Sources of Finance (Share and Debenture)
(Fixed Income and Variable Income Securities)

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Sources of Finance

Based on the source of generation, the sources of finance can be classified as external and internal sources.

External Sources of Finance

External sources of finance refer to the cash flows generated from outside sources of the organization, whether from private means or from the financial market. In external financing, the funds are arranged from the sources outside the business. It includes Shares, Debentures, Bonds, Public Deposits, Loan from banks, Financial Institutions Loan's, Lease financing, Commercial paper, Trade Credit and Factoring etc.

Internal Sources of Finance

In business, internal sources of finance delineate the funds raised from existing assets and day to day operations of the concern. It aims at increasing the cash generated from regular business activities. It includes Retained Earnings (Ploughing Back of Profits), Reserve & Surplus, Bonus Share Sale of Stock and Sale of Fixed Assets etc.

Comparison Chart

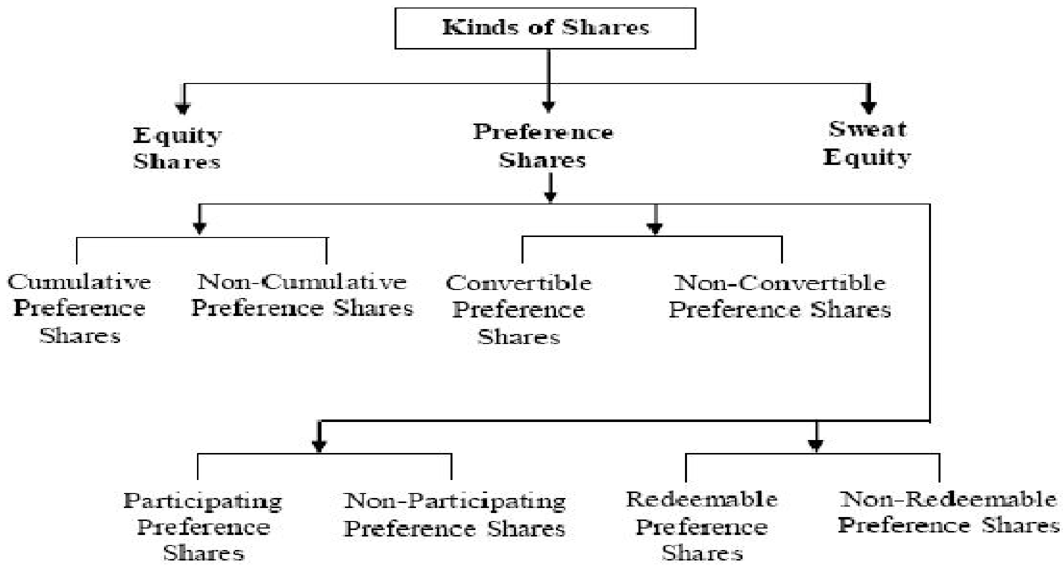
Basis for Comparison	**Internal Sources of Finance**	**External Sources of Finance**
Meaning	An internal source of finance implies to the sources of business finance that are generated within the business, from the existing assets or activities.	An external source of finance implies the arrangement of capital or funds from sources outside the business.
Includes	Sale of Stock, Sale of Fixed Assets, Retained Earnings, Reserve & Surplus and Bonus Share	Share, Debenture, Financial Institutions, Loan from banks, Debenture, Public Deposits, Lease financing, Commercial paper, Trade Credit, Factoring.
Cost	Low	High
Collateral	Not required	Sometimes required.
Amount raised	Comparatively less	Huge

Share/Stock

The capital of a company is divided into different units called Shares. A share is the movable property of a shareholder and he has a liberty to transfer his share in the manner prescribed by the Articles of the Company. Its distinct number distinguishes each share of a company.

Section 2(84) of the Companies Act, 2013, defines the shares as “Share means a share in the share capital of company including stocks.

According to Justice Farwel, “A share is the interest of a shareholder in the company measured by a sum of money, for the purpose of liability in the first place and of interest in the second, but also consisting of mutual covenants entered into by all the shareholders in terms of the act and the articles”.



Equity Shares/Common Stock (Variable Income Security)

Equity shares are also known as ordinary shares/stock or common shares/stock. Equity shareholders are the real owners of the company as they have the voting rights and enjoy decision- making authority on important matters, related to the company. The shareholders’ return is in the form of dividend, which is dependent on the profits of the company and capital gain/loss, at the time of their sale. They enjoy higher returns if the company performs well and may not get any dividend, at all, if the company does not do well or when the Board of Directors do not recommend any dividend for payment. Therefore, equity shares are known as ‘variable income security’. They are the last one to get repayment in the event of liquidation of the company.

Features of Equity Shares

1) **Maturity:** Equity shares provide permanent capital to the company, which is not under contractual obligation to refund it during its lifetime. Shareholders can demand their capital only if the event of liquidation and that too when funds are left after covering all prior claims.
2) **Claims on Income:** Equity shareholders are residual owners whose claim on income arises only when claims of creditors and preferred stock-owners are met. In many instances, residual owners do not get anything if income of the firm was just sufficient to satisfy the claim of creditors. In actual practice amount of dividend payment to equity shareholders depends essentially on earning position of the firm.
3) **Cost of Equity:** The cost of equity capital is higher than any other long-term source of finance. Firstly, since the equity dividends are not tax-deductible expenses as the interest is, and secondly the high cost of issue and the risk factor associated with it makes the cost of equity higher.
4) **Claims on Asset:** Being residual owners, equity shareholders are the last claimants to assets of the firm. In the event of winding up of the firm's business assets, are disposed off to satisfy the claims of the creditors and also preferred stockholders prior to equity stockholders.

5) **Control:** The risk of loss associated with equity share is compensated to some extent by controlling power that rests with residual owners. Equity shareholders have unchallenged voice in management. Whatever control the stockholders retain is exercised primarily through the voting privilege. Every equity shareholders has the right to vote on every resolution placed before the company and his voting right on a poll is in proportions to this share of paid -up capital of the company.
6) **Pre-emptive Right:** The pre-emptive right protects equity shareholders by ensuring that management cannot issue additional shares to person of their choice in order to strengthen their control over the company. It also protects them from dilution of their financial interest in the company.

Advantages of Equity Shares

1) **Advantages to Investors:** It includes:
   i) **Capital Profit:** In the case of progress and profit to the company the market value of the share increases. In this case the shareholders can sell the shares at higher prices to get the capital gains.
   ii) **Interest in the Company's Activities:** Equity shareholders are the owners of the company. They take a lot of interest in the company's affairs.
   iii) **Best for Investment:** The person who enjoys to take risks for them investment in equity share is good investment.
   iv) **More Income:** Dividend in the case of equity shares is not fixed. It depends on the profits generated by the company. If the company is progressive then it can be a good source of income to investors.
   v) **Right to Interfere in Management:** Equity shareholders have the right to participate in management. They can take part in the general meetings with voting rights. They elect the board of directors.

2) **Advantage to Company:** It includes:
   i) **No-Fixed Burden of Dividend:** The dividend on equity shares is not fixed. It depends on the profits generated. Dividends are not the burden as in the case of fixed preference share.
   ii) **No Outflow of Cash:** It is a permanent source of capital. The company need not have any fear of redemption with the outflow of cash. These funds are available as long as the company does not go into liquidation.
   iii) **Bear the Risk:** Money from equity shares takes the risk of the company. It is a defence wall for the company. When the long term finances are raised the company likes to take the risk for increasing the profitability.
   iv) **Simple and Cheap Source:** Issuing of equity shares is a simple and cheap source of getting long term finance. Issuing of equity shares reduces the necessity of taking the long term finances from institutions as debt.
   v) **Increase in Debt Capacity:** The money from the equity shareholders is helpful to give guarantee to the institutions from which the firm wants to take debt.
   vi) **Availability of Fixed Capital:** By issuing the equity share the company fulfills the long term financial needs. The finance from this source is issued to purchase the fixed assets.

Disadvantages of Equity Shares

1) **Disadvantages to Investors:** It includes:
   i) **Uncertainty of Income:** It is not obligatory on the part of the management to pay dividend even in the case of huge profits, management can retain all of its earnings for company's expansion or diversification.
   ii) **Irregular Income:** Payment of the dividend is dependent at the profits of the company. Many times when these are merge profits the dividends are very less.
   iii) **Capital Loss:** At the time of reduction of share prices it is not in the favor of investors to sell the shares. If one shareholder has the urgency to sell his shares then he has to incur capital loss.
   iv) **Less Attractive to Modest Investors:** Those investors who want regular and consistent income

on their investment, the investment in equity shares is not very attractive.

v) **Loss in the Case of Liquidation:** In the case of liquidation of the company, the company first pays all of its liabilities. After then the remaining part is distributed to preference shareholders in proportion. After that if any thing remains, it is distributed to shareholders. In this way the equity shares get the part in the company's assets in the cost.

2) **Disadvantages to Company:** It includes:

i) **Difficult to Remove Over Capitalization:** In the condition of over capitalization it is very difficult to reduce in the number of equity shares.

ii) **Centralization of Control:** Equity shares are transferable so few people can take the control of the company by purchasing the substantial number of shares. In this way the management of the company can go in the hands of few people.

iii) **Change in Management Policy:** Due to sale purchase of equity share the holder changes. Many times due to the change in shareholders the management of the company also changes. It changes the policy of the management.

iv) **Speculation:** Due to high risk, there is a lot of speculation which can artificially increase the value of the shares.

Preference Share/Preferred Stock (Fixed Income Security)

Preference capital represents a hybrid form of financing – it takes some characteristics of equity share and some attributes of debentures. The preference shareholders enjoy preferential rights with regard to receiving dividends and getting back capital in case the company winds-up.

Preference shares are shares having preferential rights to claim dividends during the lifetime of the company and to claim repayment of capital on wind up. In case of preference shares, the percentage of dividend is fixed i.e. the holders get the fixed dividend before any dividend is paid to other classes of shareholders.

Features of Preference Shares

1) **Accumulation of Dividends:** Preference shares may be cumulative or non-cumulative with respect to dividends. Barring a few exceptions, preference shares in India carry a cumulative feature with respect to dividends. The unpaid dividends on cumulative preference shares are carried forward and payable when the dividend is resumed.
2) **Call-ability:** The terms of preference share issue may contain a call feature by which the issuing company enjoys the right to call the preference shares, wholly or partly, at a certain price.
3) **Convertibility:** Preference shares may sometimes be convertible into equity shares. The holders of convertible preference shares enjoy the option of converting preference shares into equity shares at a certain ratio during a specified period.
4) **Redeemability:** Preference shares may be perpetual or redeemable. A perpetual preference share has no maturity period, whereas a redeemable preference share has a limited life after which it is supposed to be retired.
5) **Participation in Surplus Profits and Assets:** Companies may issue participating preference shares which entitle preference shareholders to participate in surplus profits (profits left after preference dividend and equity dividend at certain rates) .

Types of Preferences Shares

1) **Cumulative Preference Shares:** These shares have a right to claim dividend for those years also for which there are no profits. Whenever there are divisible profits, cumulative preference shares are paid dividend for all the previous years in which dividend could be not declared.
2) **Non-Cumulative Preference Shares:** The holder of these shares has no claim for the arrears of dividend. They are paid a dividend if there are sufficient profits. They cannot claim arrears of dividend in subsequent years.

3) **Redeemable Preference Shares:** The company, however, can issue redeemable preference shares if articles of association allow such an issue. The company has right to return redeemable preference share capital after a certain period.
4) **Irredeemable Preference Shares:** Those shares, which cannot be redeemed unless the company is liquidated, are known as irredeemable preference shares.
5) **Convertible Preference Shares:** The holders of these shares may be given right to convert their holdings into equity shares after a specific period. These are called convertible preference shares. The articles of association must authorize the right of conversion.
6) **Non-Convertible Preference Shares:** The shares that cannot be converted into equity shares are known as non-convertible preference shares.
7) **Participating Preference Shares:** The holders of these shares participate in surplus profits of the company. They are firstly paid a fixed rate of dividend and then a reasonable rate of dividend is paid on equity shares. If some profits remain after paying both these dividends, then preference shareholders participate in the surplus profits.
8) **Non-Participating Preference Shares:** The shares on which only a fixed rate of dividend is paid are known as non-participating preference shares. These shares do not carry the additional right of sharing of profits of the company.

Advantages of Preference Shares

The advantages of preference shares can be grouped under two categories:

1) **Advantages to Investors:** These include:
   i) **Priority in Re-payment of Capital:** Preference shareholders get the priority of repayment of capital as compared to equity shareholders.
   ii) **Best Security:** At the time of recession or decline profits preference shares are the best investment.
   iii) **Regular and Fixed Income:** Fixed and Regular dividend is paid on preference shares. It is a source of regular and fixed income for the investors.
   iv) **Less Risk:** Due to the preference in re-payment, dividend, the preference shareholders have less risk in the investment.
   v) **Safety of Interest:** Like the equity shareholders, preference share holders have the veto power to protect their rights.

2) **Advantages to Company:** It includes:
   i) **No Interference in Management:** Preference shareholders do not get the right to interfere in the management.
   ii) **Economical Financing:** Issuing the preference shares is cheaper than equity shares, so it is economical to get finance from this source.
   iii) **Availability of Wide Capital Market:** Non progressive and less risk taking investors prefer to invest in preference shares. In this way company gets a wide market for getting the capital.
   iv) **No Change on Assets:** For issuing these shares company need not to mortgage its assets. In this way the company doesn’t have any problem in getting the finance in the future.

Disadvantages of Preference Shares

1) **Disadvantages to Investors:** It includes:
   i) **Dividend at Fixed Rate:** In this case of non-participative preference share, the dividend is paid at a fixed rate. So they are not benefited by the progress of the business.
   ii) **Uncertain Position of Redeemable Preference Shares:** Encashment of the redeemable preference shares on the will of the company. Whenever the management wants, it can return the money giving the information.
   iii) **Limited Voting Rights:** Preference shareholders have the limited voting right. Despite being the owner of the company, they cannot participate in the management of the company.

2) **Disadvantages to Company:** It includes:
   i) **Disadvantage to Equity Shareholders:** In the case of less profit equity shareholder suffers because preference shareholders get the dividend first at a fixed rate.
   ii) **Fixed Economic Burden:** Company has to incur fixed economic burden because in the case of no profit, the company have to pay the dividend.
   iii) **High Cost of Capital:** Dividend paid to preference shareholders is not free from tax. So it is costly to raise the capital from preference shares than debentures.
   iv) **Difficult to Receive Additional Capital:** It is the provision in company law that the company want to issue new shares or debentures they have to take the permission from preference shareholders. So it becomes difficult to raise additional capital.

Differences between Equity Shares and Preference Shares

Bases of Difference	Preference Shares	Equity Shares
1) **Dividend**	Preference shareholder gets the preference in getting dividends.	Equity shareholder gets the dividend from the remaining income after paying dividends to preference shares.
2) **Share Price**	Normally the nominal value if preference shares are more than equity shares.	Nominal value of equity shares is generally less than the preference shares.
3) **Repayment of Capital**	Preference shareholders get the preference over equity shareholders in the repayment of capital in the case of liquidation.	
4) **Right of Management**	Preference shareholders don't have the right to participate in the administration and control of the company.	Equity shareholders have the right to participate and voting power in the management.
5) **Dividend Rate**	In case of preference share the dividend rate is fixed.	Dividend rate depends on profits. Normally dividend rate of equity shares is higher than preference shareholders.
6) **Redemption**	Preference share can be redeemed in the mid of the business.	Equity share can not be redeemed. They can be sold.
7) **Issue Expense**	They need more expenses as compared to equity shares are concerned.	Equity sharer is cheapest as far as issue expenses are concerned.

Debentures (Fixed Income Security)

The word 'debenture' itself is a derivation of the Latin word 'debere' which means to borrow or loan. Debentures are written instruments of debt that companies issue under their common seal. They are similar to a loan certificate. A debenture is an instrument executed by the company under its common seal acknowledging indebtedness to some person or persons to secure the sum advanced. It is thus a security issued by a company against the debt.

The term 'debenture' includes debenture stock, bonds, and any other security of a company whether constituting a charge on the assets of the company or not.

Features of Debenture

1) **Fixed Interest Rate:** Debenture holders are the creditors of the company. They are entitled to periodic payment of interest at a fixed rate.

2) **Maturity:** Debentures are repayable after a fixed period of time, say five years or seven years as per agreed terms.
3) **No Voting Rights:** Debenture holders do not carry voting rights.
4) **Secured Assets:** Ordinarily, debentures are secured. In case the company fails to pay interest on debentures or repay the principal amount, the debenture holders can recover it from the sale of the assets of the company.

Advantages of Debenture

1) **Advantages of the Company**
   i) **Lower Rate of Interest:** The rate of interest payable on debentures is not only fixed but is also usually lower than the rate of dividend paid on shares.
   ii) **Trading on Equity:** By issuing debentures, company is enabled to trade on equity as because the rate of interest on debentures is usually lower than the rate of earnings and thus the company can declare a higher rate of dividend on equity shares.
   iii) **Freedom in Management:** Debentureholders are not given any voting right to control the affairs of the company and thus the company can raise the finance without surrendering control to the debentureholders.
   iv) **Tax-benefits:** The payment of interest on debentures is charged against profits of the company as per income tax rules whereas the payment of dividend is an appropriation of profit hence not a charge against profits. The profits of the company are reduced by the amount of interest paid to debentureholders which results in reducing the tax liability.
   v) **Certainty of Finance:** Debentures are issued for a fairly long period. According to the new guidelines issued by the Government of India in 1982, the secured debentures shall not be redeemable before a period of seven years. Hence there is a certainty of finance for that specific period and the company may adjust its financial plans accordingly.
   vi) **Capital from Moderate Investors:** Company can collect the finance from such investors who prefer fixed income with minimum risk rather than an uncertain high rate of dividend on capital. Security of capital is more important for them.
   vii) **Controlling Over-Capitalization:** The state of over-capitalization can very easily be controlled by redeeming the redeemable debentures. In this way, it provides flexibility in the capital structure.
   viii) **Consolidation of Debt:** A company may consolidate its several debts of short duration by issuing debentures and thus may reduce it’s of capital.
2) **Advantages to Investors**
   i) **Fixed and Stable Income:** Debentures carry a fixed rate of interest. An investor can estimate his income well in advance. Thus debentures provide a fixed, regular and stable source of income to debenture holders.
   ii) **Safety Investment:** Debentureholders have specific or general charge on the assets of the company, so their investment is quite safe.
   iii) **Liquidity:** Debentures are more liquid investment, and have more ready market because they are safe and can be used as collateral security by the investors in raising loan from any financial institution. Under the new guidelines (1982), the ‘rights’ and secured (convertible and non-convertible) debentures shall be listed in a stock exchange.
   iv) **Fixed Maturity Period:** Many companies prefer issue of debentures because of a definite maturity period.
   v) **Conversion of Loan:** Debentureholders can convert their holding in shares at appropriate fine in case of convertible debentures.

Disadvantages of Debenture

1) **Disadvantages to Company**
   i) **Fixed Charge on Assets:** Debentures carry a fixed charge on all assets of the company hence the

company cannot raise loan on such assets again, if needed.

ii) **Fixed Burden:** Interest payable on debentures is a charge on the profits of the company. It will be paid even if there is no profit. Thus, it is a burden on the company especially when there is no a profits or inadequate profits.

iii) **Risk of Winding up:** The debentureholders have a right to claim winding up of the company, in case, the interest on debentures are and paid by the company. So, debenture issue is risky in lean period.

2) **Disadvantages to Investors**

i) **No Control:** Debentureholders are creditors and not the owners of company and hence get no controlling authority over the affairs of the company.

ii) **No Extra Profits:** Debentureholders get a fixed income as interest irrespective of the quantum of profits earned by the company. They cannot share the profits even if company earns huge amount as profits.

iii) **Uncertainty:** In case of redeemable debentures payable within a specified period, investors have uncertainty in their minds as to their redemption.

Difference between Share and Debenture

Basis of Difference	**Share**	**Debenture**
1) Capital vs. Loan	Share is a part of owned capital.	Debenture constitutes a loan.
2) Reward for Investment	Reward is the payment of dividend.	Reward is the payment of interest.
3) Fluctuations in the rate of interest and dividend	The rate of dividend may vary from year to year depending upon the profit decisions of directors and members.	The rate of interest is fixed.
4) Charge vs. Appropriation	Payment of dividend is an appropriation out of profits and this cannot be made if there is no profit.	Payment of interest is a charge against profits and is to be made even if there is no profit.
5) Payment of Interest/Dividend.	Payment of dividend gets no priority over the payment of interest.	Payment of interest gets priority over the payment of dividend.
6) Repayment of Principal	Payment of share capital is made after the repayment of debentures.	Payment of debentures is made before the payment of share capital.
7) Secured by Charge	Shares are not secured by any charge.	Debentures are usually secured by a charge.
8) Restriction on Issue	There are certain restriction on issue	No restriction is imposed on the purchase of debentures by the company.