**UNIT 2: CAPITAL OF A COMPANY**

**To be covered under this Unit:** Share capital- Meaning of shares- Kinds of shares- Distinction between Equity and Preference shares- Debentures- Meaning, Features and Types- SEBI guidelines for issue of shares and Debentures- Types of issue of shares(Concept only)- Book building.

**Introduction:**

Generation of funds required for business operations will be done either by issue of equity or debt securities. Issue of the securities will result in capital formation which will be invested in profitable projects. Raising of funds will attract legal provisions under the Companies Act, 2013. It is used to generate income either by investing in a business or a different income property. It is the net worth of a business (i.e., excess of assets over liabilities). Share capital is the basic sources of generating funds required by a joint stock company. Hence, from company’s point of view it carries utmost importance.

**Share Capital:**

**Meaning of Shares:**

U/s of 2(84) of Companies Act, 2013, “share means a share in the share capital of a company and includes stock.”

The term share capital refers to the amount of capital raised or to be raised by a company through the issue of shares. Share capital is the ownership capital of a company raised by the issue of its shares. It is the document that acknowledges the ownership of a company to the limit of the amount contributed. It represents a single unit of share capital reflecting the extent of the interest of shareholders.

In other words, it refers to be a bundle of rights and liabilities. It secures to its owner the right to receive a proportionate part of the profits, if any, and proportionate part of the assets of the company upon liquidation. The shareholder may also be required to pay the full value in winding up of the company.

**Features of Shares:**

1. It is owned capital of the company.
2. It remains with the company till liquidation.
3. It is dependable source of finance.
4. It is available for expansion and diversification of business.
5. Its amount can be increased by amending the capital clause of Memorandum of Association (MOA).
6. It raises the credit worthiness of the company.
7. It provides substantial funds to the company.
8. It does not create any charge on the assets of the company.
9. It gives shareholders an opportunity to participate in company’s management.
10. It enjoys the benefit of limited liability.

**Types/ Kinds of the Shares:**

Shares are classified into Equity shares and Preference shares.

1. **Preference shares** - Preference shares means shares which carry preferential right over other classes of shares, in respect of payment of fixed dividend and for the payment of capital in case of winding up of the company.

**Types of Preference shares:**

1. **Cumulative and Non-cumulative preference shares:**

Cumulative preference shares bear fixed percentage of dividend which will be accumulated till it is paid and in case of arrears of dividend, it will be paid before paying to equity shares. On the other hand, non-cumulative preference shares, the right to accumulation of dividend is lost for a particular year if no dividend is declared by the company for that year.

1. **Redeemable and Irredeemable preference shares:**

Redeemable preference shares are redeemable during the life time of the company while irredeemable preference shares are to be redeemed only in the event of liquidation of company.

1. **Participating and Non-participating preference shares:**

Participating preference shares get a share in the surplus profits of the company, if any, after paying equity shares at a fixed rate, in addition to fixed percentage of dividend. On the other hand non-participating preference shares get only fixed dividend and do not share any surplus profits with equity shareholders of the company.

1. **Convertible and Non-convertible preference shares:**

Convertible preference shares have the right to get themselves converted into equity shares as per the agreed terms while non-convertible preference shares have no such right.

(**Note:** Preference shares are always treated as non-cumulative, non-participating and non-convertible unless specified)

**Advantages or Benefits of Preference shares:**

1. It helps in raising long term capital for the company.
2. No need to mortgage property on preference shares.
3. Repayment of capital when company has surplus in case of redeemable preference shares.
4. It has guaranteed rate of return.

**Disadvantages or limitations of Preference shares:**

1. Company need to pay fixed rate of dividend which is a permanent burden.
2. No voting right for the preference shareholders.
3. Cost of raising preference share is higher.
4. **Equity shares**

Equity shares are those shares which are not preference shares. It does not enjoy any preferential right either in respect of payment of dividend or repayment of capital during liquidation of the company. The equity shareholders are the real owners of the company.

Equity shares can be of two types –

1. With voting rights
2. With differential right as to dividends, voting or otherwise in accordance with the rules and subject to such conditions prescribed.

**Advantages of Equity shares:**

**To the company-**

1. It is good source of long term and permanent capital.
2. It does not carry fixed burden to the company.
3. It does not create any charge on fixed assets of the company.
4. Company can trade on equity in bad situations on the risk of equity capital.
5. Company can follow elastic and rational dividend policy of equity shares.

**To the shareholders/ Investors-**

1. More income as dividend to equity shareholders in the boom period.
2. Equity shareholders can participate in control and management of the company.
3. It brings capital appreciation to the investors on their investment.
4. It can be purchased by persons of limited resources.

**Disadvantages of Equity shares:**

**To the company-**

1. It dilutes the control over the company as and when more shares are issued by the company.
2. Trading on equity is not possible when only equity shares are issued by the company.
3. Excess of equity shares may result in over-capitalization.
4. It creates inflexibility since it cannot be paid back during the life time of the company.
5. It involves high cost to issue equity shares.
6. It results in speculation and high fluctuation of prices.

**To the shareholders/ Investors-**

1. Income in the form of dividend is quite irregular and uncertain in nature.
2. It results in capital loss during the time of recession.
3. Permanent loss when the company is liquidated.

**Note:** The shares of the company will be issued either at par (i.e., at face value) or at premium (i.e., price higher than face value) or at discount (i.e., price lesser than the face value)

**Difference between Preference shares and Equity shares:**

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| **Sl. No.** | **Preference shares** | **Equity shares** |
| 1 | Preference shares are those shares which enjoys preference regarding dividend and repayment of capital. | Shares which bear the risk and provide permanent finance are known as equity shares |
| 2 | Preference shareholders get back their finance during lifetime of the company and before the equity shareholders. | Equity capital is not repaid during the lifetime of the company. |
| 3 | Preference shares enjoy preferential rights as regards the payment of dividend and return of capital. | Equity shares do not carry such preferential rights over preference shares. |
| 4 | Rate of dividend is fixed at the time of issue and changes are not made in this rate in due course. | Rate of dividend is not fixed but flexible. It changes every year as per the net profit of the company. |
| 5 | Preference shares do not carry normal rights, but only under exceptional situations. | Equity shares carry normal voting rights. |
| 6 | Different types of preference shares are – cumulative, redeemable, convertible, participating, etc. | All equity shares are of one category and always irredeemable. |
| 7 | Preference share appeal to relative less adventurous investors, interested in fixed, but regular return on investment. | Equity shares appeal to adventurous investors willing to take risk in their investment. |
| 8 | No capital appreciation is possible. | Capital appreciation is possible due to prospects of rising dividend . |

**Rights Issue:**

It refers to the issue of additional or further shares any time after expiry of –

1. Two years from formation, or
2. One year from allotment of shares

Whichever is earlier, to existing equity shareholders for equitable distribution of shares.

**Steps in issue of Rights shares:**

1. It must be in the ratio of existing equity shares.
2. It will be issued with 15 days notice to such shareholders.
3. Such shareholder can accept or reject the offer for issue of right shares.
4. As per SEBI guidelines, rights issue cannot be kept opened for more than 60days.
5. The above is not applicable for private companies and for conversion of debentures into shares.

**Benefits of Rights issue:**

1. More control by existing shareholders.
2. No loss to existing shareholders.
3. No cost for issue of shares to public.
4. Helpful to increase the goodwill of the company.
5. More scientific method of distribution of shares.
6. Helps in capital formation to the company.

**Bonus shares:**

They are the shares issued out of accumulated profits or reserves to existing equity shareholders of the company. It can be issued as fully paid or partly paid shares. It is issued free of cost to shareholders. There are certain conditions to be satisfied for the issue of bonus shares, they are –

1. It should be authorised by the AOA of the company. If not then AOA need to be amended for the same by passing special resolution in the general meeting.
2. It must be sanctioned by the shareholders at the general meeting on recommendations of BOD.
3. It should comply with the guidelines issued by SEBI for issue of Bonus shares.

**Sweat Equity Shares:**

U/s 2(88) “sweat equity shares” means such equity shares as are issued by a company to its directors or employees at a discount or for consideration, other than cash, for providing their know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called.

**Stock:**

It refers to bundle of fully paid shares put together for convenience.

**Features of Stock:**

1. It is consolidated amount of fully paid shares.
2. It cannot be an original issue.
3. It may be split up or transferred by shareholder in fractions.
4. It is not divided into uniform denomination.
5. It doesn’t bear distinctive numbers to identify.
6. Stockholder enjoys same rights & privileges as shareholders.
7. They can be reconverted into shares.

**Advantages of Stock:**

1. Stockholder enjoys same rights & privileges as shareholders.
2. They can be split up or divided in fractions of any amount.
3. It is issued against fully paid shares only.
4. Company need not keep a record of stocks issued.

**Share certificate:**

It is a document issued by the company under its common seal specifying the number of shares held by the member and amount paid on each share which evidences the title of member to those shares.

**Contents of Share certificate:**

1. Name and address of the member
2. Share certificate number
3. Number and class of shares held
4. Distinctive numbers of shares
5. Face value of share
6. Date of issue
7. Revenue stamp

**Share warrant:**

It is a document issued by public company under its common seal to shareholders in respect of fully paid shares and stating the bearer of the instrument is entitled to shares mentioned therein.

**Debentures:**

**Meaning Definition of Debentures:**

U/s 2(30),“Debenture” includes debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not.”

In other words, Debentures refers to a certificate of agreement of loans which is given under the company’s stamp and carries an undertaking that the debenture holder will get a fixed return (fixed on the basis of interest rates) and the principal amount whenever the debenture matures.

**Features of Debentures:**

1. Debenture holders of the company are the creditors of the company and not the owners of the company.
2. Capital raised by way of debentures is required to be repaid during the life time of the company at the time stipulated by the company. Thus, it is not a source of permanent capital.
3. Debentures are generally secured.
4. Return paid by the company is in the form of interest which is predetermined.
5. Debentures are very risky from the company’s point, if view for raising long term funds.
6. Risk on the part of debenture holders is very less.
7. Debenture holders do not carry any voting rights.
8. Debentures are a cheap source of funds from the company’s point of view.
9. Debentures are instruments in writing that acknowledge of the in debt of the company to the holder of the instrument.
10. Debentures are always made under the sale of the company. However, Certificate that has been signed by two or more directors of the company but carries no sale is considered a valid debenture documents.
11. The owner of the instrument is not an owner of the company but merely its creditor of the amount mentioned in the acknowledgement.
12. The interest needs to be paid to the debenture holder on a specified rate by a specified time.
13. The holder of the debenture document is entitled to get regular interest from the company. This continues even in case where the company has incurred losses.
14. All the debentures are redeemed on due date. In case of winding up of the company. Debentureholders are repaid after payment to shareholders is made.
15. Debenture can be converted into equity share by the issuing company.

**Types of the Debentures:**

Debentures can be classified into the following ways:

**1. Non convertible debentures (NCD):** These instruments retain the debt character and cannot be converted into equity shares.

**2. Partly convertible debentures (PCD):** A part of these instruments are converted into equity shares in the future at notice of issuer .The issuer decides the ratio for conversion. This is normally decided at the time of subscription.

**3. Fully convertible debentures (FCD):** These are fully convertible into equity shares at the issuer’s notice. The ratio of conversion is decided by the issuer. Upon conversion the investors enjoy the same status as ordinary share holders of the company.

**4. Optionally convertible debentures (OCD):** The investor has the option to either convert thesedebentures into shares at price decided by the issuer/agreed upon at the time of issue.

On basis of security, debentures are classified into the following ways:

**5. Secured debentures:** These instruments are secured by a charge on the fixes assets of the issuer company. So, if the issuer fails on payment of the principal or interest amount, his assets can be sold to repay the liability to the investors.

**6. Unsecured debentures:** These instruments are unsecured in the sense that if the issuer defaults on payment of the interest on principal amount. The investor has to be along with other unsecured creditors of the company.

**7. Registered debentures:** These are those debentures which are registered in the register of the company. The name, address and particulars of holdings of debenture holders are entered in a register kept by the company. Such debentures are treated as non-negotiable instrument and interest on such debentures are payable only to registered holders of the debentures. Registered debentures are also known as debentures payable to registered holders.

**8. Bearer debentures:** These are those debentures which are not registered in the register of the company. Bearer debentures are like a bearer cheque. They are payable to the bearer and are deemed to be negotiable instrument. They are transferrable by mere delivery. No formality of executing a transfer deed is necessary. When bearer documents are transferred, stamp duty need not be paid. A person transferring a bearer debenture need not be given any notice to the company to this effect. The transferee who acquires such a debenture in due course bonafide and for all available consideration gets good title not withstanding any defect in the title of the transfer or interest coupons are attached to each debenture and are payable to bearer.

**9. Redeemable debenture:** These debentures are issued by the company for a specific period only. On the expiry of period, debenture capital is redeemed or paid back. Generally the company creates a special reserve account known as ‘’debenture redemption reserve fund’’ for the redemption of such debenture. The company makes the payment of interest regularly.

**10. Irredeemable debentures:** These debentures are issued for an indefinite period which is also known as perpetual debentures. The debenture capital is repaid either at the option of the company by giving prior notice to that effect or at the winding up of the company .the interest is regularly paid on these debentures. The principal amount is repayable only at the time of winding up of the company. However the company may decide to repay the principal amount during its lifetime

**11. Mortgage debenture:** A mortgage debenture is pone which is secured by mortgage on the real property of the company. If the company fails to repay the borrowed amount at a specified period the debenture holder has a legal right to sell the property and recovered the loan

**12. Naked debenture:** In general the term debenture in British usage designates any security issued by companies other than their shares, including, therefore, what are in the united states commonly called bonds .when used in the united states debenture generally designates an instrument secured of securities secured by a group of securities held in trust for the benefit of the debenture holders

**13. Agency debenture:** the market place appears to believe that GSE agency debenture carry an implicit guarantee from the United States government .this is due to the GSE’s direct borrowing ability from the U.S treasury and the importance of the GES’s congressional charters and missions

**Advantages of Debenture:**

1. Control of company is not surrendered to debenture holders because they don’t have any voting rights.

2. Trading on equity is possible as debenture holders get a lower rate of return than the earnings of the company.

3. Interest on debenture is an allowable expenditure under Income Tax Act, 1961, hence incidence of tax on the company is decreased

4. Debenture can be redeemed when company has surplus funds.

**Disadvantages of Debenture:**

1. Cost of raising capital through debentures is high.

2. Common people cannot buy debenture as they are of high denominations.

3. They are not meant for companies earning greater than the rate of interest which they are paying on the debentures.

**Difference between shares and debentures**

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| Sl.No. | Shares | Debentures |
| 1 | A share is a part of equity or preference share capital of a company. The holders of the shares may be described owner of the company. | A debenture is a part loan capital of the company. The holder of a debenture is creditor of the company |
| 2 | Return on share is known as dividend. A company declares dividend only when there are profits and its rate may vary from year | Return on a debenture is known as interest and the company compulsorily pays it at a fixed rate whether there are profits or losses. |
| 3 | Dividend is an appropriation of profit and is therefore debited in profit and loss appropriation account. | Interest on debenture is a charge against profits and is therefore debited in profit and loss account |
| 4 | Shares do not create any charge on the assets of the company | Debenture create a charge on the asset of the company |
| 5 | Normally the share capital is not returned during the life time of the company | Debenture has to be returned after a stipulated period of time as per the condition of issue |
| 6 | Shares can be issued at discount only when the conditions lay down Companies Act 2013 are fulfilled. | There are no restriction on issue of debenture at a discount |
| 7 | The premium received on issue of shares can be utilised by the company subject to the companies Act 2013. | Premium received on issue of debentures can be utilized by company in any manner it likes. |
| 8 | Shares cannot be converted into debentures. | Debenture can be converted into shares according to the condition of issue of debenture. |

**Book Building:**

Book Building is a mechanism wherein the company opens the Initial Public Offer (IPO) for a fixed period within which it collects the bids from investors at various factors between the floor price and cap price. This helps the company to discover the price of the IPO.

**Process of Book Building:**

1. Company plans an IPO via the book building process.

2. Appoint a merchant banker as book runner.

3. Issue a draft prospectus containing all mandatory company disclosures other than price.

4. Draft prospectus filed simultaneously with SEBI.

5. Book runner appoints syndicate members and registered intermediaries for subscription.

6. Price discovery begins through the bidding process.

7. At the close of bidding, book runner and the company decide upon the allocation and allotment of shares.