13. Common and Preferred Stock

Companies may issue different types of stock; notably common stock and preferred stock. Being familiar with the word preferred may lead you to conclude it is the better choice, but such is not necessarily the case. The customary features of common and preferred differ, providing some advantages and disadvantages for each. As you shall soon see, preferred stock is ordinarily in a better position for dividends and any liquidation proceeds, but it can be left out of significant opportunities for share value appreciation. Before digging into the specifics, be advised that the following discussion relates to general features, and the applicability of these general features can be modified on a company by company basis. Before investing in any company's common or preferred stock, you should carefully examine the specific provisions that might be unique to that company.

13.1 Typical Common Stock Features

- The right to share in a portion of dividends that are declared and issued by the company to its common shareholders.

- An option to buy a proportional part of any additional shares that may be issued by the company. This "preemptive right" is intended to allow a shareholder to avoid dilution by being assured a place in line to acquire a fair part of any corporate stock expansion. (Numerous companies have done away with this provision.)

- The right to vote on certain general governance matters like election of the Board of Directors, employee stock award plans, mergers, and similar major items.

- The right to share in proceeds of liquidation after all creditors and other priority claims are settled.

- The right to periodic financial reports about corporate performance.

Some companies go to the added trouble of having multiple classes of common stock -- Class A, Class B, etc. A good example is a "family business" that has grown very large and become a public company. Such situations may be accompanied by the creation of Class A stock (held by the family members) and Class B stock (held by the public), where only the Class A stock can vote. Thus, the family has raised needed capital but preserved the ability to control and direct the company. You might also find it interesting that one can be forced out (in exchange for a fair price) of a stock ownership interest; this can occur when a company is bought out by another, and most of the other shareholders (oftentimes as high as 80 to 90%) have consented to the transaction. Non controlling shareholders (those who hold stock in a company where another party owns more than half of the corporation) are sometimes called the "minority interest." Minority shareholders are in a treacherous position, and governing laws vary considerably in how much protection is afforded to prevent the majority from engaging in transactions and activities that disadvantage the minority.

13.2 Possible Preferred Stock Features

- A preferred position for dividends. Preferred stock is paid a dividend prior to any distribution to common stockholders, and the dividend is more or less expected each period. The amount of the dividend is usually stated as a percentage of the preferred stock's "par value." Furthermore, preferred stock is frequently cumulative; if the annual dividend requirement cannot be satisfied, it will become a dividend in arrears, and all dividends in arrears must be paid before any dividends can be paid to common shareholders (in contrast to "noncumulative" where a missed dividend is not required to be made up in the future).

- The absence of voting rights.

- A preferred position in liquidation. In the event of a corporate liquidation, preferred stock is understood to be "paid-off" before common shareholders. Of course, creditors must first be satisfied before any funds will flow to either the preferred or common stockholders.

- A call feature, which means that the company can force the preferred shareholders to cash out of their position in exchange for a pre agreed "call price" that is oftentimes set at a certain percentage of "par value" (e.g., callable at 105, would mean the company can buy back the preferred stock at 105% of its par value). You don't have to think too long to see that this call provision can effectively limit the upside value of an investment in preferred stock, no matter how attractive its dividend might appear.

- A convertible feature, which means that the preferred shares may be exchanged for common stock at a preagreed ratio (e.g., 3 shares of common for one share of preferred). This conversion provision can effectively provide significant upside value for an investment in preferred stock, no matter how bad its dividend might appear.

- A maturity date, at which time the preferred will be bought back by the company ("mandatory redeemable").

Even a casual review of the above features will quickly lead you to conclude that preferred has its merits and its detractions depending on how the individual features are implemented for a particular company. Obviously, every company has different financing (and tax!) considerations and will tailor its package of features to match those issues. For instance, a company can issue preferred that is much like debt (cumulative, mandatory redeemable), because a fixed periodic payment must occur each period with a fixed amount due at maturity. On the other hand, some preferred will behave more like common stock (noncallable, noncumulative, convertible).

13.3 What is Par?

In the preceding discussion, there were several references to "par value." Many states require that stock have a designated par value (or in some cases "stated value"). Thus, par value is said to represent the "legal capital" of the firm. In theory, original purchasers of stock are contingently liable to the company for the difference between the issue price and par value if the stock is issued at less than par. However, as a practical matter, par values on common stock are set well below the issue price, negating any practical effect of this latent provision. It is not unusual to see common stock carry a par value of $1 per share or even $.01 per share. In some respects, then, par value is merely a formality. But, it does impact the accounting records, because separate accounts must be maintained for "par" and "paid in capital in excess of par."

To illustrate the issuance of par value stock, assume that Godkneckt Corporation issues 100,000 shares of $1 par value stock for $10 per share. The entry to record this stock issuance would be:

5-1-XX	Cash		1,000,000	
	Common Stock			100,000
	Paid in Capital in Excess of Par			900,000
	To record issuance of 100,000 shares of $1 par value common stock at $10 per share			

Occasionally, a corporation may issue no-par stock, which is simply recorded by debiting Cash and crediting Common Stock for the issue price. A separate Paid-in Capital in Excess of Par account is not needed.

By the way, the above entry assumed the stock was issued for cash. Sometimes, stock is issued for land or other tangible assets, in which case the above debit would be to the specific asset account (e.g., Land instead of Cash). When stock is issued for noncash assets, the amount of the entry would be based upon the fair value of the asset (or the fair value of the stock if it can be more clearly determined).

13.4 A Closer Look at Cash Dividends

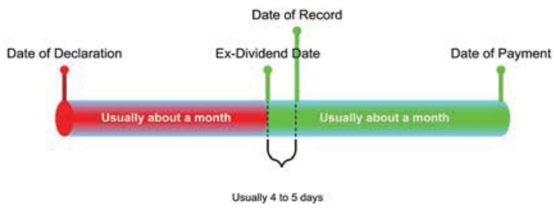
Let's begin by assuming that a company has only common shares outstanding. There is no mandatory dividend requirement, and the dividends are a matter of discretion for the Board of Directors to consider. Of course, to pay a dividend, the company must have sufficient cash and a positive balance in retained earnings (companies with a "deficit" (negative) Retained Earnings account would not pay a dividend unless it is part of a corporate liquidation action). Many companies pride themselves in having a longstanding history of regular and increasing dividends; a feature that many investors find appealing. Other companies view their objective as one of continual growth via reinvestment of all earnings; their investors seem content relying on the notion that their investment value will gradually increase due to this earnings reinvestment activity. Whatever the case, a company has no obligation to pay a dividend, and there is no "liability" for dividends until such time as they are actually declared. A "declaration" is a formal action by the Board of Directors to indicate that a dividend will be paid at some stipulated future date. On the date of declaration, the following entry is needed on the corporate accounts:

7-1-XX	Dividends		50,000	
	Dividends Payable			50,000
	To record declaration of dividends on common stock (assumed $0.50 per share on 100,000 shares outstanding); to be paid on September 1			

In observing the above entry, it is imperative to note that the declaration on July 1 establishes a liability to the shareholders that is legally enforceable. Therefore, a liability is recorded on the books at the time of declaration. Recall (from much earlier chapters) that the Dividends account will directly reduce retained earnings (it is not an expense in calculating income -- it is a distribution of income)! On September 1, when the above dividends are paid, the appropriate entry is:

9-1-XX	Dividends Payable		50,000	
	Cash			50,000
	To record payment of previously declared dividend			

Some shareholders may sell their stock between the date of declaration and the date of payment. Who is to get the dividend? The former shareholder or the new shareholder? To resolve this question, the Board will also set a "date of record;" the dividend will be paid to whomever the owner of record is on the "date of record." In the preceding illustration, the date of record might have been set as August 1, for example. To further confuse matters, there may be a slight lag of just a few days between the time a share exchange occurs and the company records are updated. As a result, the date of record is usually slightly preceded by an ex-dividend date. The practical effect of this is simple: if a shareholder on the date of declaration continues to hold the stock at least through the ex-dividend date, that shareholder will get the dividend -- but if the shareholder sells the stock before the ex-dividend date, the new shareholder can expect the dividend. In the time line at right, if you were to own stock on the date of declaration, you must hold the stock at least until the "green period" to be entitled to receive payment.



13.5 The Presence of Preferred Stock

Recall that preferred dividends are expected to be paid before common dividends, and those dividends are usually a fixed amount (e.g., a flat percentage of the preferred stock's par value). In addition, recall that cumulative preferred requires that dividends that are not paid become "dividends in arrears." Dividends in arrears must also be paid before any distributions to common can occur. Another illustration will likely provide the answer to questions you may have about how these concepts are to be implemented.

To develop the illustration, let's begin by looking at the equity section of Embassy Corporation's balance sheet. You will note that this section of the balance sheet has grown considerably. A corporation's stockholders' equity (or related footnotes) should include rather detailed descriptions of the type of stock outstanding and its basic features. This will include mention of the number of shares authorized (permitted to be issued), issued (actually issued), and outstanding (issued minus any shares reacquired by the company). In addition, you should be aware of certain related terminology -- "legal capital" is the total par value ($20,400,000 below), and "total paid in capital" is the legal capital plus amounts paid in excess of par values ($56,400,000 below).

Stockholders' Equity			
Capital stock:			
Preferred stock, $100 par value, 8% cumulative, 500,000 shares authorized, 200,000 shares issued and outstanding	$20,000,000		
Common stock, $1 par value, 2,000,000 shares authorized, 400,000 shares issued and outstanding	400,000	$20,400,000	
Additional paid-in capital			
Paid-in capital in excess of par -- preferred stock	$ 1,000,000		
Paid-in capital in excess of par -- common stock	35,000,000	36,000,000	
Total paid-in capital			$56,400,000
Retained earnings			6,600,000
Total stockholders' equity			$63,000,000

In examining this stockholders' equity section, note that the par value for each class of stock is the number of shares issued multiplied by the par value per share (e.g., 200,000 shares X $100 per share = $20,000,000).

For Embassy Corporation, note that the preferred stock description makes it clear that the $100 par stock is 8% cumulative. This means that each share will pay $8 per year in dividends, and any "missed" dividends become dividends in arrears. Let us further assume that the notes to the financial statements appropriately indicate that Embassy has not managed to pay its dividends for the preceding two years. If Embassy desired to pay $5,000,000 of total dividends during the current year, how much do you suppose would be available to the common shareholders? The answer is only $200,000 (or $0.50 per share for the 400,000 common shares). The reason is that the preferred stock is to receive annual dividends of $1,600,000 ($8 per share X 200,000 preferred shares), and three years must be paid consisting of the two years in arrears and the current year requirement ($1,600,000 X 3 years = $4,800,000 to preferred, and leaving only $200,000 for common).