET US SUM UP

Investment in fixed assets can be made only with long-term finance. The need for long-term finance is more in the case of manufacturing concerns. Public limited companies can raise long-term funds on a much larger scale than other forms of organisation. Companies can procure long-term finance from capital market, special financial institutions, leasing companies, foreign sources as also through retention of profits.

Capital market denotes transactions involving procurement and supply of long-term funds which take place among individuals and institutions.

Long-term capital which is raised by companies by issue of shares and debentures also involves transactions. Dealings in such newly floated shares and debentures of companies form a section of the capital market known as 'new issue market'. The arrangement whereby shares or debentures are decided to be allotted to friends and relatives of directors or promoters, or through private negotiation with investors is known as 'private placement'.

A company making public offer of shares and debentures must obtain prior consent of the Controller of Capital Issues if the amount to be raised during one year exceeds Rs. one crore. But public limited companies issuing shares are exempt from seeking consent provided certain conditions are satisfied. But companies must seek the consent of the Controller for issue of debentures to the public. Loans raised from financial institutions do not require the Controller's approval.

There are a number of special financial institutions at national level and state level — IFCI, ICICI, IDBI, IRCI — which provide long-term financial assistance to business enterprises. These institutions are known as development banks. Several other types of institutions known as 'investment companies' or 'investment trusts' also subscribe to the shares and debentures issued by companies. These development banks and investment institutions, besides giving loans to industrial enterprises, also guarantee loans and underwrite shares and debentures issued by such companies.

Assets may be acquired by companies for use under 'lease agreement' with any leasing company. Leasing companies invest funds in assets and charges rental from the user companies. Long-term finance is sometimes available to large industrial concerns through collaboration with foreign companies or from the World Bank or International Finance Corporation, subject to the approval of the Government of India. Non-resident Indians can also subscribe to the shares and debentures issued by companies in India subject to certain restrictions. To the extent profits are not distributed as dividends, the retained amount becomes a source of long-term finance for companies.

Underwriting of securities refers to an agreement between the promoters or directors of a company and another party (the underwriter) whereby the latter agree to take up the whole or part of the shares or debentures issued which may not be subscribed by the public. The company agrees to pay commission at an agreed rate to the underwriter subject to the maximum rate laid down in the Companies Act.

Companies are assured of the availability of finance by virtue of the underwriting agreement. Companies sometimes get the benefit of expert advice from the underwriters. Since the underwriters fully satisfy themselves about the soundness of the company which'is raising the capital, investors run less risk when they subscribe to the issues which have been underwritten. The disadvantage of underwriting is that it adds to the cost of raising finance. In India, the development banks, commercial banks, investment companies as well as stock-brokers (share brokers) engage in underwriting business.

6.6 KEY WORDS

Capital Market: The transactions through which long-term funds are procured by companies and supplied by investors. This is the market for long-term capital.

Convertible Debentures: Debentures issued initially to raise loans but subsequently convertible into equity shares.

Development Banks: Financial institutions which provide long and medium-term finance to entrepreneurs and organisations so that funds are invested in industrial ventures which are in conformity with national development plans,

Investment Institutions: Financial institutions which promote the saving habits of people with an assurance that the savings entrusted to them would be invested in profitable channels and help in earning adequate return for the saving public.

Investment Trust: Investment company which raises funds from the public for investment in profitable securities against which its own shares (or units) are issued to the public which can be encashed at any time at their underlying asset value.

Money Market: Market for short-term capital involving borrowing and lending of money for short periods.

New Issue Market: Arrangements which facilitate issue of shares and debentures by companies.

Private Placement: Shares and debentures decided to be allotted through private negotiation before offering them for public subscription.

Retained Profits: Amount of profits which is not distributed as dividend to shareholders.

Special Financial Institutions: Financial institutions set up for long-term financial assistance to industrial enterprises.

Underwriting: Agreement whereby the underwriter agrees to take up the shares or debentures issued by a company to the extent they are not subscribed by the public on payment of a commission known as 'underwriting commission'.

6.7 SOME USEFUL BOOKS

Bhushan Y.K. 1987. ***Fundamentals of Business Organisation & Management,*** Sultan Chand & Sons: New Delhi. (Part Eight, chapters 2 & 3)

Musselman, Vernon A., and John H. Jackson, 1985. ***Introduction to Modern Business,*** Prentice-Hall of India: New Delhi. (chapter 14)

Ramesh M.S., 1985. ***Principles and Practice of Business Organisation, Administration & Management,*** Kalyani Publishers: New Delhi. (Volume III chapters 15–17)

Singh, B.P., and T.N. Chhabra, 1988. ***Business Organisation and Management,*** Kitab Mahal: Allahabad. (Section Five, chapters 17–19).

6.8 ANSWERS TO CHECK YOUR PROGRESS

A 1 i) fixed assets ii) public, private
iii) reversed iv) withdrawn

2 i) False ii) True iii) False iv) True v) True

B 1 i) True ii) False iii) False iv) True v) False
vi) False vii) True viii) True

2 i) Controller of Capital Issues
ii) Short-term, long-term
iii) seven
iv) convertible debentures
v) private placement
vi) incorporation

3 i) iii ii) vi iii) i iv) v
v) ii vi) iv

C 1 i) development ii) 25 iii) 15 iv) refinances v) 10, 10, SFC

2 i) False ii) True iii) False iv) False
v) True vi) True vii) False viii) True

3 i) True ii) False iii) False iv) False
v) False vi) False vii) False

D a) iv b) iv c) iii d) ii

6.9 TERMINAL QUESTIONS

1 Briefly explain the meaning of: (a) Money Market, (b) Capital Market. and (c) New Issue Market.

2 Mention the sources from which companies may raise long-term finance. Distinguish between investment companies and investment trusts as sources of long-term finance.

3 What is meant by private placement of shares? Is private placement possible for debentures also?

4 Is it compulsory to seek the consent of the Controller of Capital Issues before offering shares and debentures to the public? What are the conditions to be fulfilled if a company wants to issue debentures to the public?

5 What do you understand by the term development bank? State the functions of two all-India development banks.

6 State briefly the functions of the Unit Trust of India.

7 What is a leasing company? How can a company secure long-term finance through a leasing company? What do you undetstand by 'sale and lease back'?

8 Write explanatory notes on the following;

a) Retained profits as a source of long-term finance.

b) Foreign sources of long-term finance.

c) Restrictions on investment in shares by non-resident Indians,

9 What is meant by 'Underwriting' of shares and debentures? How does it help companies in raising Iong-term finance? Discuss briefly the terms and conditions relating to underwriting of shares and debentures.

10 A public company issuing debentures and shares has entered into an underwriting agreement with IFCI. The agreement covers the issue of 1,00,000 equity shares of Rs. 10 each and 50,000 debentures of Rs. 100 each. Underwriting commission is payable at the maximum rate allowed under the ,Companies Act, Public Subscription has been secured for 70,000 shares and 40,000 debentures. The balance of shares and debentures are taken up by the underwriters. Calculate the amount of underwriting commission to be paid.

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not send your answers to the university. These are for your practice.

UNIT 7 STOCK EXCHANGES

Structure

7.0 Objectives
7.1 Introduction
7.2 What is a Stock Exchange?
7.3 Functions of Stock Exchanges
7.4 Method of Trading on a Stock Exchange
7.5 Types of Dealings in a Stock Exchange
7.6 Some Important Terms
7.7 Listing of Securities on a Stock Exchange
7.8 Speculation and Stock Exchange
7.9 Factors Affecting Prices in a Stock Exchange
7.10 Advantages and Shortcomings
7.10.1 **Advantages**
7.10.2 Shortcomings
7.11 Regulation and Control of Stock Exchanges
7.12 Let Us Sum Up
7.13 Key Words
7.14 Some Useful Books
7.15, Answers to Check Your Progress
7.16 Terminal Questions

7.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the meaning and importance of stock exchange
- state the economic functions of stock exchanges
- explain the method of trading on a stock exchange
- describe the terms used and types of dealings conducted at the stock exchanges
- describe the importance of listing
- explain the meaning of speculation
- identify the factors responsible for fluctuations in the prices of securities at the stock exchanges
- enumerate the advantages and shortcomings of stock exchanges
- appreciate the need to regulate and control stock exchanges
- explain the provisions of the Securities Contracts (Regulation) Act, 1956.

7.1 INTRODUCTION

In Units 5 and 6 you have learnt about the need for capital and the sources of short-term and long-term finance. You also know that companies raise capital by issuing shares or debentures known as **corporate securities.** Like companies, the central and state governments also issue bonds or instruments known as **government securities** to raise funds from the public. So do various other authorities like Port Trusts, Municipalities and public undertakings. Most investors hold securities to earn income by way of interest or dividend. But many of them might decide to sell them either to meet their urgent financial needs or to reinvest those funds in some other securities with a promise of better income. Similarly, people with accumulated savings or the institutions having surplus funds may also like to invest their funds in various securites.

If some investor wants to sell securities, he has to find another person who is interested to buy. But it is not easy to find ready buyers. Even if he finds one, the buyer may take advantage of the seller's urgency to sell and offer a lower price. A 'similar problem may be faced by a buyer also. Buyer may not be able to find a ready seller. Even if he finds, the seller may quote a high price knowing the buyer's eagerness to invest, Thus, both buyers and sellers have problems of identifying each other and arriving at a mutually satisfactory price. It would be very convenient if buyers and sellers could meet at one place to solve their problem. The stock exchange is such a place. Stock exchange is an organisation which provides facilities for the purchase and sale of existing securities.

In this unit you will learn about the meaning of the stock exchange, its importance, the procedure of dealing at stock exchange, and regulation of stock exchanges in India.

7.2 WHAT IS A STOCK EXCHANGE ?

If you break up the expression 'Stock Exchange', you get twa words: one is 'Stock' which means a part or fraction of the capital of a company, and the other is 'Exchange' which means a market for purchasing and selling. Thus, we can describe the stock exchange as a market or a place where different types of securities are bought and sold. It not only deals in shares and debentures but also in various other types of securities issued by central, state and local governments as well as institutions like Unit Trust of India, Steel Authority of India, National Thermal Power Corporation, etc. Therefore, it is also called 'securities market' or 'securities exchange'. It is a secondary market of securities because only the securities already issued are allowed to be dealt with on the floor of a stock exchange.

This market is open only to members, most of whom are brokers acting as agents of the buyers and sellers of shares, debentures and bonds. A stock exchange is generally organised as an association or a society or a company. The membership of the stock exchange is restricted to a certain number, and new members are admitted only when there are vacancies. Every member has to pay the prescribed membership fee.

The Securities Contracts (Regulation) Act, 1956 has defined stock exchange as an 'association, organisation or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business of buying, selling and dealing in Securities'.

According to Pyle, 'security exchanges are market places where securities that have been listed thereon may be bought and sold for either investment or speculation'.

K.L. Garg has described the stock exchange as 'an association of persons engaged in the buying and selling of stocks, bonds and shares for the public on commission and guided by certain rules and usages'.

Based on the above discussion and definitions, we can identify the characteristics of stock exchange as follows:

1 Stock exchange is an organised market.
2 Securities (shares, debentures, bonds, etc.) issued by central, srate and local governments, municipalities, port trusts, public utility concerns, joint stock companies and public corporations are bought and sold on the floor of a stock exchange.
3 In a stock exchange, transactions take place between members or their authorised agents on behalf of the investors.
4 In a stock exchange all transactions are regulated by the rules and bye-laws of the concerned stock exchange.

There are fourteen stock exchanges in India in different cities and towns viz., Bombay, Calcutta, Madras, Delhi, Ahmedabad, Hyderabad, Indore, Bangalore, Cochin, Kanpur, Pune, Ludhiana, Gauhati and Jaipur. They all function in accordance with the provisions of the Securities Contracts (Regulation) Act, 1956.

Check Your progress A

1 Tick mark the correct answers.

a) Stock Exchange is a market where there is buying and selling of
   i) gold, silver and bullion. ( )
   ii) commodities. ( )

iii) securities. ( )
iv) all the above. ( )

b) Securities traded in the stock exchanges are issued by
i) joint stock companies. ( )
ii) central government. ( )
iii) public trusts. ( )
iv) all the above. ( )

c) The buyers on a stock exchange are
i) government. ( )
ii) companies. ( )
iii) investors. ( )
iv) none of the above. ( )

2 Explain the meaning of a stock exchange.

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7.3 FUNCTIONS OF STOCK EXCHANGES

Stock exchange, being a part of financial market, plays a very important role in the economic development of the country. Let us now examine the functions of stock exchanges from the economic point of view. These functions may be enumerated as (a) primary functions, and (b) secondary functions,

Primary functions

1 **Marketability and price continuity:** The stock exchange provides for easy marketability of securities as securities can be bought and sold conveniently on the floor of the stock exchange. Since transactions take place regularly, there is continuity in the dealings. Prices quoted are duly recorded and reported in the newspapers for the benefit of investing public. Besides, price fluctuations are also moderated because of the continuity of buying and selling.

2 **Mobilising surplus savings:** Stock exchange is an integral part of the capital market of a country. It is because through stock exchanges the savings from all parts of the country are made available to the industrial and commercial undertakings for meeting their financial requirements.

3 **Barometer of economic and business conditions:** The intensity of buying and selling of securities and the corresponding rise or fall in the prices of securities reflect the investors' assessment of the economic and business conditions. Thus, during periods of economic and business prosperity prices of securities tend to rise. Conversely, prices tend to fall when there is economic stagnation or when business activities slow down as a result of depression in the markets. Indeed, change in security prices are known to be highly sensitive to changing economic, social and political conditions. In the words of Alfred Marshall, the well known economist. stock exchanges are not merely the chief theatres of business transactions, they are also barometers which indicate the general conditions of the atmosphere of business.

4 **Mobility of capital:** Stock exchanges furnish an open and continuous market for securities. Savings invested in securities are converted into cash for reinvestment in other securities. Thus, stock exchanges provide mobility to capital and facilitate sound investment.

5 **Contribution to capital formation:** Savings are encouraged when people come to

know about the avenues of investment. Stock markets educate investors as regards where and how to invest their savings for a fair return.

6 Shock absorber: Stock exchanges bring about equilibrium in the prices of securities which are bought and sold by speculators. Speculators generally buy securities in anticipation of rise in the prices. As a result of their buying, prices do not decline as low as might have been the case without their buying. Again when prices are high, speculators sell securities in anticipation of decline in the prices. Their selling prevents price rising too high. Thus, speculative activities regulate excessive price fluctuations.

7 Sifting process: Investors generally prefer to invest their savings after proper assessment of the relative risks and returns associated with different securities. The comparative advantages and disadvantages of investment in various types of securities may be grasped by investors from the dealings which take place on the stock exchanges. Hence they can pick and choose from among different securities and make investment decisions on a sound basis.

8 Facilitates resource allocation: As a result of stock market transactions, funds flow from the less profitable to more profitable enterprises. Thus the existence of stock exchange provides for mobility of funds i.e. movement or flow of funds in the economy as a whole. Industries which have potentials of growth are able to attract the savings of people towards their ventures relatively more than those which have no such prospects. Thus, financial resources of the economy are allocated on a reasonable basis. It is said that "without the stock exchange, the savings of the community, the sinews of economic progress and productive efficiency, would be used much less completely and be much more wasteful, than they are now".

Secondary Functions

1 Safety of investment and equity in dealings: The stock exchanges do not allow trading in each and every company's securities. Companies which want their securities to be traded on the floor of a stock exchange have to fulfil certain conditions. The stock exchange satisfies itself about the genuineness and soundness of the company to protect the investors from being cheated. There are a wide variety of securities. The investors have the opportunity to assess the relative advantages of investing in securities of companies dealing in various products (engineering goods, consumer goods, etc.) having wide markets and situated in different parts of the country. Every region or state and every industry gets a fair share of the investor's attention for investment of their savings.

2 Easy liquidity: The investors usually prefer liquidity of their investment i.e.. easy conversion into cash, besides adequate return on their investment. The stock markets provide that assurance to investors. These are markets which facilitate buying and selling of securities. As such the investors readily come forward to subscribe to new issues. Thus, stock exchange assures liquidity of investments which goes to serve the investor's need.

3 Accurate and continuous report regarding sales: All stock exchanges maintain regular record of the securities traded each day and the prices at which deals are finalised. This information is supplied to newspapers and other information media alongwith the prices of important securities which ruled at closing time. The statistics relating to prices at which securities were traded are published in weekly bulletins for the information of the investors. This information helps in ascertaining the trend of price fluctuations and promotes healthy speculation.

4 Full information regarding listed companies: The organised stock exchanges collect information about the companies listed with them and publish the information in the form of "Official Year Book". This proves very useful to the investors in making investment decisions.

5 Helpful in re-investment decisions: The investors sometimes want to switch their investments from one type of securities to others depending on which will be more rewarding. If shares or debentures of a company are in greater demand there is a rise in their market price indicating that the investors have assumed the company's performance and prospects to be better than others. On the other hand, if shares or debentures are offered for sale by many, the price tends to fall indicating that

investors are not satisfied with the earnings and future prospects of the company. **Thus,** changes in the prices of securities provide **a** fair index of demand and supply **of** securities of **particular** companies. The investors can make their investment decisions accordingly.

6 Safeguards to investors: Every stock exchange has its own rules and regulations for the control of operations of the exchange. Only members are allowed to deal in securities and make transactions. As the members have to transact their business strictly according to the rules, the investors' interests are safeguarded against dishonesty or malpractices.

7.4 METHOD OF TRADING ON A STOCK EXCHANGE

All the securities issued by companies and other bodies are not permitted to be quoted on a recognised stock exchange. Only the listed securities are permitted to be traded. You will study about listing of securities in detail later in this unit. Only members of the stock exchange or their authorised agents can buy or sell securities on the floor of the stock exchange. Suppose you want to buy or sell securities you have to contact a stock broker who is a member of the stock exchange.

When you wish to buy some shares you have to place an order with the broker for the purchase of those shares. You can also depend upon the broker for selecting the type of securities you should buy. After taking the decision about the securities you are to buy, you have to deposit the estimated cost of the securities with the broker.

The broker usually entrusts the task to his authorised clerk in the hall of the stock exchange who announces his requirement by 'shouting in the hall' during the time allotted for dealings in the particular class of securities. He will announce the particulars of the securities, the quantity required as also the price which he offers. Some other broker shall respond to your broker's call. He will either accept the offer made by your broker or may make a counter call/offer. Through such process the bargain/deal is struck,

Each broker has a note book, known as sauda bahi, on which he obtains the signature of the broker from whom he has bought the securities. The signature is obtained as a confirmation of the transaction by the other party. At the end of the day, every broker submits his copy of the transactions recorded in his book to the stock exchange. This is done to reconcile all purchase transactions with those of sales. On the settlement day, the broker takes the delivery of the securities and makes the necessary payment.

You have to pay to your broker the cost of securities purchased and the commission. This commission is a fixed percentage as per the schedule fixed by the stock exchange. The broker prepares a contract note in favour of the client and forwards it to him. The contract note mentions the quantity and the description of the securities bought and the price (inclusive of his commission) at which they are bought.

A similar procedure is followed when some security is to be sold. Look at figure 7.1 which depicts the process of purchase and sale of securities in the stock exchange.

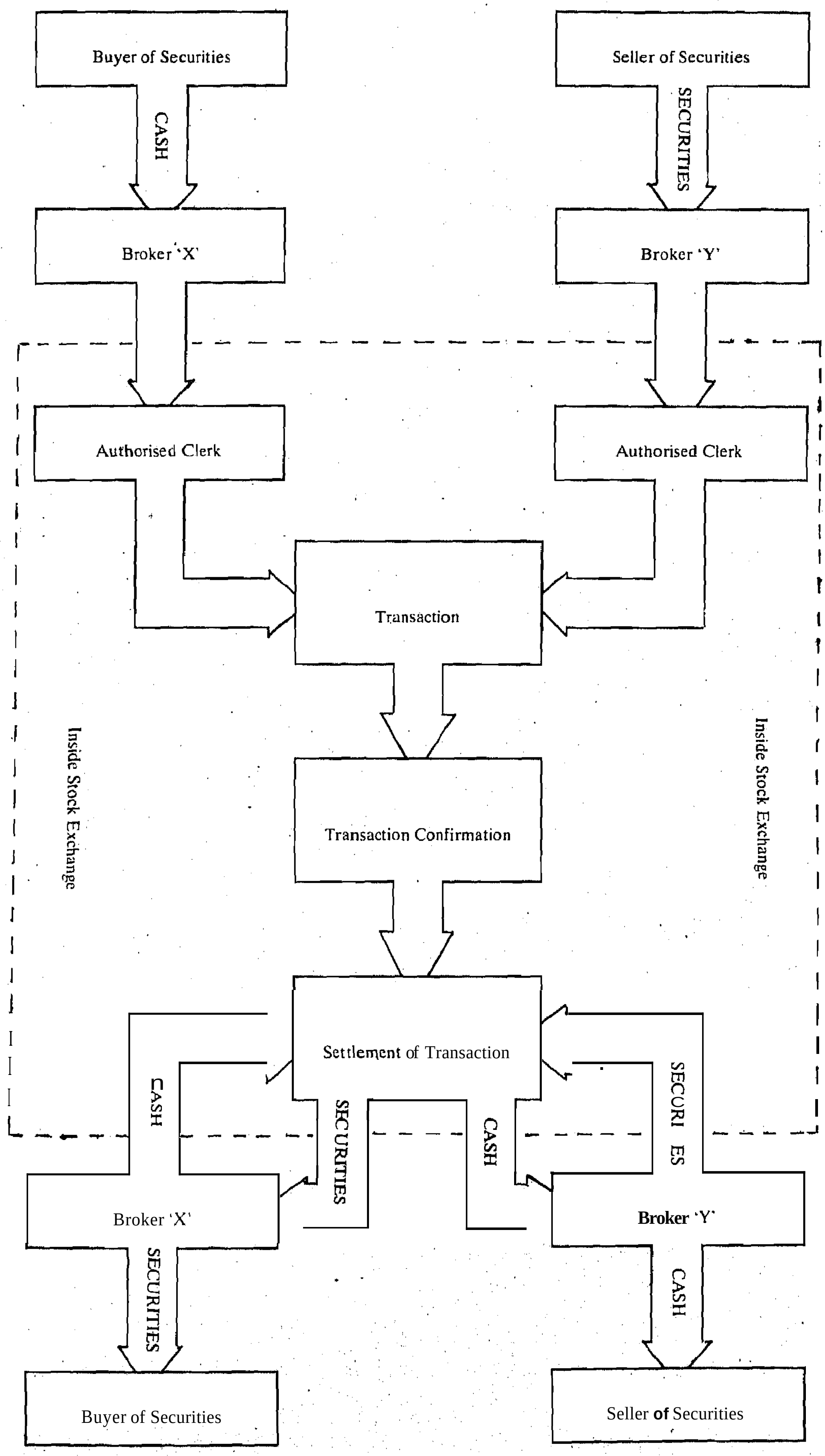
7.5 TYPES OF DEALINGS IN A STOCK EXCHANGE

There are various types of dealings in stock exchanges. Let us now discuss about them briefly.

1 Spot delivery contracts: Such contracts are settled on the spot i.e., the delivery and payment are made on the day of the transaction itself or latest by the following day. It is not a common practice now-a-days.

2 Ready delivery contracts: Such contracts are settled within a short period of time. Usually the period allowed is twelve days and the settlement takes place on the \following settlement day. No postponement is allowed in case of ready delivery contracts.'

Figure 7.1 : The Process of Purchase and Sale of Securities in the Stock Exchange



3 Forward Delivery Contracts: Such contracts are also due for settlement on the following settlement day but they can be postponed to the next settlement day, if so desired. This facility is provided by the stock exchange only in those scrips which are included in the specified list (List A). Such transactions are meant for speculation where the buyer has no intention to take delivery and make payment. He simply covers it by another transaction and earns or loses the difference in prices.

For example Mr. Sanjay buys 1,000 shares of Modi Rubber at Rs. 50 per share in the hope that its price will go up. If the price rises as expected, he will settle it by a transaction for sale of 1,000 shares and pocket the difference, If the price falls, he may decide to settle it by a transaction for sale at a lower price and pay the difference. Alternatively, expecting the price to rise, he may seek postponement of its settlement to the next settlement day by paying the necessary charges. Technically, such postponement is known as 'Carry Over' or **'Badla'** and the charges paid are called **'badla** charges' (also known as contango or backwardation as explained later in this unit). Sometimes the professional badlawalas may advance the necessary sum of money to finance purchase of shares by the hull speculator at certain rate of interest and thus help him to postpone the sale.

Forward delivery contract is not the same **thing** as future trading. Future trading means entering **into** a transaction to sell or buy at a future **date. This** kind of trading is prohibited in India.

7.6 SOME IMPORTANT TERMS

The terminology used by the operators on the stock exchange is somewhat different from what is commonly used in business. The terms have been adopted for official records as well as reports on stock exchange transactions.

Bull or Long: A person who buys securities in the expectation of a rise in their prices, is called 'Bull'. He becomes active whenever there is anticipation of a rise in the prices of securities. He buys with the object of selling them in future. He is also known as tejiwala. If his expectations come true, he earns a profit. If the market goes against his expectation, he incurs a loss. Suppose, he makes a deal for purchase of 100 shares at Rs. 105, expecting it will go up. On the settlement day the price of the share rises to Rs. 110. He informs his broker to settle the deal. He earns a profit of Rs. 500. On the other hand, if the market price of the share goes down he may incur a loss on settlement of the transaction. In such a situation he can postpone the settlement due to unfavourable price by paying budla charges (also called contango). He is called 'bull' as he has a tendency to raise the price artificially like a bull who generally throws his victim upwards.

Bear: A person who sells short i.e., sells what he does not possess at the time of selling, is called a 'Bear'. He does so in the hope of buying at a lower price at the time of delivery. Thus a bear anticipating a fall in price in future sells at the current price which is high. If his expectations come true, he gains, otherwise he loses. If the market goes against him i.e. if the market prices rises, he can postpone his settlement by paying badla charges (also called backwardation). A sale of securities by bears is called 'short selling'. He has to buy them from the market for making delivery to the buyer.

Stag: A person is called a 'stag' if he deal's in the new issues of companies. He applies for shares on the basis of prospectus, and sells these shares at a premium soon after the allotment is made to him. He is just like a bull, since he also foresees a rise in the price of the securities. He applies for a big allotment, since he has to pay only application money to the company at the time of application. A stag sometimes creates artificial demand for the securities in the market so as to cause a rise in their prices. If the response for such shares is poor, and he is allotted all the shares applied for, then he has to sell these shares at a discount. In such conditions he sustains loss.

Contango: Budla charges paid by a bull to the broker for carrying over his transaction to the next settlement date, is called 'contango', Contango amount depends upon the class of securities, their quantity, value, and interest rates prevailing in the market at the time of transaction. Usually it is equivalent to the 'middle price' of the difference between the agreed price and the market price prevailing on the day of the settlement.

Backwardation: This is also a type of badla charge payable to the bull by the bear seeking postponement of the transaction to the next settlement date.

Cum-Dividend: Cum means 'with' or 'including'. Where shares are quoted as Cum-Dividend, the buyer gets a right to receive the dividend on such shares which is payable after the date of sale. The purchase price includes the amount of dividend due. This is because the buyer becomes a registered shareholder and he is entitled to get dividend as and when it is declared by the company. Most transactions in securities are cum-dividend.

Ex-Dividend: This term refers to the price of shares purchased without the right to get the dividend from the company. The dividend declared or accrued is payable to the person whose name appears in the books of the company. Hence, when the buyer purchases the shares after the closure of the books of the company, he buys them ex-dividend.

Cornering: Cornering refers to the condition in the market in which almost the entire supply of a particular security is held by an individual or a group of individuals. In such a situation the bears find it difficult to buy them to meet their commitments of delivering the scrips. This term also refers to purchase of securities by an outsider in large quantities in order to oust the existing management of a company or to put them in an ernbarassing situation.

Margin Trading: It refers to the practice of buying and selling securities by depositing with the broker a certain percentage of the value of the securities involved in the transaction. The percentage of value so deposited is called 'Margin Money' or 'Margin'. The objective is to meet the loss, if any, out of this deposit. When the margin money is deposited, the broker credits the Margin Account of the customer. Deposit of margin money is a precondition for the securities to be held on account of the client. Where the margin falls short of the amount of loss suffered by the client on the securities held in his account, the broker may ask the client to deposit additional amount to cover the shortfall. In case he does not deposit such amount, the broker can sell the securities and recover the amount.

Arbitrage.: Buying in one market where the price is low and selling the same. securities in another market where the price is comparatively higher is termed as 'Arbitrage Operation'. Such dealings confer all the benefits of a continuous market, and bring the divergent prices of various stock exchanges to a uniform level. The scope of operations of the stock exchange is also expanded through such operations. The prices are equalised subject to the cost of communication and transfer of funds from one place to another..

Rigging the Market: When the prices of particular shares are artificially forced up in the market, it is known as 'Rigging'. This is generally the result of activities of bulls (speculative buyers) who raise the demand and thereby push up the market price. Those who hold large blocks of shares often buy and sell to make the market active and then gradually unload their holdings at a profit.

Settlement Day: In every stock exchange a particular day is fixed for the settlement of transactions between buyers and sellers. This day may be every Monday or every Saturday of the week. In other words, there is a weekly settlement. The speculators may settle their deals on a particular settlement day or postpone it to the next settlement day on payment of the 'badla' charges. As stated earlier, postponement of settlement is allowed only in case of shares included in the specified list (List A) of the stock exchange concerned.

Blank Transfer: When shares are sold, the seller has to sign a transfer deed giving necessary particulars about the shares and the transferee, It also involves stamp duty which is payable at the prescribed rates. When the deed is filed with the company, the transfer is duly registered and the name of the transferee is recorded in place of that of the transferor. However, when the seller signs the transfer deed without filling in the name of the transferee it is known as 'blank transfer'. This type of transfer is found to be convenient where the speculators carry over their deals involving temporary purchase and sale of securities. Blank transfer permits speculators to buy and sell securities without paying stamp duty for some time. This tends to encourage excessive speculation. Hence, to discourage blank transfers it is required that the transfer deed in a prescribed form must be presented to the Registrar of Companies before it is signed by the transferor. The date of presentation is endorsed on the deed. Thereafter, the transfer deed must be delivered to the company for registration of the transfer within a certain period. In the case of listed securities, it must be delivered before the first closure of the Register of Members after the date of presentation endorsed on it. In the case of non-listed securities the deed must be delivered within two months from the date of presentation endorsed on it.

List A Securities or Specified Securities: In every stock exchange, there are certain specified securities in respect of which carry over facility is permitted. These securities are known as 'List A Securities' or 'Specified Securities'.

List B Securities or Cash Securities: Securities other than List A Securities are known as 'List B Securities' or 'Cash Securities'. The transactions in such securities have to be settled within a limited period. No postponement is allowed.

Jobber: There are two types of members in the London Stock Exchange known as brokers and jobbers. Every member of the London Stock Exchange has to declare whether he will act as a broker or a jobber. A broker is to act on behalf of the customers and derive his income through the commission he will charge on the purchase and sale of the securities. He is not allowed to buy or sell in his own name. The jobber, on the other hand, is an independent dealer in securities. He can purchase and sell securities in his own name and deal with a broker or with another jobber. He does not work on behalf of non-members. The distinction between a broker and a jobber is not followed in India. The member of the stock exchange can act as a broker and also buy and sell in his own name. At the Bombay Stock Exchange the members are unofficially divided into two categories: (i) **brokers,** and (ii) **tarawaniwalas. A** member who acts both as a broker and a jobber is known as 'Tarawaniwala'. In India most members fall in this category.

Check your Progress B

1 You want to buy 100 scrips of Gama Ltd. State the various stages through which you have to proceed for the purpose.

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2 What is the difference between Spot Delivery Contract and Ready Delivery Contract?

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3 What is a Forward Delivery Contract?

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4 State whether the following statements are True or False.

i) Stock exchange provides liquidity to investment.

ii) Fluctuations in the value of securities reflect the economic and business conditions in the country.

iii) Stock exchange does not lead to excessive speculation.

iv) Buying of securities in one market where price is lower and selling the same in another market where the price is higher is called arbitrage operation.

v) Stock exchanges facilitate capital formation in the country.

5 Fill in the blanks.

i) A person who buys securities in the expectation of a rise in the price is called ....

ii) Ready delivery contracts are settled within .... days of the transaction.

iii) If the settlement is deferred at the request of the seller, the budla charges he pays is called ....

iv) Artificial forcing up of the market price of a particular share is called ....

v) Scrips are usually sold .... dividend.

7.7 LISTING OF SECURITIES ON A STOCK EXCHANGE

We have stated earlier that all securities issued by companies and other bodies are not traded in stock exchanges but only the listed securities are traded. Now, let us discuss in detail about this listing. Listing means addition of new securities to the existing list of securities being traded on a stock exchange. If a joint stock company or any other body who has issued new securities want them to be traded on the floor of stock exchange and their prices duly published, it has to get the securities included in the list of the stock exchange. For listing, the company has to make an application and furnish the prescribed information to the stock exchange. Section 19 of the Securities Contracts (Regulation) Rules 1957 lays down the minimum requirements with respect to the listing of securities on a stock exchange. **Listing implies that the securities have met the satisfaction of stock exchange authorities, in respect of certain prescribed standards of legality, security and work-manship.** When a security is admitted to dealings on a stock exchange, it does not guarantee the soundness or profitability of the company, in any manner. It is also not a certificate of the stock exchange for consideration by the investors. However, it indirectly gives an impression to the investor that the quoted security can be considered for investment, as the issuing company has satisfied the management of the stock exchange by fulfilling the required conditions and that there is no concealment. Listing provides a reasonable basis upon which the investor may assure himself about the genuineness of the company.

Advantages of Listing: The main advantage of listing of securities is that the investor gets all the required information about the securities he wants to buy or sell. Certain other advantages of listing are:

1 It provides a continuous market for securities.

2 It enhances the prestige of the company.

3 It provides an indirect check against manipulation of prices by the management.

From the point of view of a company, listing of securities is beneficial in two ways: i) it enhances credit worthiness of the company, and ii) it widens the market of the securities. From the point of view of investors, listing provides safety of dealing and liquidity.

But listing of securities of a company does not guarantee the financial soundness of a company. It also does not recommend the purchase of securities. It only **indicates that at the time of listing the company was legally incorporated and was solvent as a going concern.** This creates a favourable climate for the securities listed.

7.8 SPECULATION AND STOCK EXCHANGE

The word 'speculation' is derived from the Latin word 'speculare' which means 'to see from a distance or take a decision in anticipation of future happenings'. However, in the share market, it means dealing in securities keeping in view the present and future prices with the object of making profits from the difference of the two prices. Emery of USA has stated the meaning of speculation in the following words: "Speculation consists of buying and selling commodities, or securities, or other property, in the hope of a profit from anticipated changes of value" Speculative transactions are different from investment transactions. Graham, Dodd and Cottle have explained the difference between speculation and investment as follows:

"Investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculation".

You can very well understand this difference if you know the working of a stock exchange. The stock exchange provides an arrangement for the marketing of listed securities which are also called 'scrips'. The actual functioning of this market consists of buying and selling of these scrips. The buyers and sellers undertake two types of operations; one for investment and the other for speculation. Those who buy securities so as to earn a regular income from the investment are called 'genuine investors'. They get delivery of the scrips on payment of the price. Such transactions are called investment transactions. In the second type of transactions, the object is to deal in the difference of price. The buyers buy scrips with the object of selling them in future at a profit, or sell now in the expectation of buying at a lower price in future. They are known as speculators and their transactions are known as speculative transactions.

Speculation and Investment: Even though speculation and investment are different in some respects, in practice it is very difficult to say who is a genuine investor and who is a pure speculator. Buyers and sellers are partly speculators and partly investors. There is a difference of degree only, Let us take the following example. A buyer agrees to purchase 100 shares at Rs. 110 per share. On the settlement date, the price goes up to Rs. 120 per share. The buyer may either ask the seller to deliver 100 shares and pay him at the rate of Rs. 110 and complete the transaction, or ask the seller to pay the difference of the two prices i.e. the price prevailing on the date of transaction (Rs.110) and the price prevailing on the date of settlement (Rs.120). If he insists on the delivery of shares, we may call it an investment transaction. But, if he settles the transaction by taking up the difference of Rs. 10 per share, it will be called a speculative transaction. Sometimes, a person who purchased shares with the intention of investment may decide to sell the shares and reap the benefit if the price of shares goes up very high. On the other hand, if the price declines very low, he may decide to sell to avoid heavier loss. Thus, a genuine investor may also think of buying and selling securities and take advantage of changes in the prices over time. But he cannot be called a speculator because his intention is to invest and not to make profit out of changing prices.

Speculation and Gambling: One may be inclined to think that speculation and gambling are synonymous. No doubt, speculation and gambling have some common features. For instance, both depend upon uncertain happenings of the future, both involve risk of loss, and both lead to gain for someone and loss for another. In spite of these similarities, however, we can make the following distinctions.

1 Speculation is based on foresight while gambling does not involve use of foresight.

2 In speculation the intention is to gain from difference in prices while gambling is purely based on betting, either winning the bet or losing it.

3 The risk of loss is assumed and anticipated in speculation while gambling artificially creates risk of loss.

4 Speculation is a rational activity, based on reasoning while gambling is a kind of blind or reckless activity.

5 Speculation is a recognised activity, while gambling is a punishable act.

7.9 FACTORS AFFECTING PRICES IN A STOCK EXCHANGE

The prices of securities, particularly those of equity shares, sometimes fluctuate very widely and critically. The changes in price take place mainly because of buying and selling activities of speculators. But underlying their speculative dealings, there are one or more other factors responsible for the price fluctuations. Generally speaking, the fluctuations are due to the following factors.

1 Interest rate: If there is a change in the rate of interest charged by banks on loans and overdrafts, there is a change in the speculative activities, and security prices also change as a consequence of it. Thus, if banks allow credit at lower interest rate, it may induce people to borrow money from banks and engage more in speculative activities to make profits. Hence, price of securities may go up as a result of speculative buying. However, if the interest on bank credit goes up, borrowing will be reduced and demand for securities will be relatively lower. Hence prices of securities will tend to go down.

2 Activities **of** the financial institutions: When financial institutions start buying securities on a large scale, prices tend to move up because it leads to high expectation among the public about the prospects of the company and there is increased demand all around. Similarly, if there is large scale selling of securities by financial institutions, the price tends to go down.

3 Performance **of** the company: The prospects of a company as regards future profits and dividend payment are often reflected in the rising or falling prices of its shares. This is because the profit earning capacity and expected dividend rates influence the expectations of investors about the rate of return on investment and future rise in prices. If the prospects are good, there is increased demand for shares, and prices move up. On the contrary, if a company's performance in terms of profit earning and dividend payment shows an unsatisfactory trend, the price of its shares start declining due to reduced demand.

4 **Business** cycles: Business conditions are periodically found to be subject to prosperity and depression. Prices of securities continue to rise during prosperity as bull speculators are active and go on purchasing securities. However, when speculators are unable to meet their liabilities due to lack of adequate funds, they are forced to bargain for sale as a result of which prices rapidly decline and cause a state of depression in the market.

5 Changes in **Board** of Directors: Sometimes, security prices change as a result of changes in the Board of Directors of particular companies. The death or resignation of a well known director may cause doubt or apprehension about the future prospects of the company concerned. In that situation, generally, there would be an adverse effect on the price of shares of that company.

6 **Sympathetic** fluctuation: The prices of securities traded in more than one stock exchange often change due to changes in another exchange. If the prices of some securities fall in one stock exchange due to some particular reason, it leads to a decline in the prices of the same securities in other exchanges too. This happens due to immediate communication among speculators.

7 Political events: Changes in the composition of government, changes in international relations, conflicts and political upheavals and wars between nations are always found to cause changes in the securities prices. This is because conditions of business and industry are generally affected by political events.

8 Changes in government policy: The changes in government policy with regard to taxation, import-export, price controls, licensing, etc. also influence the prices of securities, For example, if government decides to exempt dividends from income tax, the share prices will go up. If, on the other hand, government decides to raise income tax rates on company profits, the prices may fall. In fact, these days the policy changes by the government have become a major cause for an upswing or a downswing in prices of shares.

9 **Miscellaneous** factors: Various factors which may not be directly related with stock exchanges also affect prices of securities due to the psychological reaction of speculators. For example, unexpected changes in weather conditions, inadequate or excessive rainfall (which affects agricultural output), may bring about changes in the prices of shares of companies manufacturing fertilisers, edible oils, cotton textiles, etc. Similarly, lockout for a prolonged period may cause prices of shares to decline or illness of a powerful head of government may cause fall in security prices.

~hec Your Progress C

1 Why is listing of securities necessary?

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2 What is speculation?

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3 State whether each of the following statements is True or False.

i) Speculation is the same as gambling.

ii) It is normally difficult to distinguish between a speculative transaction and an investment transaction.

iii) In speculative transaction the intention is to gain from difference in prices.

iv) Speculation helps in establishing uniform prices of scrips in different stock exchanges.

v) Excessive speculation is not harmful.

vi) Listing of securities on a stock exchange guarantees that the company is financially sound.

vii) Listing of a security implies that the security has met the requirements of the stock exchange authorities.

viii) If a company's profits and the dividend rate are satisfactory, the prices of its shares will have a falling trend..

ix) Any security can be treated at the stock exchange.

4 Fill in the blanks.

i) Listing of security means addition of .... security to the list of secutities traded on a stock exchange.

ii) Listing of security provides a .... market for the security.

iii) If bear speculators are active, security prices have a tendency to go ....

iv) If interest on bank loan .... the prices of securities tend to go down.

7.10 ADVANTAGES AND SHORTCOMINGS

7.10.1 Advantages

Having discussed the functions of stock exchanges, we may outline their advantages from the point of view of:

1 Companies
2 Investors
3 Society as a whole

From the Companies' Point of View

i) **Increase in the credit and goodwill of the company:** Every company is not allowed to have its shares traded on the stock exchange. Permission is to be obtained by the company for getting its shares included in the list of securities to be bought and sold on the floor of the stock exchange. Before granting the permission, stock exchange authorities check whether the company is financially sound and managed by qualified people. Therefore, companies whose securities are listed are supposed to be sound companies. They enjoy better goodwill and credit in the market as compared with other companies.

ii) **Extensive markets:** The securities issued by companies and other corporate bodies are quoted on the stock exchanges and are traded on the floor of the exchanges. This increases the marketability of the securities. Investors all over the world come to know about the securities and get an opportunity to invest in such securities.

iii) **Increase in the value of securities:** As investors all over the world come to know about the availability of certain securities, the value of securities increases as a result of higher demand.

iy) **Knowledge about investment to the company:** The companies come to know from stock exchange quotations fluctuations in the price of securities as well as the intensity of buyers' demand. While planning for raising additional capital, proper decisions can be taken whether to issue shares or debentures and about the terms of issue.

From the Investor's Point of View

i) **Facility of investment:** The stock exchange provides facility of investment to the investors. Liquidity as well as safety of investment in securities are assured through the mechanism of stock exchange. Investors can buy and sell securities on the floor of stock exchange as and when they want to do so.

ii) **Protection of investors' interest:** Stock exchanges are well organised markets and are regulated under the Securities Contracts (Regulation) Act, 1956. Thus, they work under the control of the Central Government. Hence, the interest of the buyers and sellers of securities is safeguarded and protected.

iii) **Publication of quotations:** All the stock exchanges regularly publish the prices quoted for securities on the floor. This facilitates buyers as well as sellers in getting information of the prices of securities, which in turn helps them to decide whether to purchase or sell.

iv) **High collateral value:** Listed securities are preferred by banks and creditors as collateral against losses, since they can easily sell such securities in case of default of borrowers and debtors who have pledged these securities with them.

v) **Best possible use of capital:** Stock exchanges provide opportunities to the investors to compare the relative demands of different securities on the basis of sale and purchase of those securities. Consequently, the profitable companies attract more investors and get an edge over the less profitable ones. Thus, the investors are able to invest their savings in more profitable companies.

From the Point of View of Society as a Whole

If we look at the operations of a stock exchange from the point of view of society as a whole, its usefulness may be found in the role it plays in creating congenial environment for savings and investment.

i) **Facilitates capital formation:** The existence of stock exchange induces people to save as it provides avenues of investment and facilitates buying and selling of securities without difficulty. This leads to increased capital formation in the country, i.e., savings become productive capital.

ii) **Promotes industrial growth:** Long-term capital for large industrial firms can be procured by companies as savings become available for investment with the organised markets facilitating purchase and sale of securities. Promotion and expansion of industrial units in turn contribute to the industrial growth of the economy. The buying and selling of securities in stock exchanges take place not only among investors from within the country but also among foreign investors. The existence of stock exchange encourages flow of capital from abroad, and thus adds to the growth of industries.

iii) **Proper use of capital:** Investors are generally attracted towards the more profitable and growing industrial units. Since stock exchanges facilitate investments to be withdrawn from the less profitable and loss making companies (by sale of securities) and invested in more profitable undertakings, the financial resources are put to proper use and the economy as a whole benefits from it.

iv) **Reduces fluctuation of security prices:** When particular securities are purchased in anticipation of future rise in price, the existing low prices tend to go up. On the other hand, selling in anticipation of futuredecline in price leads to the existing high prices being checked. Thus, wide fluctuations in the prices of securities are prevented due to regular dealings in securities.

v) **Facilitates government borrowing:** Government securities which are issued by the Reserve Bank of India can also be bought and sold on the floor of stock exchanges. Investors who subscribe to the issue of government securities find it convenient to hold them as long as they want and also to sell them easily without loss due to the existence of stock exchanges. Hence governments depend a great deal on stock exchanges while raising loans.

7.10.2 Shortcomings

So far we have discussed how beneficial the stock exchanges are from the point of view of companies, the investors and the society as a whole. But, like other institutions, stock exchanges too are not free from limitations. If operations on stock exchanges are not controlled, they may be harmful to companies as well as investors, Let us, therefore, examine the shortcomings of the stock exchanges.

Briefly, the shortcomings of stock exchanges arise out of brokers' and jobbers' tendency to engage in speculative buying and selling of securities without legitimate reasons. This causes severe fluctuations in the security prices.

Excessive speculation: It is one of the common evils associated with stock exchange operations. Speculation implies buying or selling securities in anticipation of future prices. Speculators generally deal in securities with the main objective of gaining from the difference in prices. They do not have the intention of paying for the securities or taking delivery of securities if they are speculative buyers. Prices go up just because they make bids to buy. On the other hand, speculative sellers do not possess the securities, nor do they intend to receive payment and deliver securities. But, their bids to sell pushes prices down. When there is no genuine reason for prices to move up, high prices may suddenly crash if buyers are required to pay for the securities which they cannot generally do for lack of funds. Similarly, if the sellers are required to deliver securities they may not be able to do so. This kind of situation does not permit real investors to rely on the changes in securities prices as an index of the future prospects of a company.

Wide fluctuations in prices: Another shortcoming of stock exchange operations is that security prices may fluctuate due to unpredictable political, social and economic factors as well as due to rumours which may be spread by interested parties. Sudden changes in social, economic and political factors are not easily predictable. Speculators with knowledge and skill normally help to reduce price fluctuations. But when rumours are spread by speculators only to raise or reduce prices of particular securities for their own profit, there is excessive rise or fall of prices, and genuine investors are unable to decide whether to buy or sell. Many of them get panicky when prices of securities steeply decline. Others buy in haste just because prices are rising. In both cases, the investors may repent for selling or buying securities which may lead to losses.

7.11 REGULATION AND CONTROL OF STOCK EXCHANGES

We have discussed earlier the importance, functions and working of stock exchanges. They play an important role in the capital formation and industrial growth of the country. The members of the stock exchange, brokers, investors and speculators are the people who engage in stock market operations. All these people derive advantages from the working of the market. However, stock markets suffered from a number of evils in the past and were regarded as gambling dens of the brokers.

The attention of the Government was drawn from time to time to the ills of stock markets as a result of which the Securities Contracts (Regulation) Act, was passed in 1956 to regulate and control stock market operations in the wider interests of the financial markets, institutions and the public. The main provisions of this Act are as follows:

1 There shall be only one recognised stock exchange in one region. This will have a unitary control.

2 Dealers and brokers outside the area of the recognised stock exchange will be licensed.

3 A recognised stock exchange shall be entitled to frame its own bye-laws for regulation and control of contracts subject to the approval of the Central Government. The bye-laws may regulate (i) opening and closing of market; (ii) regulation of trading hours; (iii) establishment of clearing house; (iv) regulation of prohibition of blank transfer (now these are regulated by the Companies Act); (v) listing of securities on the stock exchange; (vi) regulation or prohibition of carry over or budla system; (vii) limitations on the volume of trading by members and on their open positions; (viii) fixing minimum and maximum prices for securities in emergencies; and (ix) separation of functions of jobbers and brokers and regulation of tarawani (jobbing) business.

4 The Central Government is empowered to make and amend bye-laws after consulting the governing bodies of these exchanges.

5 Dealings in future are prohibited, since they are regarded as gambling contracts.

6 The Central Government has a right to withdraw recognition to, or supersede, the governing body of the exchange in, abnormal situations.

7 A recognised stock exchange must submit periodical returns relating to its affairs and give information as required by the Government from time to time.

8 Central Government has wide powers relating to the listing of securities. It can compel any public limited company to list its securities. It can vary or set aside the refusal of a stock exchange to list securities on an appeal made by a company.

The Government of India has recently set up a high-power body known as the Securities Exchange Board of India which will provide necessary guidance for the healthy and orderly development of securities markets which will instil confidence among the investors and provide adequate protection to them.

Check Your Progress D

1 State whether the following statements are True or False.

i) Stock exchanges increase the credit and goodwill of a company.

ii) Stock exchange ensures safety to dealings in securities.

iii) Stock exchanges are regulated under the Companies Act, 1956.

iv) Dealings in future transactions in securities are not permitted in stock exchanges in India.

2 Tick mark the correct answer.

a) Stock exchanges facilitate buying and selling of securities as a

i) local market. ( )
ii) provincial market. ( )
iii) national market. ( )
iv) international market. ( )

b) Stock exchanges serve the need of
i) companies which need capital. ( )
ii) persons who want to invest. ( )
iii) society which wants to improve. ( )
iv) all the above ( )

c) Stock exchange operations lead to
i) wide fluctuations in prices. ( )
ii) normalisation of prices. ( )
iii) both (i) and (ii) ( )
iv) none of the above ( )

d) Stock exchanges come under the purview of
i) central government. ( )
ii) state government. ( )
iii) local municipality. ( )
iv) none of the above ( )

e) Stock exchanges facilitate
i) purchase and sale of securities. ( )
ii) speculation in securities. ( )
iii) gambling in securities. ( )
iv) all of them ( )

7.12 LET US SUM UP

Stock exchange is an important part of capital market. It means a market place for buying and selling of securities already issued by joint stock companies, public trusts, central and state governments and local authorities. It is an organised market controlled and recognised by the Central Government under the Securities Contracts (Regulation) Act, 1956. The members are entitled to deal in securities either on their own or through their agents (authorised clerks). All transactions on the floor of a stock exchange are regulated by the rules and bye-laws of the concerned stock exchange. The stock exchange provides avenues for savings to be invested not only at the national level but sometimes at international level. Stock exchanges not only provide liquidity and safety to the investor, but also provide capital to the industrial units and thus assist the industrial growth of the country.

To make a deal on the floor of a stock exchange, you have to contact a broker, seek his advice and place an order with him. Three types of transactions are generally undertaken in the stock exchange: i) spot delivery transactions, ii) ready delivery transactions, and iii) forward delivery transactions.

Bulls, Bears and Stags are three types of dealers who operate in the stock exchange. Bulls are those who expect price of securities to rise. Bears expect securities prices to fall in future. Stags deal in new securities issued by companies. They apply for a large number of securities and sell them soon after they are allotted to them. Certain terms used in the dealings on stock exchange have their special meaning. Examples of such terms are contango, backwardation, cornering, arbitrage, etc.

All securities of every company are not quoted on stock exchanges. The company has to take permission from the concerned stock exchange for getting its securities quoted. Such permission is termed as Listing of Securities and is granted only after the company fulfilled the requirements.

It is said that stock exchange encourages speculation and leads to fluctuations in the prices of securities quoted on its floor. But speculation also has its advantages. It equalises and normalises price fluctuations, apart from mobilising capital and widening the market of the securities. There are various factors which influence the prices on the stock exchange such as the financial position of the companies, speculative pressures, business cycles, political events and the activities of the financial institutions, etc.

Stock exchanges have several important economic functions and are advantageous to investors, companies and the society at large. Due to several malpractices in the working of these stock exchanges, the Central Government had to enact the Securities Contracts (Regulation) Act in 1956. Since then the stock exchanges have to get recognition from the Central Government and work under its control. They have also to frame their rules and bye-laws.

7.13 KEY WORDS

Arbitrage: Buying in one market where the price is low and selling it in another market where the price is comparatively high.

Authorised Clerk: An employee of the broker who is authorised to transact business at the stock exchange on behalf of the broker.

Backwardation: Budla charges paid by the seller (bear) for the postponement of transactions to the next settlement date.

Bears: Speculators who anticipate fall in prices in future and so they sell securities in the present to buy them in the future when the prices fall.

Badla Charges: Charges paid for the postponement of transactions to the next settlement date.

Bulls: Speculators who anticipate rise in the price of securities in future and so they buy securities in the present to sell them in future when the prices rise.

Carry Over: Postponing the settlement of a transaction to the next settlement day on payment of badla charges.

Contango: Badla charges paid by the buyer (bull) for the postponement of transactions to the next settlement date.

Contract Note: **A** statement sent by the broker to a client showing details of securities (including price) bought or sold on behalf of the client.

Cum-div: When the shares are quoted cum-div, the buyer gets a right to receive the dividend on such shares, payable or declared after the sale of such securities.

Ex-div: When the shares are quoted ex-div, the buyer is not entitled to receive the dividend to be declared or payable after the sale of such shares.

Forward Delivery Contract: A contract for purchase or sale of securities the settlement of which can be postponed to the next settlement day.

Jobber: A member of a stock exchange who buys and sells securities in his own name.

Margin: A deposit made by the customer with the broker to cover the anticipated loss.

Ready Delivery: A contract settled within seven days of the transaction i.e., on the settlement day fixed by the stock exchange.

Remisier: **A** person who helps in securing business for the broker.

Sauda Bahi: A note book used by brokers for daily record of purchases and sales of securities made on the floor of the stock exchange.

Scrips: Securities like shares, debentures, bonds, etc.

Settlement **Day:** The day fixed for the settlement of transactions on a stock exchange.

Speculation: Dealings in securities with the object of making profit from the difference in prices.

Spot Delivery: Contract settled on the same day on which the transaction takes place.

Stags: Speculators having bullish tendency, who apply in bulk for new issues of securities and sell them in the market soon after the allotment is made to them.

Stock or Securities Market: An organised market place on the floor of which securities are bought and sold.

Tarawaniwala: A member of the stock exchange who acts as a broker as well as a jobber.

7.14 SOME USEFUL BOOKS

Bhushan, Y.K. 1987. *Fundamentals of Business Organisation & Management*, Sultan Chand & Sons: New Delhi. (Part Eight, Chapter 4).

Ramesh, M.S. 1985. *Principles & Practice of Modern Business Organisation, Administration & Management,* Kalyani Publishers: New Delhi. (Volume III, Chapter 17).

Singh, B.P., and T.N. Chhabra, 1988. *Business Organisation* and *Management,* Kitab Mahal: Allahabad. (Section Five, Chapter 19).

Sohni, S.K. 1985. *Stock Exchanges in India—Practices Problems Prospects,* North Publishing Corporation: Delhi.

7.15 ANSWERS TO CHECK YOUR PROGRESS

A 1 a) iii b) iv c) iii

B 4 i) True ii) True iii) False iv) True v) True

5 i) bull ii) 7 iii) backwardation iv) rigging v) cum

C 3 i) False ii) True iii) True iv) True v) False vi) False vii) True viii) False ix) False

4 i) new ii) continuous iii) down iv) rises/increases

D 1 i) True ii) True iii) False iv) True

2 a) iii b) iv c) iii d) i e) i

7.16 TERMINAL QUESTIONS

1 Define a stock exchange and explain fully its economic functions.

2 Explain briefly the importance of stock exchange in a modern society. What are its shortcomings?

3 Why is the stock exchange called a barometer of the economic and business conditions in a country?

4 Explain the following terms used in connection with dealings of securities.
i) Arbitrage ii) Forward Delivery Contracts iii) Bull iv) Rigging v) Contango vi) Cum-dividend vii) Margin Trading viii) Authorised Clerk.

5 Why do prices of securities traded on a stock exchange fluctuate widely and frequently'? Discuss tlie causes briefly.

6 What do you mean by listing? State briefly the advantages of listing securities on a stock exchange from the point of view of a company and an investor.

7 Describe the method of trading on a stock exchange. State tlie procedure to be followed if you decide to sell *500* shares of a conipany which you hold. The shares were allotted to you at par value of Rs. 10 each.

8 What were the reasons of passing the Securities Contract (Regulation) Act, 1956? State its main features.

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not send your answers to the university. These are for your practice.

APPENDIX TO
UNIT 6: SOURCES OF LONG-TERM FINANCE AND UNDERWRITING

Ever since the Government of India initiated the economic liberlisation programme in 1991, there are several developments in capital market. Hence there is a need to revise this unit to incorporate all such changes. Some of the major developments in the capital market which are relevant to you are discussed in this Appendix.

In Section **6.3.1** Capital Market of this Unit, the discussion on Control of Capital Issues (pages 26 & 27) is to be deleted. This delition is necessary in view of the abolition of the Controller of Capital Issues in June 1992.

In section **6.3.4** Foreign Sources (Page 31) we have discussed three main foreign sources viz., foreign collaborators, international financial institutions and non-resident Indians, as sources of long-term finance. In this context you have to add International Capital Market as the fourth source. From 1992 onwards Government of India permitted Indian companies to raise capital in the international capital markets in the form of Global Depository Receipts (GDRs) and Bonds. This is briefly stated under point 12 of Capital Market Reforms discussed below.

CAPITAL MARKET REFORMS

The Government of India initiated several capital market reforms, as part of economic reforms programme started in June 1991. The capital market reforms programme of the government is mainly aimed at protecting investors' interest, improving market efficiency, making stock market transactions more transparent, curbing unfair trade practices, and bringing Indian capital market upto international standards. The main aspects of capital market reforms are listed below:

1. **Abolition of** Controller of Capital Issues : Capital Issues (Control) Act 1947 was repealed and the office of the Controller of Capital Issues (CCI) was abolished in June 1992. Thus, all the controls over price and premium of shares were removed. Companies are now free to approach capital market whenever they want and fix the premium on shares as they wish, after getting clearance from Securities Exchange Board of India (SEBI).

2. Statutory Recognition to SEBI: Statutory recognition was granted to the Securities Exchange Board of India (SEBI) in February 1992 to regulate and reform the capital market in India. SEBI has been vested with powers concerning various aspects of the capital market such as (a) regulating the stock exchanges, various intermediaries and mutual funds, (b) promoting investor's education and training of intermediaries and (c) prohibiting insider trading, fraudulent and unfair trade practices in the securities market. SEBI initiated several measures in this direction.

3. Measures in the Primary Market: New reforms by SEBI in the primary market included improved disclosure standards in the public issue documents, introduction of prudential norms and simplifications of issue procedures. Companies are now required to disclose all material facts and specific risk factors associated with their projects while making public issues. All the issue documents are to be compulsorily vetted by SEBI to ensure that the disclosures are not only adequate but also authentic and accurate, so that the investors in the primary market are able to take informed investment decisions.

   'Merchant Banker' and 'Banker to the Issue' are brought under the regulatory frame work of SEBl and a code of conduct issued.

   The due diligence certificate by lead managers regarding the disclosures made in the offer document has been made a part of the offer document itself for better accountability and ttansparancy on the part of the lead managers.

   SEBI introduced a code of advertisement for public issues for ensuring fair and truthful disclosures. To reduce cost of issue, underwriting of issues is made optional. However, this is subject to the condition that if an issue was not underwritten and was not able to collect 90 per cent of the amount offered to public, the entire amount collected would be refunded to the investors.