RAMA UNIVERSITY

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FACULTY OF COMMERCE AND MANAGEMENT

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LECTURE-6

1.2 FINANCIAL INSTRUMENTS: EQUITY SHARES, PREFERENCE SHARES, RIGHT ISSUE

Why there is a need for Finance: Every business needs funds both for short term and long term. They may need working capital, or, fixed capital. The finance may be obtained from the varied sources and through various instruments. The various sources of finance include shareholders, financial instruments, and financial institutions and so on. The funds can be collected through various instruments such as equity shares, convertible bonds, non- convertible debentures, fixed deposits, loan agreements, and so on. The finance is needed at various stages and for various purposes like promoting a business, smooth conduct of business activities.

Methods of Raising Finance

Public Issue of Shares: The company can raise a substantial amount of fixed capital by issue of shares- equity and preference. In India, however, equity shares are more popular as compared to preference shares. The issue of shares requires a number of formalities to be completed such as approval of prospectus by S.E.B.I., appointment of underwriters, bankers, and registrars to the issue, filing of the prospectus with the registrar of companies, and so on.

Rights Issue of Shares: A Right issue is issue of shares to the existing shareholders of the company through a Letter of Offer made in first instance to the existing shareholders on pro data basis. The shareholders have a choice to forfeit this right partially or fully. The company, then issue this additional capital to public. This is an inexpensive method as underwriting commission, brokerage are very small. Rights issue prevents dilution of control but it may conflict with the broader objective of wider diffusion of share capital.

Private Placement of Shares: This is a method of raising funds from a group of financial institutions and others who are ready to invest in the company.

Issue of Debentures: There are companies who collect long term funds by issuing debentures- convertible, or, non convertible. Convertible debentures are very popular in the Indian market.

Long Term Loans: The company may also obtain long term loans from banks and financial institutions like I.D.B.I., I.C.I.C.I., and so on. The funding of term loans by financial institutions often acts as an inducement for the investors to sub- scribe for the shares of the company. This is, because, the financial institutions study the project report of the company before sanctioning loans. This creates confidence in the investors, and they too, lend money to the company in form of shares, debentures, fixed deposits, and so on.

Accumulated Earnings (Reserves): The Company often resorts to ploughing back of profits that, is, retaining a part of profits instead of distributing the entire amount to shareholders by way of dividend. Such accumulated earnings are very useful at the time of replacements, or, purchases of additional fixed assets.

We will discuss rights issue in detail.

Rights Issue: Rights issue is an invitation to the existing shareholders to subscribe for further shares to be issued by a company. A right simply means an option to buy certain securities at a certain privileged price within a certain specified period. The Company Act, 1956 lays down the manner in which further issue of shares, whether equity or preference, is to be made so as to ensure equitable distribution of shares without disturbing the established equilibrium of shareholding in the company. According to Section 81 of the Companies Act, whenever a public limited company proposes to increase its subscribed capital by the allotment of further shares, after the expiry of two years from the formation of the company or the expiry of one year from the first allotment of shares in the company, whichever is earlier, the following conditions or procedure must be followed:

Such shares must be offered to holders of equity shares in proportion, as nearly as circumstances admit, to the capital paid-up on those share.

The offer must be made by giving a notice specifying the number of shares offered.

The offer must be made to accept the shares within a period specified in the notice being not than 15 days.

Unless the articles of association of the company provide otherwise, the notice must also state that the shareholder has the right to renounce all or any of the shares offered to him in favor of his nominees.

Shares so offered to existing shareholders are called **Right Shares** as the existing equity shareholders of the public company have a first right of allotment of further shares. The offer of such shares to the existing equity shareholder is known as **Privileged Subscription or Right Issue**. The prior right of the shareholders is also known **as pre-emptive right.** After expiry of the time specified in the notice or on receipt of earlier information from the shareholder declining to accept the shares offered, the Board of Directors may dispose them off in such a manner as they think most beneficial to the company.

Advantages of Rights Issue

- It ensures that the control of the company is preserved in the hands of the existing shareholders.
- The expenses to be incurred, otherwise if shares are offered to the public, are avoided
- There is more certainty of the shares being sold to the existing shareholders.
- It betters the image of the company and stimulates enthusiastic response from shareholders and the investment market.
- It ensures that the directors do not misuse the opportunity of issuing new shares to their relatives and friends at lower prices on the one hand and on the other get more controlling rights in the company.

Types of shares: Shares can be broadly divided into equity shares and preference shares

Equity Shares: Shares which enjoy dividend and right to participate in the management of Joint Stock Company are called equity shares, or, ordinary shares. They are the owners and real risk bearers of the company. Equity shares can be defined as per as our Indian Companies Act (1956) as, "Shares which are not preference shares are equity shares, or, ordinary shares". Equity shareholders are the real owners of the company and, therefore, they are eligible to share the profits of the company. The share given to equity shareholders in profits is called "Dividend". At the time of winding of company, the capital is paid back last to them after all other claims have been paid in full.

Advantages of Equity Shares:

- The company has no immediate liability to pay it.
- No fixed dividend obligation.
- Increases creditworthiness of business, ceteris paribus.
- No charge created on assets of the business.
- Shareholders control the company.
- Limited liability of the investors.
- High dividends.
- No collateral security needed.

g. Increases firm credibility.

Disadvantages of Equity Shares:

Equity dividend not tax- deductible.

High cost of equity issue.

Gradual dilution of shareholder’s control over business.

Manipulation by a few shareholders.

Dividend at the discretion of the Directors.

Very risky investment.

Residual claim on investments.

Preference Shares: Shares which enjoy preference as regards dividend payment and capital repayment are called “Preference Shares”. They get dividend before equity holders. They get back their capital before equity holders in the event of winding up of the company. The owners

of these shares have a preference for dividend and a first claim for return of capital; when the company is closed down. But, their dividend rate is fixed. Preference share can be of following types:

Cumulative Preference Shares: Such shareholders have a right to claim the dividend. If, dividend is not paid to them, then, such dividend gets accumulated, and, therefore, they are called as “Cumulative Preference shares”.

Non- Cumulative Preference Shares: They are exactly opposite to cumulative preference shares. Their right to get dividend lapses if, they are not paid dividend and it does not get accumulated. Thus, their right to claim dividend for the past years will lapse and will not be accumulated.

Participating Preference Shares: Such shareholders have a right to participate in the excess profits of the company, in addition to their usual dividend. Thus, if, there are excess profits and huge dividends, are declared in the equity shares, the holders of these all shares get a second round of dividend along with equity shareholders; after a dividend at a certain rate has been paid to equity shareholders.

Non- Participating Preference Shares: Such shareholders do not have any right to share excess profits. They get only fixed dividend.

Convertible Preference Shares: Such shares can be converted into equity shares, at the option of the company.

Redeemable Preference Shares: Such shares are to be redeemed, or, paid back in cash to the holders after a period of time.

Non- Redeemable Preference Shares: Such shares are not paid in cash during the life of the company.

Merits of Preference Shares

Fixed dividend.

First claim on company assets.

Cost of capital is low.

No dilution over control.

No dividend obligation.

No redemption liability.

Demerits of Preference Shares:

Not a very high dividend rate.

No voting rights.

Dividends paid are not tax- deductible.

Non payment of dividend affects firm.

Financial Instruments: The capital of a joint stock company can be divided into "Owned capital" and "Borrowed capital". Owned capital means the capital of the owners which comprises of shares, both preference and equity and borrowed capital comprises of debentures, fixed deposits and bonds.

Shares: A share can be defined as "A fraction part of the capital of the company which forms the basis of ownership and interest of a subscriber in the company". Precisely, a share is a small part of the total capital. When the owned capital is divided into a number of equal parts, then, each part is called as a share. A person who contributes for a share is called as a share- holder.