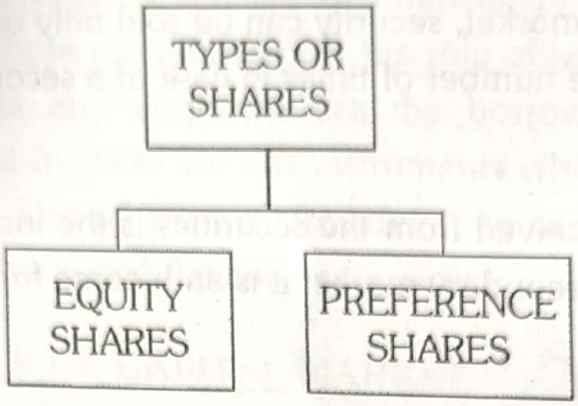
1.3.2 TYPES OF SHARES

According to Section 86 of the Companies Act, a company can issue only two types of shares viz:

(a) Preference and

(b) Equity.



(a) **Preference Shares. The law defines preference share capital as that part of the share capital of a company which fulfils both the following conditions namely:**

(i) It carries a preferential right in respect of the dividends;

(ii) It carries preferential right in regard to the repayment of capital.

The preference shareholders are entitled to receive the fixed rate of dividend out of the net profits of the company.

(b) **Equity Shares:**

Equity shares are those shares which are not preference shares. These shares do not enjoy any preferential rights. They rank after the preference shares for the purpose of dividend payment and repayment of capital. The rate of dividend is also generally not fixed and may vary from year depending upon the profit of the company.

1.3.3 EQUITY SHARES V/S PREFERENCE SHARES

Basis For Comparison	Equity Shares	Preference Shares
Meaning	Equity shares are the ordinary shares of the company representing the part ownership of the shareholder in the company.	Preference shares are the shares that carry preferential rights on the matters of payment of dividend and repayment of capital.

Payment of dividend	The dividend is paid after the payment of all liabilities.	Priority in payment of dividend over equity shareholders.
Repayment of capital	In the event of winding up of the company, equity shares are repaid at the end.	In the event of winding up of the company, preference shares are repaid before equity shares.
Rate of dividend	Fluctuating	Fixed
Redemption	No	Yes
Voting rights	Equity shares carry voting rights.	Normally, preference shares do not carry voting rights. However, in special circumstances, they get voting rights.
Convertibility	Equity shares can never be converted.	Preference shares can be converted into equity shares.
Arrears of Dividend	Equity shareholders have no rights to get arrears of the dividend for the previous years.	Preference shareholders generally get the arrears of dividend along with the present year's dividend, if not paid in the last previous year, except in the case of non-cumulative preference shares.

1.4 EQUITY SHARES

1.4.1 MEANING

Equity shares are those shares which are ordinary in the course of company's business. They are also called as ordinary shares. These share holders do not enjoy preference regarding payment of dividend and repayment of capital. Equity shareholders are paid dividend out of the profits made by a company. Higher the profits, higher will be the dividend and lower the profits, lower will be the dividend.

1.4.2 FEATURES OF EQUITY SHARES:

(1) **Owned capital:** Equity share capital is owned capital because it is the money of the shareholders who are actually the owners of the company.

(2) **Fixed value or nominal value:** Every share has fixed value or a nominal value. For example, the price of a share is Rs. 10/- which indicates a fixed value or a nominal value.

(3) **Distinctive number:** Every share is given a distinct number just like a roll number for the purpose of identification.

(4) **Attached rights:** A share gives its owner the right to receive dividend, the right to vote, the right to attend meetings, the right to inspect the books of accounts.

(5) **Return on shares:** Every shareholder is entitled to a return on shares which is known as dividend. Dividend depends on the profits made by a company. Higher the profits, higher will be the dividend and vice versa.

(6) **Transfer of shares:** Equity shares are easily transferable, that is if a person buys shares of a particular company and he does not want them, he can sell them to any one, thereby transferring the shares in the name of that person.

(7) **Benefit of right issue:** When a company makes fresh issue of shares, the equity shareholders are given certain rights in the company. The company has to offer the new shares first to the equity shareholders in the proportion to their existing share holding. In case they do not take up the shares offered to them, the same can be issue to others. Thus, equity shareholders get the benefits of the right issue.

(8) **Benefit of Bonus shares:** Joint stock companies which make huge profits, issue bonus shares to their ordinary shareholders out of the accumulated profits. These shares are issued free of cost in proportion to the number of existing equity share holding. In case they do not take up the shares offered to them, the same can be issued to others. Thus, equity shareholders get the benefits of the right issue.

(9) **Irredeemable:** Equity shares are always irredeemable. This means equity capital is not returnable during the life time of a company.

(10) **Capital appreciation:** The nominal or par value of equity shares is fixed but the market value fluctuates. The market value mainly depends upon profitability and prosperity of the company. High rate of dividend

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is paid with high rate of profit, the shareholders capital is appreciated through an appreciation in the market value of shares. (i.e. higher the rate of dividend, higher the market value of the shares.)

1.4.3 ADVANTAGES OF EQUITY SHARES

Equity shares are amongst the most important sources of capital and have certain advantages which are mentioned below:

i. Advantages from the Shareholders' Point of View

(a) Equity shares are very liquid and can be easily sold in the capital market.

(b) In case of high profit, they get dividend at higher rate.

(c) Equity shareholders have the right to control the management of the company.

(d) The equity shareholders get benefit in two ways, yearly dividend and appreciation in the value of their investment.

ii. Advantages from the Company's Point of View:

(a) They are a permanent source of capital and as such; do not involve any repayment liability.

(b) They do not have any obligation regarding payment of dividend.

(c) Larger equity capital base increases the creditworthiness of the company among the creditors and investors.

1.4.4 DISADVANTAGES OF EQUITY SHARES:

Despite their many advantages, equity shares suffer from certain limitations. These are:

i. Disadvantages from the Shareholders' Point of View:

(a) Equity shareholders get dividend only if there remains any profit after paying debenture interest, tax and preference dividend. Thus, getting dividend on equity shares is uncertain every year.

(b) Equity shareholders are scattered and unorganized, and hence they are unable to exercise any effective control over the affairs of the company.

(c) Equity shareholders bear the highest degree of risk of the company.

(d) Market price of equity shares fluctuate very widely which, in most occasions, erode the value of investment.

(e) Issue of fresh shares reduces the earnings of existing shareholders.

ii. Disadvantage from the Company's Point of View:

(a) Cost of equity is the highest among all the sources of finance.

(b) Payment of dividend on equity shares is not tax deductible expenditure.

(c) As compared to other sources of finance, issue of equity shares involves higher floatation expenses of brokerage, underwriting commission, etc.

1.5 OWNERSHIP & MANAGEMENT(CONTROL) – A DIVORCE

The so-called "divorce between ownership and control" happens when the owners of a business do not control the day-to-day decisions made in the business. For example, the majority of shareholders in public companies are not involved in any way with operational decision-making by the companies in which they have invested.

1.5.1 OWNERSHIP AND CONTROL OF A BUSINESS

a) The owners of a company normally elect the ***Board of Directors*** to control the business's resources for them. Often in smaller firms, there is no difference between the Directors and the Shareholders - they are the same person or people.

b) However, when the share ownership of the business becomes more widespread (for example when shares are sold to external investors) the original owners of the business sacrifice some of their control.

c) Other shareholders can exercise their voting rights, and providers of loans often have some control (security) over the assets of the business.

d) This may lead to conflict between them as different shareholders can have varying objectives. This is known as the **principal agent problem**.

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1.5.3 DEALING WITH THE DIVORCE BETWEEN OWNERSHIP & CONTROL

Strategies to deal with the potential conflict between shareholders and managers include:

- **Financial Rewards:**

  Ensuring that financial rewards and incentives offered to managers are aligned with shareholder holder interests - e.g. based on the share price, dividends, profits achieved

- **Corporate Governance:**

  Implementing suitable corporate governance procedures to ensure shareholders are protected as far as possible (e.g. through non-executive directors, management remuneration committees)

- **Accountable:**

  Company legislation ensures that Directors are accountable for their actions to shareholders.

1.5.4 THE ADVANTAGES OF THE SEPARATION OF OWNERSHIP & MANAGEMENT

Separation of ownership and management in corporate governance involves placing the management of the firm under the responsibility of professionals who are not its owners. Owners of a company may include shareholders, directors, government entities, other corporations and the initial founders. This separation allows skilled managers to conduct the complicated business of running a large company.

a) Professional Managerial Skills :

The growth of a company comes with the demand for different skills to manage the operations of the company, meaning the owners of a company may not have all of the necessary skills and experience needed for certain managerial roles. Creating a management team separate from the ownership enables the company to be run by professionals with diverse skills such as in marketing, corporate financing and public relations.

b) Easier Performance Appraisals :

Performance appraisals are an essential part of good corporate governance, as they enable managers to evaluate the company and to point out areas of improvement. It can be complex to evaluate performance where there is a lack of separation of ownership and management. But separation makes it easier for the board and those in management to be evaluated objectively. Owners can freely deal with the chief executive officer and other senior managers, even after the appraisals.

c) Capital Utilization :

Capital utilization involves the arrangements that determine the way in which resources and assets are managed in a company. Separating personal assets and liabilities from the business assets and liabilities may prove difficult for company owners. Managers come in to devise ways in which business assets are managed to generate the highest profits for all shareholders.

d) Checks and Balances :

Separate managers and owners in a firm ensure that a system of checks and balances is in place. Managers act as a buffer between the company and stakeholders such that they can alleviate negative impacts of stakeholder activities and avoid hitches in public relations. Managers are well suited to put in place strategies that will lessen losses to the rest of the stakeholders as a result of the actions of another stakeholder.

e) Democratic Decision Making :

One of the advantages of the modern corporation is that it uses a democratic decision-making process on major issues. When the shares of a corporation divide, each share of common stock typically carries with it one vote. The shareholders get the opportunity to vote on matters for the company. Instead of having one person that is in charge of making all of the important decisions, the group can decide what is most appropriate.

f) **Unbiased Structure :**

Another advantage of separating the control and the ownership of the company is that the executives and the upper level managers of the company are not necessarily those that own the majority of the company. This separates those who make the day-to-day operational decisions for the company from those who own stock. This means that the managers and Chief Executive Officer, or CEO, can make decisions based on the interest of the company and not themselves.

1.5.5 THE DISADVANTAGES OF THE SEPARATION OF OWNERSHIP & MANAGEMENT

1. **Initial cost:** incorporation may cost thousands of dollars and require expensive lawyers and accountants.
2. **Extensive paperwork:** a corporation must keep detailed financial records.
3. **Double taxation:** corporate income is taxed twice. First the corporation pays tax before dividends to stockholders. Then the stockholders pay income tax on the divide they receive.
4. **Two tax returns:** an individual who incorporates must file both a corporate tax return and an individual tax return.
5. **Size:** large corporation sometimes become too inflexible and tied down in red tape to Respond quickly to market changes, and their profitability can suffer.
6. **Difficulty of termination:** once a corporation has started, it's relatively hard to end.
7. **Conflicts:** Possible conflict with stockholders and board of