CHAPTER ONE

INTRODUCTION TO EQUITY CULTURE

1.1 Introduction
1.2 Importance of Finance
1.3 Sources of finance in a market Economy
1.4 Financial Infrastructure in India
1.5 Financial Instruments
1.6 Financial Services
1.7 Indian financial System
1.8 Equity Culture And Development
1.9 Regulatory Frame Work
1.10 Financial System and RBI
1.11 Share
1.12 Equity Shares Or Equities
1.13 Rights Of Equity Shareholder
1.1 Introduction:

The topic is opened with the importance of finance today and further covers sources of finance, financial infrastructure in India, Indian financial system, Equity culture and its development and equity related term discussion.
1.2 Importance of finance:

"Money is like a sixth sense without which you cannot make a complete use of the other five" - Somerset Maugham. Survival, development of the activity totally depends upon efficient use of finance.

Every organization, irrespective of its size and mission, may be viewed as a financial entity. Finance has become a form of economic engineering in which money in circulation is comparable to kinetic energy and unemployed capital to potential energy.

Finance has been defined as "the art of providing the means of payment". It may also refer to sum of total resources available for any activity. *1

The term ‘finance’ in real world has been interpreted variably by different finance scholars. At one time it was related only to the extent of acquiring funds on reasonable conditions for the activity. In another approach finance is related to cash. Every business activity is related to cash.

In the third, finance is related with procurement of funds and better applications of these procured funds. In business organization finance manager is placed not only to acquire adequate cash to satisfy business requirements but extends beyond this to optimal utilization of funds. It is the job of the finance manager to utilize cash in such a manner, which leads to maximum value of enterprise. The only genuine purpose of a business organization is wealth maximization of its owners. It is also the most important social objective of business, to earn profit, so that it can contribute to the economic betterment of the people. Profit also prevents a business from becoming a parasite on the society, living on subsidies and grants like some public sector undertakings.

The common thread running through all decisions taken by the various managers is money. Irrespective of activity, there is hardly any person to whom money does not matter.*2

The results of all activities in an organization are reflected in the financial statements in rupees.
1.3 Sources of finance in a Market Economy:

The Indian financial system is divided into three broad categories of institutions:

1. Collection of savings and transfer to the actual investors – the banking system, the insurance companies, mutual funds, investment and other institutions, which promote savings among the public.

2. The borrowers or investors—Individuals, industrial and trading companies, and the government.

3. Facilitators – these organizations work as facilitators. They facilitate savings and investment in the country.

The new issue market (Primary Market) and the stock exchange (Secondary Market) and these organizations, contribute indirectly to promote savings and investments as they facilitate easy transfer of funds.

The saving-investment process known as capital formation is the foundation for economic development of the country. The finance system is also called as financial market. The purpose of the financial market is to mobilize savings, effectively, and allocate the same efficiently among the ultimate users of funds i.e. investors.

1.4 Financial Infrastructure in India:

The Indian financial infrastructure is unquestionably one of the strongest among the developing countries, both in term of financial institutions and financial services.

The financial institutions working are:

1. Banking Institutions
2. Insurance companies
3. Development Financial Institutions
4. Specialized financial Agencies like NABARD, SIDBI, NSIC
5. Mutual Funds
6. Venture Capital Funds
7. Stock Exchanges
8. Leasing and Hire purchase companies.
10. Credit Card Agencies.
11. Factoring companies
12. Housing Finance.

1.5 Financial Instruments:
The financial instruments are the means by which money exchanged between those who have it and those who need it.

The popular financial instruments used for exchange are:
1. Equity Shares.
2. Preference shares
3. Convertible Debentures
4. Non Convertible Debentures
5. Commercial papers
6. Public deposits
7. Inter-corporate Deposits.

1.6 Financial Services:
A variety of financial services are rendered by the public and private sector institutions. The few important are:-

1. Merchant Banking
2. Loan Syndications
3. Credit Rating
4. Mergers and acquisitions
5. Portfolio Management
6. Securities Dealing
7. Issue houses and Registrars
8. Issue underwriting
9. Private placements
10. Securitization
11. Education & Training.
1.7 Indian Financial System:

In a nutshell, the Indian financial system consists of a variety of institutions, markets, and instruments. It depicts ways by which savings are transformed into investments. The following chart summarizes the discussions about the relationship among institutions, markets, and instruments.

The rapid economic growth and globalization of financial markets is perhaps one of the most significant developments at the international level. The past two decades have witnessed a process of accelerating changes in the global financial markets. New financial products have emerged due to the process of liberalization. It has eliminated the old boundaries between financial intermediaries. The above financial innovations have brought many merits i.e.
1. Availability of financial assets and liabilities to end users.
2. Reduction in cost of financial intermediaries
3. Development of sophisticated risk management tools.
4. New ways to mobilize domestic and international savings.

The liberalization policies adopted by the Indian Govt. have helped the country to record better performance. During last few years the growth and performance of the economy have improved due to the important policy pronouncements made by the Government.

The eighties have seen a quantum jump in the new issues and the cult of equity has begun to grow aided by many tax benefits and the operations of mutual funds in the economy. A number of venture capital funds were set up by financial institutions to help new and risky ventures. Many public sector banks and LIC, GIC have come out with their mutual funds recently, which have helped the new issue market as well as the secondary market. In addition to the UTI, these mutual funds started mobilizing funds for investment in the capital market since 1987.

Tax concessions regarding dividend income, debenture interest, investment in equity issues, venture capital funds, change in definition of period for long term capital gain i.e. 3 years to 1 year, have given a boost to equity investments. In addition to this financial restructuring and deregulations have also helped the sentiments.

The process of liberalization initiated by the government has not been new, but prior efforts were not stable and widespread. The structural reforms initiated during the period 1991-95 have had a positive impact on the investment climate of the country. The new economic policies, aimed at liberalization and globalization are consistent and irreversible.

The Domestic capital market, especially the new issue market (NIM), became the predominant channel for financing corporate sector investments in India, subsequent to the liberalization of capital market controls in July 1992. One of the significant factors that helped the growth of the NIM in India was the growing
significance of financial assets, with increase in the saving rate and monetization of the economy. *4

The government has geared up the financial sector to meet the global challenges. Therefore, we see that, the Indian financial markets are undergoing a process of rapid change, which has transformed the entire complexion of the financial system.

Strong economic and corporate fundamentals burgeoning of Forex reserves at US$ 22 billion, rise in custom and excise revenue by 17% in the first five months (April to Aug 1994), recovery in steel and cement industries, setting-off of the boom in petrochemicals, textiles and automobile industries, good monsoon and further Merlyn- Lynch rated Indian markets as the best among the top seven emerging markets in the world, has ultimately resulted in the BSE sensitive Index touching all time high of 4643 points, the breaking HM barrier on Sept 12, 1994.*5

All said and done, long bull markets have always been followed by long stretches of stagnant / recessionary markets. *6

Stock market is no longer the place to make quick bucks. Indian stock markets have become too complex for the common man. The stock markets are no longer immune, say, to devaluation of Mexican peso or an interest rate hike in USA. We have become a part of the global village and are susceptible to events happening even in far off places like Mexico. In fact, the market has become so complex that it is difficult, if not impossible, to make money in the short run. Sir John Templeton, the legendary fund manager says, “People are always asking me, where is the outlook good, but that’s the wrong question. The right question is: Where is the outlook the most miserable? The time to buy is when everyone is scared and you are a bit scared of yourself.”*7

To boost the capital market, the presence of retail investors is a must. Strengthening of mutual funds with a strong distribution network, like that for banks, would pave the way for the growth of the equity market. If a regulator takes swift action and protects small investor’s interests, it goes a long way in instilling confidence among them. The Indian markets have seen large system failures in the
last 5 years. The Ketan Parekh scam and collapse of UTI, too, have taken their toll on the markets. This has hurt investor's sentiments severely. *8

The Indian financial system was tailored for the requirements of the mixed economy. During the nineties, the domestic as well as the global context has dramatically changed to market regulated economy. This has made us to look at the status and future of the financial sector. This has also put forth new challenges before intermediaries of financial sector and the regulators.

1.9 Regulatory framework:

Financial markets are taking shape. Corporate investment and financing decisions are guided, shaped and circumscribed by a comprehensive regulatory framework with the objectives to:

- Define areas of investment available to business firms in different categories, ownership wise and size wise.
- Induce investments along certain lines by providing incentives, concessions and relief.
- Impose restrictions on the ways and means by which business firms can raise and deploy funds.

The principal elements of this regulatory framework are – Industrial policy, Company Act and SEBI guidelines.

What is the most heartening trend is the growing involvement of the banking sector in the capital market. It looks as if the commercial banks have started colonizing the capital market. The banking sector, under proper guidance and encouragement, has become a trendsetter in a number of directions. The banks are permitted:

- To float merchant banking subsidiaries which are not offering a package of services to the corporate sector.
- To start mutual funds which are having far reaching impact on the mobilization of savings of the community and in activating the stock exchanges.
- To manage investment portfolios of non resident investors.
- To create secondary market in public sector bonds.
- To participate in the floatation of OTC market etc.

1.10 **Financial System and RBI**:

This has increased the role of a controller, the RBI in India. As a banker to the banks, the RBI controls the credit and banking systems including the financial institutions. These are all together called the organized sector of the financial system.

The functions of RBI with respect to financial system are:

1. Provision of finance and refinance
2. Regulation of banking and financial institutions for protecting the interest of the public and for monetary stability, and
3. Development of sound financial system by strengthening the institutional structure and by promoting savings and investments in the economy.

Banks have linkages with both the brokers and the dealers in securities through the credit limits granted to them and through their operations in the primary and secondary markets.

1.11 **Share**:

Shares are the universal and typical form of raising long term capital from capital market. Share represents a portion of capital, which refers to the amount of money raised by issue of shares. Share, in finance, is that part of the capital of a company held by a member (shareholder). Fully paid shares can be converted into stock. *9

*Section 2(46) of Indian Companies Act, 1956, has defined share as:

“Share means share in the share capital of the companies and includes stock, except when a distinction between stock and share is expressed or implied”.

Stock as per Section 94(i) (c) of a company means – “ when shares have been fully paid up they may, if so authorized by the articles, be turned into stocks by the company in general meeting”.***
Thus stock is merely a name for the aggregate ownership of a company, which is divided into a number of units, each unit called a share.

The important characteristics of the shares are:

1) Life time fund for the company
2) Ownership of the company
3) No fixed obligations
4) Share is like a commodity.

Under the Indian Companies Act section 82 and section 111 deal with the transfer of shares. In the case of public Ltd. Company, the objectives of the Companies Act as also of the Listing Agreement with the Stock Exchange, is to ensure free and unfettered transfer of shares. Under the Act, shares are treated as any movable property. As any right to property, these are freely transferable. By an amendment in 1985, Section 22(A) of the Securities Contracts (Regulations) Act has denied the right to refuse to transfer shares by a public Ltd. company except on technical grounds. The Company has to specify the reasons for refusal to transfer, as specified in the Act, and reference has to be made to the Company Law Board whose decision to refuse or not to refuse the transfer of share will be final.

Thus, the essential characteristics of shares of transferability is well preserved which gives them the market which in turn extends liquidity to these shares. This has led to the emergence of securities markets in India.

As per section 86 of the Indian companies Act 1956 a company can issue only two types of shares:


1.12 **Equity shares or Equities:**

Ordinary shares of publicly held companies, conferring a share of ownership of the company on the holder who shares the company’s profits but whose liability for its losses is limited to the sum of his holding. Since the price of equity shares of successful companies is many times above their face value, the dividend yield is often low, as compared to other saving investments like term deposits, but the appreciation in their price is a good hedge against inflation. *10
The equity share is evidence of ownership in a company. The physical evidence of this ownership is a document called the share certificate. It has your name endorsed on it and is proof that you are a part owner of the company.

Your ownership rights are proportionate to the number of shares you own. The number of shares and proportionate ownership rights refer to purchase of fractional ownership of the company and its assets.

Each company issues shares of a certain fixed denomination called face value or par value of that share.

This is clearly indicated on the share certificate. The face value can be anything but mostly the shares issued having face value of Rs.10 or Rs.100 and now the new issues are of Rs. 10 only.

Face value is the value of the share when it is first issued by the company. It contributes to retain this value as far as the company is concerned. The price at which it may be brought and sold may be different called as Market Value.

Issue price is the price at which the equity share is issued. Generally the issue price and par value are same. If the company, new or existing company, issues shares higher than the par value, the difference is referred as the share premium. It may be noted that the share price can’t be lower than the par value as per law.

The book value of equity share is equal to paid up equity capital plus reserves and surplus divided by number of outstanding equity shares. The book value of an equity share tends to increase as the ratio of Reserves and Surplus to paid up equity capital increases.

1.13 **Rights of Equity Shareholder:**

Equity shareholders have following important rights:

1) **Right to income:**

The share holder has a residual claim to the income of the firm. Equity earnings, which are ploughed back in the firm, tend to increase the market value of equity share. The equity dividend decision is the prerogative of the
Board of Directors and equity share holders can not challenge the decisions in the court of law.

2) Right to control:
   Equity share holders as the owners of the firm elect the board of directors and have the right to vote on every resolution placed before the company.

3) Pre-emptive right:
   This right enables the existing share holders to maintain their proportional ownership by purchasing the additional equity shares issued by the firm. Therefore, the first priority to purchase additional issues of equity capital on pro rata basis is given to existing equity share holders. The preemptive right protects the existing share holders from the dilution of their financial interest as a result of additional equity share.

4) Rights in liquidation:
   In the event of liquidation, the equity share holders have a residual claim over assets of the firm. The advantages of equity capital are that it represents a permanent source of finance, does not carry any fixed burden and enhances the credit worthiness of the firm. The disadvantages are that its cost is very high and issue of equity to outsiders causes dilution of control.
References:

4. Muralik K: An Alternative to Investment Promotion in Developing Countries; A Case Study of Indian Primary Market, Research and Information System (RIS) for the Non- Aligned and Other Developing Countries, Occasional Paper No.61,2001. P. 2, 12.