LESSON: 2

OWNERSHIP SECURITIES

2.0 Objective :

The main objective of this lesson are to:

- know the different types of financial instruments
- discuss the features of equity share capital
- understand the various other forms of equity shares
- explain the role of preference share capital and its kinds

STRUCTURE:

2.1 Introduction:

For an investor, the problem of surplus gives rise to the question of where to invest and in what form. In the past, investment avenues were limited to real assets, schemes of the post office, banks, etc. At present, a wide variety of investment avenues are open to the investors to suit their needs and nature. Hence, knowledge about the different avenues and instruments enables the investors to choose investment intelligently. The investment alternatives range from traditional to financial securities, which are negotiable or non-negotiable.

2.2 Financial Instruments:

Financial instruments are the basic products of the financial system. The movement of funds from the suppliers of funds takes place when they are exchanged for a financial asset issued by the user of funds. Financial asset is a piece of paper evidencing a claim of the holder (investor) over the issuer (user). Currently financial assets are on de-matting form. They represent claim against the incomes and the assets of the issuing company. The financial securities are transferable and may yield varied income or fixed income based on their nature. Securities like equity shares are variable income securities, whereas, Bonds, debentures, Post office Saving Certificates, Government Securities and money market instruments yield fixed income.

The non-negotiable financial instruments as the name itself suggest that they are not transferable, which are also known as non-securitized financial investments. Deposit schemes offered by the post offices, banks, companies, and non-banking financial companies are of this category. The tax-sheltered schemes such as public provident fund, national savings certificate and national savings scheme are also non-securitized financial investments.

These instruments are classified into the following types based on their return, risk, liquidity, transferability, maturity, tax consideration, etc. They are divided as fixed income securities and variable securities, which are discussed as under:

2.3 Fixed Income Securities:

Fixed income instruments that have a fixed income claim and have a maturity of more than one year are traded in the debt market. Debentures, bonds and other debt instruments are examples of debt instruments in the capital market.

i) ***Debentures*** Corporate debentures are an option available to the investors who are willing to sacrifice liquidity for higher return. If the debentures are not actively traded in the debt segment of the capital market, the investors may have to hold the instrument till maturity. If the instruments were actively traded in the secondary market, it would have perhaps changed hands at a considerable premium, thereby lowering the yield on par with the present interest rate.

ii) ***Bonds:*** Bonds are similar to the debentures but they are issued by the public sector undertakings. The value of the bond in the market depends upon the interest rate and the maturity. The coupon rate is contractual involving the terms and conditions of the issuance of the debt security. Being contractual it cannot be changed during the tenure of the instrument. The investors are not affected by lowering of the bank rates. When the bank rates are lowered, the value of the bonds, which are carrying interest rates above the bank rate, would appreciate.

iii) Post Office Certificates: Indira Vikas and Kisan Vikas Patras are the saving certificates issued by the post office with a specified face value. These are like bearer bonds, transferable by hand delivery and therefore are attractive to the persons who prefer cash transactions. No income tax concession is available for this type of investment.

iv) Government *Securities:* The securities issued by the Central, State Government and Quasi Government agencies are known as Government securities or gilt edged securities. Government guaranteed security is a secured financial instrument, which guarantees the income and the capital. The rate of interest on these securities is relatively lower because of their high liquidity and safety.

2.4. Variable Income Securities:

The variable income securities are also of several types based on the type of issue, right to claim the dividend and principal, participation in voting, etc. The following are the different types of variable income instruments in the capital market.

2.4.1 Equity shares:

Equity shares are also called ordinary shares and from the investment point of view these are more risky than preferred stock and debt instruments. However, the equity shareholders enjoy several rights over other security holders, viz., right to vote, the right of dividend, right shares, bonus shares and certain tax-benefits.

Besides, the equity shareholders are also offered the following rights according to section 85 (2) of the Companies Act 1956. They are right to:

(a) control the management affairs,

(b) claim on the residual amount in case of winding-up,

(c) pre-emption on new issue capital matters,

(d) apply to court if there is any discrepancy in the rights,

(e) receive copies of the statutory reports, annual reports, etc.,

(f) apply the central government to call an annual meeting,

(g) apply for calling an extraordinary general meeting.

In addition to these rights to the equity shareholders they have certain advantages, which are: capital appreciation, limited liability, free tradability, tax advantages and hedge against inflation. In a limited company the equity shareholders are liable to pay the company's debt only to the extent of their share in the paid up capital In the early nineties, the stock market was the best and safest place for the common individual to invest. Since 1996 the share market prices have been low, which made the retail investors to turn away from the stock market.

Though the words shares and stocks are interchangeably used, there is a difference between them. The share capital of a company is divided into a number of small units of equal value called shares. The term stock is the aggregate of members’ fully paid up shares of equal value merged into one fund, which is a set of shares put together in a bundle. The "stock" is expressed in terms of money and not as many shares, which can be divided into fractions of any amount and such fractions, may be transferred like shares.

Types of Shares :

The stock market classifies shares into Growth shares, Income shares. Defensive shares. Cyclical shares and Speculative shares.

i) **Growth *shares:*** The stocks that have higher rate of growth than the industrial growth rate in profitability are referred to as growth shares.

ii) **Income *shares:*** These stocks belong to companies that have comparatively stable operations and limited growth opportunities.

iii) ***Defensive shares:*** Defensive stocks are relatively unaffected by the market movements. The pharmaceutical industry owing to its inherent nature of demand is not affected by the down turn in the economy.

iv) ***Cyclical shares:*** The upward and downward movements of the business cycle affect the business prospects of certain companies and their stock prices whose shares provide low to moderate current yield and the capital gain may be highly variable.

v) ***Speculative shares:*** Shares that have lot of speculative trading in them are referred to as speculative shares. During the bull and bear phases of the market, this type of shares attracts the attention of the traders.

The shares, which fall under one category in one period, may change in to another category in another period and hence, the classification should not be considered rigid.

2.4.2 Sweat equity:

Sweat equity is a new equity instrument introduced in the Companies (Amendment) Ordinance, 1998 which falls under the category of preferential issue as per Section 81 (1A) of the Companies Act, 1956. Section 79A (2) explains that all limitations, restrictions and provisions applicable to equity shares are applicable to sweat equity However; it should be issued out of a class of equity shares already issued by the company. Thus, sweat equity forms a part of equity share capital and it cannot claim a new class of equity shares.

The sweat equity has two different dimensions, i.e., issued at a discount to employees and directors, issued for consideration other than cash. In its first form, issue of sweat equity may be priced at a discount to the preferential pricing or at a discount to face value. The amount of discount to normal price may be decided on the basis of the valuation of the intangibles to be acquired or below the par value the equity. The second type of sweat equity can be issued at par or above par, which can be issued against know-how, intellectual property rights or in recognition of value additions.

Reasons for issuing sweat equity

As a matter of fact, in every business concern, its directors and employees contribute intellectual property rights for its future growth and prosperity. This may be in the form of providing technical know-how captured by way of research, contributing a strategy, designing software for the company or adding profit. The age-old practice of recognizing the employees and directors by way giving monetary and non-monetary benefits is deficient. Further, the incentive in the form bonus on the basis of performance also failed to reward them adequately. Therefore, the contributing employees/directors in the matter of intellectual property right are to be rewarded through issue of sweat shares for their contribution.

Thus, the sweat equities are issued to the Directors/employees who designed strategic alliance and helped the company to attain sustain-able market share. In the service industry, sweat equity has a special relevance. The major industries where the directors and employees can be rewarded through sweat equity are:

- Computer hardware and software development
- Management consultancy where a standard strategy is issued to earn a fee, like Enterprise Resource Planning (ERP) solution
- NBFCs where product design is crucial
- Other non-traditional financial service industries like custodians, depositories and credit rating wherein basic service design is important
- In life insurance segment, commission-based business can be converted into sweat equity with development officers and branch managers.

2.4.3 Non-Voting Shares:

Non-voting shares carry no voting rights. They have right to participate in the bonus issue and thus, carry additional dividends instead of the voting right. The non-voting shares can also be listed and traded in the stock exchanges. If non-voting shares were not paid dividend for two years, the shares would automatically get the voting rights. The company can issue these shares to a maximum of 25 per cent of the voting stock. The dividend on the non-voting shares would have to be 20 percent higher than the dividend on the voting shares.

2.4 4 Right Shares:

Right shares are another type of shares offered to the existing shareholders at a price by the company. These shares are offered to the shareholders as a matter of legal right. If a public company wants to increase its subscribed capital by way of issuing shares after two years from its formation date or one year from the date of its first allotment, whichever is earlier, such company should be offered its shares first to the existing shareholders in proportion to the capital paid-up on the shares held by them at the date of such offer. The shareholders through a special resolution can forfeit this pre-emptive right. The shareholder can renounce all or part of these shares offered to him in favor of his nominee. The minimum subscription limit is prescribed for right issues and in the event of company failing to receive 90% subscription, the company shall have to return the entire money received, at present, the SEBI has removed this limit. Right issues are regulated under the provisions of the Companies Act and SEBI.

2.4.5 Bonus Shares

The retained earnings of the company are account for through the bonus shares in addition to the cash dividends to the existing shareholders. Bonus shares are issued to the existing shareholders without any payment of cash. The bonus issue could be made only when all the partly paid shares, if any, existing are made fully paid-up.

The issue of bonus shares used to have a favourable impact on the psychology of the shareholders. The directors declare bonus shares only when they expect a rise in the profitability of the concern. The issue of bonus shares enables the shareholders to sell the shares and get capital gains while retaining their original shares.

Equity shares investment has less demand in India than the debt securities due to risk in these securities. But these are a strong need to develop the equity culture to achieve the economic growth of the nation. The individual investors who want to invest in the equity are widely scattered and no much communication network, and therefore the equities are bound to remain unimportant and unexposed.

2.5 Preference Shares:

Preference shares are no longer regarded as inferior to the equity capital. High tax paying companies or investors prefer to subscribe to the preference shares and investors with a low tax burden would prefer to go in for debt instruments. The conversion options provided in the by preference shares also make it attractive. The biggest advantage is the tax-exempt status of the preference share's dividend.

The features of the preference share are hybrid in nature, which resemble the debt and equity shares. Like debt capital, their claim on the company's income is limited and receive fixed dividend. In the event of liquidation of the company their claim on the assets of the firm are also fixed. At the same time, like equity capital, it is a perpetual liability of the company. The decision to pay dividend to the preference shares is at the discretion of the Board of Directors. The dividend received by the preferred stock is treated on par with the dividend received from the equity share for the tax purposes. These shareholders do not enjoy any of the voting powers except when any resolution affects their rights.

2.5.1 Types of Preference Shares*:*

The preference shares are different varieties, which are available depending on the clause inserted in the deal at the time of issue of these shares.

(i) Cumulative preference shares*:*

The cumulative preference shares have the right of dividend of a company even in those years in which it makes no profit. Therefore, the cumulative total amount of all unpaid preferred dividends must be paid before dividends are paid on the common equity. The unpaid dividends are known as arrears, which do not earn interest and these arrears accrue only for a limited number of years and not indefinitely. Generally three years of arrears accrue and the accumulative feature ceases after three years. In the case of liquidation, no arrears of dividends are payable unless there is a provision for them in the Articles of Association.

(ii) Non-cumulative shares*:*

As the name suggests, the dividend does not accumulate. If there is no profit or inadequate profit in the company in a particular year, the company does not pay the dividends. The advantage of preference shares is that they are usually issued as cumulative. At the time of the winding-up of a company if the preference and equity shares are fully paid, they have no further rights to have claims in the surplus, unless there is a provision in the Articles of Association for such claims, then they have the rights to claim.

(iii) Convertible preference shares*:*

The convertibility feature makes the preference share a more attractive investment security. The conversion feature is almost identical with that of the bonds. These preference shares are convertible as equity shares at the end of the specified period and are quasi-equity shares. This gives the additional privilege of sharing the potential increase in the equity value, along with the security and stability of income.

(iv) Redeemable preference shares*:*

All preference shares are non-redeemable in nature, but to attract the investor, a clause is inserted for redeeming the preference shares after a certain period. If there is a provision in the Articles of Association, redeemable preference shares can be issued but redemption of the shares can be done only when the partly paid up shares are made fully paid up, the fund for redemption is created from the profits, which would otherwise be available for distribution of dividends or out of the proceeds of a fresh issue of shares for the purpose, if any premium has to be paid on redemption, it should be paid out of the profits or out of the company's share premium account and when the redemption is made out of profits, a sum equal to the nominal value of the redeemed shares should be transferred to the capital redemption reserve account.

(v) Irredeemable preference shares*:*

Irredeemable means like the equity shares its existence is permanent in nature and its shareholding is continuous till the liquidation of the company**.** The investors should generally avoid investing in these shares. This type of shares is not redeemable except on occasions like winding-up of the business. In India, this type of shares was permitted till 15th Junel988 and the introduction of section 80A in the Companies Act 1956 put an end to it.

(vi) Cumulative Convertible Preference Shares (CCPS*):*

The government in 1984 introduced this CCPS. This preference share gives a regular return of 10% during the gestation period from three years to five years and then converted into equity as per the agreement.

2.6 Summary:

The securities are broadly grouped them as fixed income securities and variable income securities. The fixed income securities that have a fixed income claim and have a maturity of more than one year are traded in the debt market. Debentures, bonds and other debt instruments are examples of debt instruments in the capital market. The variable income securities are also of several types based on the type of issue, right to claim the dividend and principal, participation in voting, etc. The equity share and various forms of equity and preference shares are the different types of variable income instruments in the capital market. The sweat equity, right shares and bonus shares are the various forms of equity share capital.

2.7 Key words:

Equity share: the right to receive dividend and residual claim.

Sweat equity: it is issued to employees for their contribution.

Right shares: they are issued to the existing shareholders at a price on the pro-rata basis.

Bonus Shares: these are issued to the existing shareholders in addition the dividend out of the reserves

Preference shares: they have fixed dividends but have a perpetual liability on the companies.

2.8 Self Assessment Questions

1. Define Security. Discuss the different types of securities.
2. Discuss the characteristic features of equity shares..
3. How does a common stock differ from preference stock?
4. What are the different types of preference shares? Explain them briefly
5. What is seat equity? Explain the reasons for issuing sweat equity.

2.9 Further Readings

1. Brigham, E.F. Fundamentals of Financial Management, Dryden Press, Chicago.
2. James C. Van Horne, Financial Management and Policy, Prentice Hall of India, New Delhi.
3. Solomon Ezra, Theory of Financial Management, Columbia University Press, New Delhi.
4. Pandey, I.M., Financial Management, Vikas Publishing House Pvt. Ltd., New Delhi
5. Prasanna Chandra, Financial Management: Theory and Practice, Tata Mc Graw Hill, New Delhi.
6. Kulkarni P V and Satyaprasad B G., Financial Management, Himalaya Publishing House, Mumbai.

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