Lecture 23

Capital markets

shares and securities

1. Issue of Shares

This is the most common method of raising long-term funds. Every company in India generally uses this method.

***Meaning of* share**

A share may be defined as one of the units into which the share capital of a company has been divided. According to Section 2 (46) of the Companies Act, "a share is the share in the capital of a company and includes stock except where a distinction between stock and share is expressed or implied".

The person holding the share is known as a shareholder. He receives dividend from the company as a consideration for investing his money into the company. However, payment of dividend is not legally compulsory. The power to recommend dividend vests in the Board of Directors of the company. The recommendation of the Directors is put before the general meeting of the shareholders who may reduce the rate of dividend as recommended by the Board but cannot increase it.

Types of Shares

A public company can issue only two types of shares. They are (i) Preference shares, and (ii) Equity shares.

(a) Preference shares

Preference shares are those which carry the following preferential rights over other classes of shares:

(i) A preferential right in respect of a fixed dividend. It may consist of a fixed amount (say Rs. 50,000 p.a.) or a fixed rate.

(ii) A preferential right as to repayment of capital in the case of winding up of the company in priority to other classes of shares.

Merits of Preference Shares

(i) Financing through preference shares is a flexible financing arrangement since payment of dividend is not a legal obligation of the company issuing the preference shares.

(ii) Preference shares have no final maturity date (except redeemable preference shares) and thus, in a sense, the funds provided by them is a sort of perpetual loan.

(iii) Preference shares add to the equity base of the company and thereby strengthen its financial position.

(iv) Preference share capital is also a sort of cushion to the debenture holders and thus they save the company from paying higher rate of interest.,

(vi) Preference shares are entitled to a fixed rate of dividend.

(vii) Issuing of preference shares does not materially disturb the existing pattern of control of the company as compared to the issue of equity shares since preference shareholders are entitled to vote only on such resolutions which directly affect their interests.

(viii) Financing through preference shares is cheaper as compared to financing through equity shares.

(ix) Preference shares are particularly useful for those investors who want higher rate of return with comparatively lower risk.

(x) The company can utilise huge surplus funds at its disposal by redeeming the redeemable preference shares as per the provisions of the Companies Act.

Demerits of Preference Shares

(1) One of the principal disadvantages of financing through preference shares is that preference dividend is not deductible as an expense for taxation purpose out of the profits of the company.

(ii) Preference shares dilute the claim of the equity shareholders over the assets of the company.

(iii) Preference shares may pave the way for the insolvency of the company in cases where the directors continue to pay dividends on them in spite of lower profits to maintain their attractiveness.

b) Equity Shares

These are shares which are not preference shares. They do not carry any preferential right. They will rank after preference shares for the purposes of dividend and repayment of capital in the event of company's winding up. The rate of dividend on these shares is not fixed. It depends on the availability of divisible profits and the intention of the directors. The shares have the chance of earning good dividends in times of prosperity and also run the risk of earning nothing in periods of adversity. The equity shareholders control the company on account of their entitlement to vote at the general meeting of the company. These shares are preferred by persons who prefer risk to better return and also wish to have a say in the management of the company. The equity share capital is also termed as the venture capital on account of the risk involved in it.

Sweat Equity Shares

The term Sweat Equity Shares means the equity shares issued by a company to employees or directors at a discount for consideration other than cash or for providing know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called.

Merits of Equity Shares

(i) Financing through equity shares does not impose any burden on the company since payment of dividend on these shares depends on the availability of profits and the discretion of the Directors.

(ii) Capital raised through equity shares is also a sort of perpetual loan for the company since it is not repayable during the lifetime of the company. It is repayable only in the event of company's winding up and that too only after the claims of preference shareholders have been met in full.

(iii) Equity shares do not carry any charge against the assets of the company hence the capacity of the company to raise additional funds through borrowings on the security of its assets is in no way diminished.

(iv) The company does not face the risk of magnifying its losses in periods of adversity.

(v) Financing through equity shares also provides the company with sufficient flexibility in the utilisation of its profits and funds since neither the payment of dividend is compulsory not any provision is to be made for repayment of capital.

Demerits of Equity Shares

(i) Financing through equity shares is costly. Moreover, the dividend on equity

shares is not deductible as an expense out of profits for taxation purposes.

(ii) The control of the company can be easily manipulated through cornering of shares by a group of shareholders for their personal advantage at the cost of company's interest.

(iii) Excessive reliance on financing through equity shares reduces the capacity of the company to trade on equity. This may ultimately result in over capitalisation of the company.

(v) The cost of underwriting; and distributing the equity share capital is generally higher than that for preference share capital or debentures.

Methods of Issue of Shares

Shares can be issued at par, premium or discount. There are no restrictions regarding issue of shares at par. However, for issue of shares at premium or discount, a company has to follow the restrictions imposed by the Companies Act, 1956. These restrictions are as follows:

Issue of shares at premium. A company can *always Issue* shares at a premium, i.e., for a value higher than the face value of shares whether for cash or for consideration other than cash. However, according to Section 78 of the Companies Act, the amount of such premium shall have to be transferred by the company to the Securities Premium Account.' The securities premium can be used by the company only for the following purposes:

(a) for the issue of fully paid bonus shares to the members of the company,

(b) for writing off preliminary expenses of the company;

(c) for writing off the expenses of, or the commission paid or, discount allowed, on any issue of shares or debentures of the company; and

(d) for providing premium payable on the redemption of any redeemable preference shares or debentures of the company.

Issue of shares at discount. A company can issue shares at a discount (i.e., for a consideration less than the nominal values of the, shares) subject to the following conditions laid down by Section 79 of the Companies Act.

I . Shares to be issued at a discount must be of a class already issued.

2. Issue of shares at a discount must be authorised by an ordinary resolution of the company.
3. Issue must be sanctioned by the Company Law Board.
4. Resolution must specify the maximum rate of discount. No such resolution shall be sanctioned by the Company Law Board if the maximum rate of discount specified in the resolution exceeds 10% unless the Board is of the opinion that a higher percentage of discount may be allowed in the special circumstances of the case.
5. One year must have passed since the date on which the company was allowed to commence business.
6. Issue must take place within two months after the date of the sanction of the Company Law Board unless the time is further extended.
7. Every prospectus relating to the issue of shares shall disclose particulars of the discount allowed on the issue of shares or that amount which has not been written off at the date of the issue of prospectus.

Restrictions on the issue of shares at a discount as set out above do not apply in the case of debentures since they do not form the capital fund to the company but are merely creditor ship securities.