RAMA UNIVERSITY

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FACULTY OF COMMERCE AND MANAGEMENT

COURSE: BBA III SEM.

SUBJECT: INTRODUCTION TO FINANCIAL MANAGEMENT

SUBJECT CODE: BCH 505

LECTURE: 7

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LECTURE-7

1.3 DEBTS: DEBENTURES, TYPES OF DEBENTURES

DEBENTURES: When borrowed capital is divided into equal parts, then, each part is called as a debenture. Debenture represents debt. For such debts, company pays interest at regular intervals. It represents borrowed capital and a debenture holder is the creditor of the company.

Debenture holder provides loan to the company and he has nothing to do with the management of the company.

Kinds of Debentures: A company can issue different kinds of debentures.

Registered and Bearer Debentures: This classification of debentures is made on the basis of transferability of debentures. Registered debentures are those in respect of which the names, addresses, and particulars of the holdings of debenture holders are entered in a register kept by the company. The transfer of ownership of such debentures is possible through a regular instrument of transfer which is duly signed by the transferee and the transferor. However, the transfers are freely allowed through the execution of a regular Transfer Deed. Only formal approval of the Board is necessary. Interest on such debentures is paid through interest warrants. Bearer debentures are transferable by mere delivery. They are freely negotiable instruments. The company keeps no records of the debenture- holders in the case of bearer debentures. Such debentures are similar to Share Warrants; the interest on them is paid by means of attached coupons which encashed by the holder are as and when cash falls due. On maturity, the principal sum of Bearer Debenture is paid back to the holder.

Secured and Unsecured Debentures: This classification is made on the basis of security offered to debenture-holders. Secured debentures are those which are secured by some safe charge on the property of the company. The charge or, mortgage may be “Fixed”, or, “Floating”, and thus, there may be “Fixed Mortgage Debentures”, or, “Floating Mortgage Debentures” depending upon the nature of charge under the category of Secured Debentures. Unsecured, or, Naked Debentures are those that, are secured by any charge on the assets of the company. The holders of such debentures are like ordinary creditors of the company. The general solvency of the company is the only security available to unsecured or, naked debentures.

Redeemable And Irredeemable Debentures: This classification is made on the basis of terms of repayment. Redeemable Debentures are for fixed period and they provide for payment of the principal sum on specified date, or, on demand, or, notice. Irredeemable Debentures are not issued for a fixed period. The issuing company does not fix any date by which the principal would be paid back. The holders of such debentures cannot demand payment from the company so long as it is a going concern. Such debentures are perpetual in nature as they are payable after a long time, or, on winding up of the company.

Convertible And Non- Convertible Debentures: This classification is made on the convertibility of the debentures. Convertible Debentures are those which are convertible into Equity Shares on maturity as per the terms of issue. Convertible Debentures are those which are convertible into equity shares on maturity as per the terms of issue. Convertible debentures are now popular in our India and many companies issue convertible debentures which are automatically converted into shares after a fixed period, or, date (usually, after three years). The rate of exchange of debentures into shares is also decided at the time of issue of debentures. Interest is paid on such debentures till conversion. Such debentures are popular with the investing class. Non- Convertible Debentures are not convertible into Equity Shares after some period, or, on maturity. Prior approval of the shareholders is necessary for the issue of convertible debentures. It also requires sanction of the central government. The conversion of debentures into shares particularly of profitable companies is always advantageous to debenture holders as well as to the company.

Demerits of Debentures

Interest obligatory.

High liability.

Charged against assets.

Not meant for weak firms.

Merits of Debentures

Issuing is cheap.

No dilution of control.

Best for depression periods.

1.4 INDIAN FINANCIAL SYSTEM

Savings mobilization and promotion of investment are functions of the stock and capital markets, which are a part of the organized financial system in India. The objective of all economic activity is to promote the well being and standard of living of the people, which depends on the income and distribution of income in terms of real goods and services in the economy. The production of output, which is vital to the growth process in the economy, is a function of the many inputs used in the productive process. These inputs are material inputs (in the form of physical materials, viz., raw materials, plant, machinery, etc.), human inputs (in the form of labor and enterprise) and financial inputs (in the form of capital, cash and credit). The easy availability of financial inputs promotes the growth process through proper coordination between human and material inputs.

The financial inputs emanate from the financial system, while real goods and services are part of the real system. The interaction between the real system (goods and services) and the financial system (money and capital) is necessary for the productive process. Trading in money and monetary assets constitute the activity in the financial markets and are referred to as the financial system.

Financial System: The term “liquidity” is used to refer to cash, money and nearness to cash. Money and monetary assets are traded in the financial system. Thus, provision of liquidity and trading in liquidity are the major functions of the financial system. While cash creation is the function of the RBI, banks do credit creation and financial institutions including the RBI, banks and term-leading institutions, deal in claims on money or monetary assets.

These institutions are all a part of the financial system. Sector-wise, government and business sectors are the major borrowers whose investment is always greater than savings. On the other hand, in India the household and foreign sectors are the net savers, with savings exceeding investment. The financial system provides the intermediation between investors and helps the process of specialization and sophistication in the financial infrastructure, leading to greater financial development that is prerequisite for faster economic development.

1.4.1 Functions of Financial Markets

The primary function of the financial markets is to facilitate the transfer of funds from surplus sectors (lenders) to deficit sectors (borrowers). Normally, households have excess of funds or savings, which they lend to borrowers in the corporate and public sectors whose requirement of funds, exceed their savings. A financial market consists of investors or buyers, ‘sellers, dealers and brokers and does not refer to a physical location. Formal trading rules and communication networks for originating and trading financial securities link the participants in the market. The primary market in which public issue of securities is made through a prospectus is a retail market and there is no physical location. The investors are reached by direct mailing. On the other hand, the secondary market or stock exchange where existing securities are traded is an auction market and may have a physical location such as the rotunda of the Bombay Stock Exchange or\the trading floor of Delhi, Ahmedabad and other exchanges where the exchange members meet to trade securities face- to-face. In the Over-The-Counter (OTCEI) market and National Stock Exchange, trading in securities is screen-based. The Bombay Stock Exchange (BOLT) now introduces on-line trading, and other exchanges are in the process of introducing the same that is screen-based.

Financial markets trade in money and their price is the rate of return the buyer expects the financial asset to yield. The value of financial assets changes with the investors’ expectations on earning or interest rates. Investors seek the highest return for a given level of risk (by paying the lowest price) and users of funds attempt to borrow at the lowest rate possible. The aggressive interaction, of investors and users of funds in a properly functioning capital market ensures the flow of capital to the best user. Investors receive the highest return and the users obtain funds at the lowest cost.

The three important functions of financial markets are:

Financial Markets Facilitate Price Discovery. Financial markets help in establishing the prices of financial assets. Well organized financial markets seem to be remarkably in the rate of return and other incentives, funds flow from less efficient in price discovery. That is why financial economists productive to more productive activities. The efficient functioning say: “If you want to know what is the value of a financial asset simply look at its price in the financial market”

Financial Markets Provide Liquidity to Financial Assets. Investors can readily sell their financial assets through the mechanism of financial markets. In the absence of financial markets, which provide such liquidity, the motivation of investors to hold financial assets will be considerably diminished. Thanks to negotiability and transferability of securities through the financial markets, it is possible for companies (and other entities) to raise long-term funds from investors with short-term and medium-term horizons. While one investor is substituted by another when a security is transacted, the company is assured of long-term availability of funds.

Financial Markets Considerably Reduce the Cost of Transacting. The two major costs associated with transacting are search costs and information costs. Search costs comprise explicit costs such as the expenses incurred on advertising when one wants to buy or sell an asset and implicit costs such as the effort and time one has to put in to locate a customer. Information costs refer to costs incurred in evaluating the investment merits of financial assets.