Marks : 40 Date :	SYJC March' 19 Subject : Secretarial Practice Chapter – 1 & 2	Duration: 1 hour 30 mins. Set – A Solution

Q.1. Give one word. **(5)**

1. The ratio between debt capital (fixed interest) and equity capital (variable dividend).
   Ans: - Capital Gearing.
2. A definite promise in writing from buyer for paying the amount on a specific date.
   Ans: - Bills of Exchange.
3. A bond on which no interest is paid but issued at discount.
   Ans: - Deep discount Bond.
4. The value of share which is written on the share certificate and mentioned in the Memorandum of Association.
   Ans: - Face Value on Shares.
5. A mix -up of various sources of funds in desired proportion.
   Ans: - Capital Structure.

Q.2. Fill in the blanks and rewrite the statements. **(5)**

1. The SEBI has prescribed debt - equity ratio norm of **2:1**
2. If credit policy is **Sound,** it is possible for the company to improve its cash flow.
3. Trading on equity means use of **Borrowed** capital for financing a firm
4. A **Share** is indivisible unit of share capital.
5. Overdraft facility is allowed to **Current** account holders.

Q.3. Distinguish Between. (Any One) **(5)**

1. Fixed Capital & Working Capital.

Sr. no.	Points	FIXED CAPITAL	WORKING CAPITAL
1	Meaning	Fixed capital refers to any kind of physical capital i.e. fixed assets.	Working capital refers to current assets minus current liabilities.
2	Nature	It stays in business almost permanently i.e. for more than one accounting year.	Working capital is circulating capital.
3	Purpose	It is not used up in production of product but invested in fixed assets such as land building, equipment, etc.	Working capital is invested in short term assets such as cash, account receivable, inventory, etc.
4	Sources	Fixed capital funding can come from selling shares, debentures, long term loans, bonds, etc.	Working capital can be funded with short term loans, deposits, trade credit, etc.
5	Objective of investor	Investor invests money in fixed capital hoping to make future profit.	Investor invests money in working capital for getting immediate return.
6	Risk involved	Investment in fixed capital implies a risk.	Investment in working capital is less risky.
7	Authority	Generally Top level Management decides on matters related to fixed capital Investment	Middle level or lower level managers can decide on matters related to working capital needs.
8	Factors Affecting	It depends upon such various factors such as size of	It depends upon various factors such as seasonal fluctuation,

		business nature of machinery required, expansion etc.	production cycle, requirement of cash etc.

2. Equity Shares & Preference Shares.

No.	POINTS	EQUITY SHARES	PREFERENCE SHARES
1	**Meaning**	Equity Shares are those shares, which do not enjoy preferential right in regard to payment of dividend and repayment of capital.	Preference Shares are those shares, which enjoy preferential right in regard to payment of dividend and repayment of capital.
2	**Right of Dividend**	Equity Shares receive dividend only after Preference Shares are paid fixed rate of dividend.	Preference shareholders are given preference in the payment of dividend over the Equity Shares.
3	**Rate of Dividend**	The dividend rate is not fixed. It is fluctuating. The rate of dividend depends upon the profits of the company during the year.	The dividend rate is fixed on Preference Shares. It is fixed at the time of issue of Preference Shares.
4	**Types**	There are two types of Equity Shares viz. Equity shares with normal voting rights and Equity shares with differential voting	There are eight types of Preference Shares viz. cumulative, non- cumulative participating, non-participating, redeemable, irredeemable, convertible & non-convertible.
5	**Return of Capital**	Equity Share Capital is permanent capital repaid only in the event of winding up if anything remains after paying Preference Shares.	Redeemable Preference Shares are paid after certain period. Convertible Preference Shares are converted into Equity Shares, but irredeemable Preference Shares are fixed in nature. They are paid before Equity Shares in the event of winding up.
6	**Voting Rights**	Equity Shareholders enjoy normal voting rights.	Preference Shareholders do not enjoy normal voting rights, but can vote on matters affecting their interest.
7	**Bonus & Right Shares**	Equity shareholders are eligible for bonus shares and rights shares, if issued by the company.	Preference shareholders are not eligible for bonus shares and right shares, if issued by the company.
8	**Nature of Investors**	Those investors who are ready to take a risk, invest in Equity Shares. Equity Share Capital appeal to the risk-bearing investors.	Those investors who are not ready to take a risk, invest in Preference Shares. Preference Shares appeal to the cautious investors.
9	**Redeemability**	Equity Shares are not redeemed during the life of a company.	Redeemable Preference Shares are redeemed after certain period of time.

10	Face value	Normally, Equity Shares are issued for a face value of Rs.10. The face value of Equity Shares is relatively low.	Normally, Preference Shares are issued for a face value of Rs.100. The face value of Preference Shares is relatively high.
11	Risk	Equity Shares are subject to higher risk. Investment in equity shares may get less dividend when company earns less profits.	Preference Shares are subject to Less risks. Investment in Preference Shares normally get steady and regular dividend.

Q.4. Short Notes. (Any Two) (10)

1. Capital Structure and its Components.

Ans: Meaning :

Capital structure constitutes two words i.e. capital and structure. Capital refers to investment of funds in the business while structure means arrangement of different components in proper proportion. Thus capital structure means 'mix-up of various sources of funds in desired proportion'.

Once the capital requirement of firm is decided, attention is given to the kind of capital sources which can be raised to meet this need.

A company can raise its capital from different sources i.e. owned capital or borrowed capital or both. The owned capital consists of equity share capital, preference share capital, reserves and surplus. On the other hand, borrowed sources arc debentures, loans, etc. Proportion of different sources are used in capital structure.

To decide capital structure means, to decide upon the ratio of different securities in total capital. It is nothing but 'composition of capital'.

Definition :

Weston and Bringham

"Capital structure is the permanent financing of firm represented by long term debt, preferred stock and net worth."

Components of Capital Structure :

The components of Capital Structure are as follows:

i. Equity Share Capital:
- Equity share capital is provided by equity shareholders and it is the basic source of financing activities of business.
- The holders of such shares bear ultimate risk associated with the ownership.
- Equity shares carry dividend at a fluctuating rate, depending upon the profits earned by the company.

ii. Preference Share Capital:
- Preference shares carry dividend at a fixed rate and enjoy preferential right over quality shares for return of capital in case of winding up of the company.
- Unlike equity shareholders, preference shareholders have limited voting rights.

iii. Retained Earnings:
- The part of the profit retained by the company for meeting future financile needs and for expansion of the firm is known as retained earnings.
- In simple words, it is ploughing back of profits.

iv. Borrowed Capital:

It consists of the following :
- **Debentures:**
  A debentures is a certificate of loan evidencing the fact that the company is liable to pay a specified amount with interest at an agreed rate.
- **Term Loans:**

- Term loans are provided by banks and other financial institutions at a fixed rate of interest.

2. Fixed Capital and Explain its Factors.

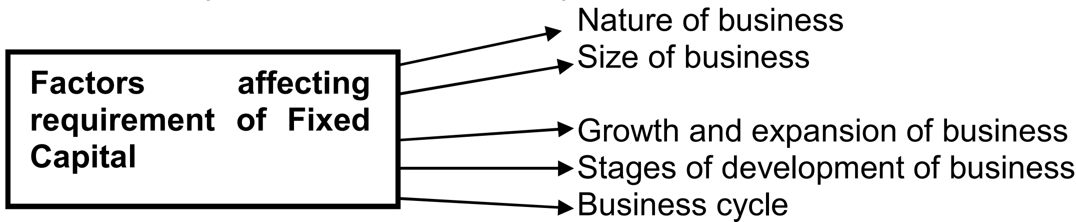
Ans: Meaning

The concept of 'fixed capital' was first theoretically analysed by economist David Recardo

It refers to any kind of real or physical capital i.e. fixed assets. It is not used for the production of goods. Fixed capital is that portion of total capital which is invested in fixed assets such as land, building, equipment, etc.

According to Karl Marks

'Fixed capital also circulates, except that the circulation time is much longer".



1. **Nature of business :** The nature of business certainly plays a vital role in determining fixed capital requirement. For e.g. Rail, Road and other public utility services have large fixed investment. They need to invest in huge sum in fixed assets. Their working capital requirements are nominal, because they supply services and not product. They deal in cash sales only.
2. **Size of business :** The size of business also affects fixed capital needs. A general rule applies that the bigger the business, the higher the need of fixed capital. Size of firm, either in terms of its assets or sales, affects the need of fixed capital.
3. **Growth and expansion :** A growing firm may need to invest money in fixed assets in order to sustain its growing production and turnover.
4. **Stage of development of business** : The requirement of fixed capital for a new undertaking is greater than that of an established business.
5. **Business cycle :** When there is boom period in the economy, additional investment in permanent assets may be made by firm to increase their production capacity. Hence the need of fixed capital increases .

B. WORKING CAPITAL

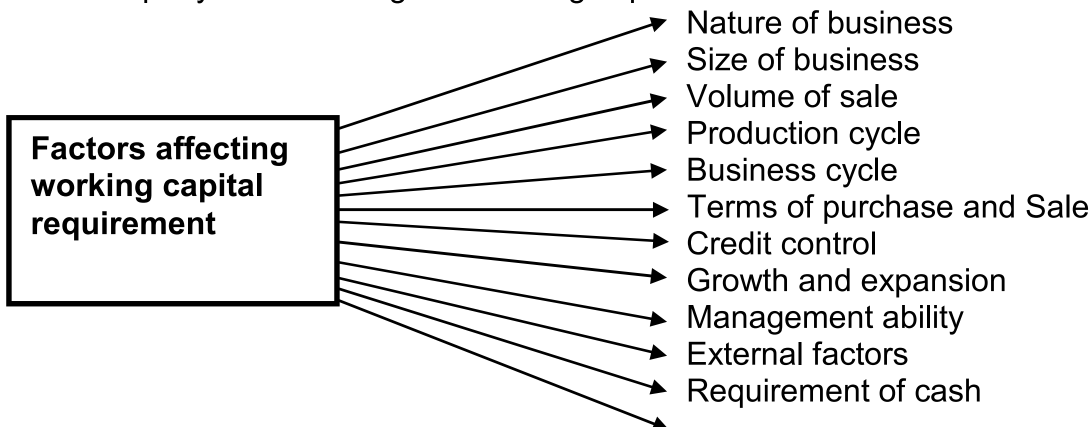
Meaning

In broad sense, the term working capital is defined as follows

Western and Brigham

'Working capital refers to a firm's investment in short term assets cash, short term securities, account receivable and inventories".

This approach has broader application. It takes into consideration all current resources of the company. It refers to 'gross working capital.'



Seasonal fluctuation

1. **Nature of business** : The working capital requirements are highly influenced by the nature of business. Industrial and manufacturing enterprises, trading firms require large sum of working capital. Big retail stores need a large amount of working capital as they have to maintain large stock of variety' of goods. It is because they have to satisfy varied and continuous demand of consumers.
2. **Size of business :** The size of business also affects the requirement of working capital. Size of the firm may be estimated in terms of scale of operation. A firm with large scale operation will require more working capital.
3. **Volume of sale :** This is the most important factor affecting size of working capital. The volume of sale and the size of working capital are directly related with each other. If the volume of sales increases, there is an increase in amount of working capital.
4. **Production cycle :** The process of converting raw material into finished goods is called 'production cycle.'
   If the production cycle period is longer, the firm needs more amount of working capital. If the manufacturing cycle is short, it requires less working capital.
5. **Business cycle :** When there is upward-swing in economy, sales will increase. This will lead to increase in investment in stock. This act will require additional working capital.
   During recession period, sales will decline and consequently the need of working capital will also decrease.
6. **Terms of purchase and sales :** If credit terms of purchases are favourable and terms of sales are less liberal, then requirement of cash will be less. Thus working capital requirement will be reduced. A firm gets more time for payment to suppliers. A firm which enjoys more credit facilities needs less working capital.
   On the other hand, if firm does not get proper credit for purchases and adopts liberal credit policy for sales, requires more working capital.
7. **Credit control :** Credit control includes the factors such as volume of credit sales, the terms of credit sales, the collection policy, etc. If credit control policy is sound, it is possible for the company to improve its cash flow. If credit policy is liberal, it creates a problem of collection of funds. It can increase possibility of bad debt. A firm selling on easy credit terms requires more working capital. The firm making cash sales requires less working capital.
8. **Growth and expansion activities :** The working capital requirement of a firm will increase with growth of firm. The growth of firm is in terms of sales or even fixed assets.
   A growing company needs funds continuously to support large scale operation.
9. **Management ability :** The requirement of working capital is reduced if there is proper co - ordination in production and distribution of goods.
   A film stocking on heavy inventory calls for higher level of working capital.
10. **External factors :** If the financial institutions and banks provide funds to the firm as and when required, the need of working capital is reduced.
11. **Requirement of cash :** The working capital requirement is also influenced by the amount of cash required by firm for various purposes.
    If the requirement of cash is more then company needs higher amount of working capital.
12. **Seasonal fluctuations :** The demand for products may he of seasonal nature. During certain season the size of working capital may be bigger than that in another period for e.g. Before rainy season umbrella and raincoat manufacturing companies need more working capital to manufacture above goods so that they can put these goods before monsoon starts.

3. Preference Shares and Explain its Features.

Ans: Preference shares are those shares, which enjoy preferential rights over equity shareholders in regard to payment of dividend and repayment of capital. The dividend payable to Preference Shareholders is fixed and they get priority over Equity Shareholders in respect of

return of capital in the event of winding up of the company. However, they do not enjoy normal voting rights.

Preference shareholders are co-owners of the company but not controllers. They are cautious investors who are satisfied with low but regular income by way of dividend.

Features of Preference Shares :

1) **Preference for Dividend :** Preference Shareholders have preference over Equity Shareholders in respect of payment of yearly dividend.
2) **Repayment of Capital** : In the event of winding up of the company, the company returns the preference share capital first and then equity share capital.
3) **Earns fixed dividend** : The rate of dividend on Preference Shares is fixed at the time of issue of shares in market itself.
4) **Face Value** : Usually, Preference Shares are of face value of Rs.100.
5) **Redeemability** : As per Companies (Amendment) Act, 1988, a company cannot issue irredeemable Preference Shares. In other words, Preference Shares are to be redeemed (paid back) after certain period of time.
6) **Enjoy preferential voting rights :** They do not enjoy normal voting rights at company meetings. They have voting rights in respect of only those matters, which affect their interests.
7) **No Bonus Shares** : Preference Shareholders are not entitled to bonus shares and right shares.
8) **Cautious Investors** : Preference Shares attract cautious investors who do not want to take any risk.

4. Types of Bonds.

Ans: There are various types of bonds depending upon the terms and conditions, purpose of issue, method of paying interest and payment, features etc.

Some of them can be classified as follows.

A. Based on Coupon / Interest:

a) Fixed Rate Bonds:
- Fixed rate bonds consist a coupon that remains constant throughout the life of the bond.
- The rate of interest thereon remains fixed.

b) Floating Rate Bonds:
- Floating rate bonds have variable or fluctuating rate of interest.
- Here, the rate of interest is recalculated periodically.

c) Zero Coupon Bonds:
- These bonds are issued without any coupon.
- They are issued at a discount.
- On maturity, these bonds are redeemed at par.
- The difference between the acquisition cost of bond and its face value is the profit for the investor.
- **For e.g.** A company issues bonds having face value ₹ 500 at ₹ 400. On maturity, the company will redeem these bonds at per i.e. at ₹ 500. The difference amount of ₹ 100 (₹ 500 - ₹ 400) is the profit of the bond holders.

d) Deep Discount Bonds:
- Deep discount bonds are similar to zero coupon bonds but have huge discount and longer period of maturity i.e. 25 years and more.
- These bonds are not entitles to any interest.
- The difference between cost and maturity value is profit for the investor.

e) Inflation – Indexed Bonds:
- The principle amount of such bonds and interest payments are indexed in inflation.

- The principle amount grows and payment of interest increases with the inflation.

B. Based on Option:

a) Bond with Call – Option:
- These bonds are also known as callable bonds.
- The issuer has a right to redeem his issue of bonds before maturity of bonds at the pre-determined price and date.

b) Bond with Put Option:
- These bonds are also known as put table bonds.
- The holders of such bonds have rights to sell his bonds to the issuer at the pre – determined price and date.

C. Based on Redemption:

a) Bonds with Single Redemption:
- In this case, principal amount of bond is paid at the time of maturity only.

b) Amortizing Bond:
- In this case, payment made by borrower to bond holder on maturity, includes both interest and principal.

Q.5. True or False with reasons. (Any One) (5)

1. Deposit holders are entitled to receive dividend.

Ans: This statement is **FALSE**.

Fixed deposit holders are entitled to receive interest.

Reasons :

(a) Dividend is a return on investment in shares. Shares are owned capital of the company.
(b) Interest is return on investment in borrowed capital. It is income given to the creditors of the company.
(c) Company collects its borrowed capital through debentures, loans and public deposits.
(d) Company collects deposits for 6 months to 3 years i.e. short term.
(e) These deposits are returned at the end of the predetermined maturity date.
(f) Depositors are financers or lenders for the company. They are creditors of the company.
(g) Creditors invest in companies so that they get fixed rate of interest as a ‘return’ irrespective of company’s profit.

2. Trading on equity is a double – edged sword.

Ans: This statement is **TRUE**.

Reasons :

(a) Trading on equity means the use of borrowed capital for financing a firm.
(b) It is based on the principle that if the rate of interest on debt is lower than the rate of company's earnings, then the equity shareholders will enjoy additional profit. Out of company's earning, first interest is paid to debenture holders,
(c) Distribution of more dividend to shareholders increases company’s goodwill, market value of shares, company's credit worthiness. Company can raise further loan at lower rate of interest,
(d) On the contrary if company earnings are not sufficient, shareholders would not get dividend which will affect company's credit worthiness. Company may not get further loans,
(e) If business earns sufficient profit, it will increase the income of shareholders otherwise it will increase risk of loss under adverse conditions.

Q.6. Long Answers. (Any One) (10)

1. Explain factors influencing capital structure.

Ans:

Internal Factors	**External Factors**
1. Requirement of capital	1. Market conditions
2. Size and nature of business	2. Attitude of investors
3. Growth of business firm	3. Cost of capital
4. Adequate and stable earning	4. Government regulations
5. Cash position	5. Attitude of financial institutions
6. Period of finance	6. Rate of interest
7. Future plan	7. Taxation
8. Trading on equity	8. Competition
9. Capital gearing	
10. Attitude of management	

The pattern of capital structure of various firms varies widely. There is no hard and fast rule for the proportion of owned funds and borrowed funds. So, to determine the best pattern of capital structure many factors are to be borne in mind. The factors which play vital role in capital structure determination arc divided into two

A) Internal factors

B) External Factors

A. Internal Factors

1. **Requirement of capital :** When a new business is started, it cannot issue variety of securities. This is because there is considerable risk involved at initial stages of new company. The ideal structure for new company is to raise capital through equity shares.
   Other types of securities may be issued by company in future. The company may require additional funds for expansion or modernization, etc.
2. **Size and nature of business :** The size of business has great impact on its capital structure. Large manufacturing companies have huge investments in fixed assets such as land, machinery, building etc. Further these fixed assets can be offered as securities against issue of debentures. Hence, these firms may raise funds by issue of equity shares along with debentures.
   On the other hand trading concerns require more working capital. They can raise funds by issue of equity as well as preference shares.
   In case of small companies capital requirement is less. They have less capacity to raise funds from external sources.
3. **Growth of business firm :** Different capital structures may be required at various stages of development of company.
   At initial stages of development, equity capital and short term loans are the main sources of finance. When a company grows in size, it can utilize sources of finance such as preference shares, debt capital, etc.
   The well-established concerns with goodwill and reputation can acquire funds from various sources.
4. **Adequate and stable earning :** The business firms with stable earning will have 'stable earnings per share' (i.e. EPS). Such companies can utilize source of debt capital as they can easily pay a fixed rate of interest. Therefore, developed companies usually employ more amount of loan capital.
   The business firm with unstable earning should not opt debt in their capital structure, as they may face difficulty in meeting fixed amount of interest.
5. **Cash position :** The companies expecting large and stable cash inflow in future, can utilize large amount of debt capital in their capital structure.
   It is quite risky for those companies whose cash inflow is unstable and unpredictable to have debt capital. It is because when company raises loan capital it becomes

compulsory to pay interest on that. If company fails to pay interest, this may cause situation of financial insolvency for the company.

6. **Period of finance :** While framing capital structure the ‘period for which finance is needed’, should also be considered.
   If funds are required on regular basis, the company should raise funds through issue of equity shares.
   If funds are required for short period of time the firm should raise funds through issue of debentures or redeemable preference shares.
7. **Future plan and development :** while designing capital structure, management should keep in mind the future development and expansion plans.
   Equity capital can be issued in the beginning. The debentures and preference shares may he issued in future to finance developmental plans.
8. **Trading on equity :** The use of borrowed capital for financing a firm is known as Trading on equity. The policy of ‘Trading on equity’ is based on premise that, if the rate of interest on debt is lower than rate of companies earning, the equity shareholder will enjoy advantage in the form of additional profit. Higher rate of dividend to equity shareholders improves goodwill of the company. It increases market value of shares. This improves creditworthiness of the company and company will be able to raise further loan at lower rate of interest.
   But if company earnings are not sufficient, it may face financial crises. The interest on debt has to be paid even in case of loss. The whole earnings may exhaust in payment of interest.
   No dividend would be declared to shareholders. This will affect goodwill and creditworthiness of the company. It will not be able to raise further loans.
   Thus, trading on equity is double edged sword. It may increase income of shareholders if the things go right. On the other hand, it increases risk of loss under adverse conditions.
9. **Capital gearing :** It is a ratio between debt capital (fixed interest) and equity capital (variable dividend). If the proportion of debt capital is high as compared to equity share capital, it is high gearing. On the other hand, if the proportion of debt capital is less as compared to equity share capital, it is a state of low gearing. A proper mix of various types of finance should be maintained in capital structure, so that the interest of equity shareholders is protected.

10. **Attitude of Management :** The capital structure is influenced by the attitude of persons in the management. The management's attitude towards ‘control of firm’, should be noted minutely. If the management has strong will of exclusive control, then preference shares and debt capital are used as source of finance.

B. External Factors

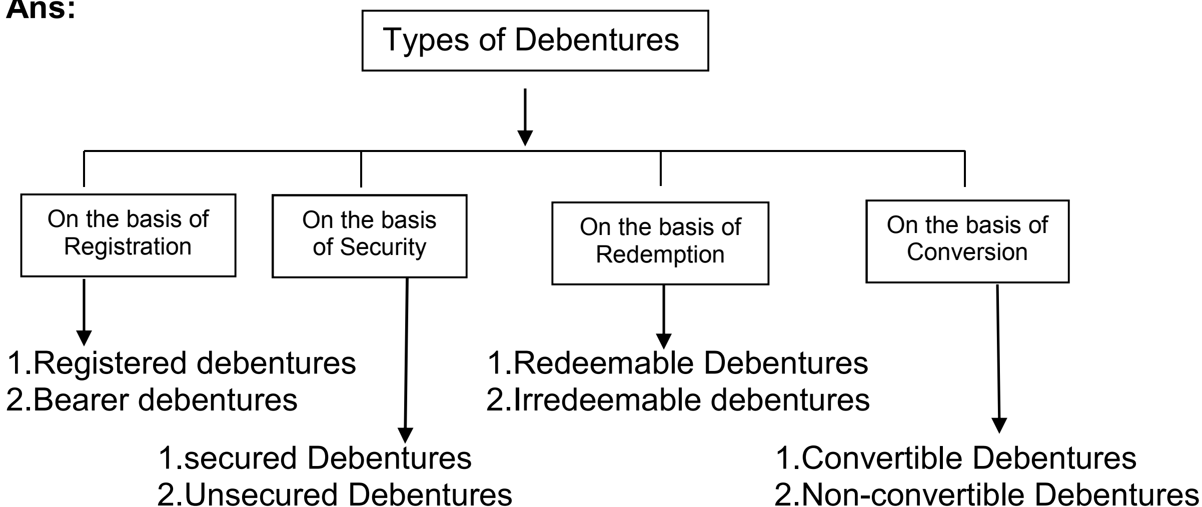
1. **Market conditions :** The pattern of capital is also influenced by prevailing market conditions. Readiness of investors to purchase shares, interest rate, stages of business cycle, tax, risk of investment, etc. together form market conditions.
   The various methods of financing should be considered in the prevailing market conditions. For eg: If share market is in a declining situation, a company should not issue equity shares but issue debt. On the other hand, during the period of boom in share market, it should issue equity shares to raise capital.
2. **Attitude of investors :** Attitude of investors also plays an important role in determination of capital structure. The investors who are ready to take risk and expect higher returns prefer equity shares for investment. On the contrary, cautious investors, who are interested in safe and assured income, invest in debentures.
3. **Cost of capital:** Cost of capital is one of the important factors while designing capital structure. The cost of capital is the minimum return expected by its investor. The expected return depends upon the degree of risk. The high degree of risk is assumed

by shareholders than debt holders. In case of debt holder, rate of interest is fixed, while rate of dividend given to shareholders is not fixed. The loan of debt holder is repaid within the prescribed period whereas shareholders get back their capital only when company is liquidated. Thus 'debt' is a cheaper source of capital than equity. The preference share capital is also cheaper but not cheap as debt. However, it should be realized that company cannot minimize cost of capital by employing only debt.
At a particular point beyond which, debt becomes more expensive because of increased risk of excessive debt.

4. **Government rules and regulations :** Statutory obligations play important role in capital structure decision. The SEBI has prescribed debt : equity ratio norm of 2:1. A higher debt-equity ratio of 3:1 has been permitted for large capital intensive project. The small industrial projects are given concession and aid by government to avail more debt capital as compared to equity capital.
5. **Attitude of financial institutions :** It is another factor which is to be considered while determining capital structure.
If financial institutions prescribe high terms of lending, then management has to move to other source of financing.
If financial institutions prescribe easy terms of lending, it would be advantageous to obtain funds at cheaper rate.
6. **Rate of interest :** The prevailing rate of interest plays vital role in determining capital structure. If prevailing interest rates are higher, firms will delay debt financing. On the other hand, if prevailing interest rates are lower, firm will opt for debt financing.
7. **Taxation :** Interest paid against debt is tax deductable expenditure. Dividend is not considered as tax deductable expenditure for the company. As such, issue of debt capital is more advantageous than issue of share capital.
The companies with higher taxes employ debt capital as it is tax deductable expense.
8. **Competition :** The firms which are facing cut-throat competition prefer to issue equity shares, because their earnings are not certain and adequate. But the companies which have monopolies may issue debt capital because of certainty' of earnings.

2. Explain kind of debentures.

Ans:



(1) On the basis of Registration :

(a) Registered Debentures : In the case of these Debentures, the names, addresses and particulars of holding are entered in a register kept by the company. Such Debentures are non- negotiable or transferable by mere delivery. Interest on such Debentures are payable only to registered holders of the Debentures through interest warrants. Transfers are freely allowed by executing proper transfer deeds and on formal approval of the Board of Directors.

(b) Bearer Debentures : Debentures which are not recorded in the Register of Debenture holders and also holder's names are not entered on the certificate

(Debenture) are bearer debentures. These Debentures are freely transferable by mere delivery. No need of executing a transfer deed and no stamp duty is to be paid. Interest is payable to the holders on presenting interest coupons attached to the Debentures.

(2) On the basis of Security :

(a) Secured Debentures : Secured Debentures are those, which are secured by some charge on the property or assets of the company. They are also called mortgage debentures. If the company fails to repay the principal and interest to the debenture holders, the debenture holders have a right to recover the amount of Debentures and interest from the company by selling of the assets charged to them.

(b) Unsecured Debentures : These Debentures are also known as simple or naked debentures. Such debentures are not given any security for repayment of principal amount and interest. Unsecured debenture holders are ordinary creditors of the company. The general solvency of the company is the only security available to unsecured debentures.

(3) On the basis of Redeemability :

(a) Redeemable Debentures : These debentures are issued for a specific period say for 5 years or 10 years. On expiry of the specific period, debenture capital (principal) is redeemed or paid back. Interest is paid regularly, annually or half-yearly. Generally, all Debentures are redeemable debentures, if specifically not stated at the time of issue of debentures.

(b) Irredeemable Debentures : Irredeemable Debentures are those Debentures, which are not repaid or redeemed by the company so long as it is a going concern. On winding up of the company, these debentures are paid prior to the preference and equity shares. Interest on these debentures is a permanent charge on the profits of the company, which is paid regularly as per the agreement.

(4) On the basis of Convertibility :

(a) Convertible Debentures : Convertible Debentures are those debentures, which are convertible into Equity Shares on maturity as per the terms of issue. Interest is paid till the date of conversion. These are most popular among investors in India. Prior approval of shareholders and that of Central Government is required to issue convertible Debentures

(b) Non-convertible Debentures : Non-convertible Debentures are those Debentures which are not converted into Equity Shares. Till they are redeemed or not, they remain as creditorship or borrowed capital. Normally, all debentures are non-convertible unless specified or declared.