УДК 330.336

V.A. Karmazin
Associate Professor of Faculty of Management and Marketing
A.O. Bondar
National Technical University of Ukraine «KPI»

THE ADVANTAGES AND DISADVANTAGES OF FINANCING WITH PREFERRED AND COMMON STOCK

ПЕРЕВАГИ ТА НЕДОЛІКИ ФІНАНСУВАННЯ ПРИВІЛЕЙОВАНИХ ТА ЗВИЧАЙНИХ АКЦІЙ

This article discusses equity financing. The advantages and disadvantages of issuing preferred and common stock are addressed, along with the various circumstances in which either financing source is most suited. Stock rights are also described. Consideration is given to the advantages and disadvantages of public versus private placement, or sale. Also discussed is the role of the investment banker. The economic benefits of a well-run stock exchange is considered. Facilitates improvement in corporate behavior and the high level of public awareness of the business explored in conditions of market economy. The special attention is paid to dividend policies. Certainly essence and types of dividend policy of enterprises. The factors of influence on the dividend policy of enterprises are analyzed and systematized. Treats the issue of generated profit distribution by a company taking into consideration planned investments. It is marked necessity of individual approach to forming mechanism of payments and extra charge of dividends for different enterprises.

У даній статті досліджено пайове фінансування. Розглянуто переваги та недоліки випуску привілейованих та звичайних акцій наряду з різноманітними обставинами, в яких кожне джерело фінансування може бути найбільш придатним. Визначено права акціонерів на випуск додаткових акцій. Розглянуто переваги та недоліки публічного та приватного розміщення або продажу акцій. Розглянуто роль інвестиційного банкіра. Визначені економічні вигоди від добре керованої фондової біржі, що у свою чергу сприяє поліпшенню корпоративної поведінки та підвищенню громадської обізнаності про вивчення бізнесу в ринкових умовах. Особлива увага приділяється дивідендній політиці, а саме її сутності та основним видам. Проаналізовано та систематизовано фактори впливу на дивідендну політику підприємства. Розглянуті питання про розподіл прибутку, згенерованого компанією з урахуванням запланованих інвестицій. Визначається необхідність індивідуального підходу до формування механізму платежів і нарахування дивідендів для різних підприємств.

В статье исследовано долевое финансирование. Рассмотрены преимущества и недостатки выпуска привилегированных и обыкновенных акций на ровне с разнообразными обстоятельствами, при которых каждый источник финансирования может быть наиболее приемлемым. Определены права акционеров на выпуск дополнительных акций. Рассмотрены преимущества и недостатки публичного и частного размещения или продажи акций. Рассмотрена роль инвестиционного банкира.

Определены экономические выгоды от хорошо управляемой фондовой биржи, что в свою очередь способствует улучшению корпоративного поведения и повышению общественной осведомленности об изучении бизнеса в рыночных условиях. . Особое

внимание уделяется дивидендной политике, а именно ее сущности и основным видам. Проанализированы и систематизированы факторы влияния на дивидендную политику предприятия. Рассмотрены вопросы о распределении прибыли, созданного компанией с учетом запланированных инвестиций. Определяется необходимость индивидуального подхода к формированию механизма платежей и начисление дивидендов для различных предприятий.

Key words: financial securities, preferred stock, common stock, stockholders, equity financing.

Analysis of the latest publications. Equity and debt securities may be issued either publicly or privately. A consideration in determining whether to issue securities publicly or privately is the type and amount of the needed financing.

In a public issuance, the shares are bought by the general public. In a private placement, the company issues the securities directly to either one or a few large investors. The large investors involved are financial institution such as insurance companies, pension funds, and commercial banks.

Stock markets, or stock exchanges, are centralized trading places, where companies can raise equity shape capital. Traditionally, the four biggest and most well known are the London Stock Exchange, the New York Stock Exchange (NYSE), the NASDAQ (which is also based in New York but is separate from the NYSE) and the Tokyo Stock Exchange.

The primary purpose of all stock exchanges is to raise equity capital for firms in return for securities issued in the form of preferred and common stock. The purpose of the issue of equity is to provide the firm with capital for investment purposes. Shareholders have a direct stock in the firm as their share certificate gives them fractional ownership in proportion to the amount of the firm’s equity that they own.

The economic benefits of a well-run stock exchange can be considerable. Some of the benefits of financing with preferred and common stock are considered in the article.

Formalization of the task. Private placement has the following advantages, when compared to a public issuance:

1. The flotation cost is less. Flotation cost is the expense of registering and selling the stock issue. Examples are brokerage commissions and underwriting fees. The flotation cost for common stock exceeds that for preferred stock. Flotation cost expressed as a percentage of gross proceeds is higher for smaller issues than for lager ones.
2. It avoids SEC filing requirements.
3. It avoids the disclosure of information to the public at large.
4. There is less time involved in obtaining funds.
5. It may not be practical to issue securities in the public market when a company is so small that an investment banker would not find it profitable.

6. The company’s credit rating may be low, and as a consequence investors may not be interested in buying securities when the money supply is limited.

Private placement has the following disadvantages, when compared to a public issuance:

1. It is more difficult to obtain significant amount of money privately compared to publicly.

2. Large investors usually employ stringent credit standards requiring the company to be in a strong financial position.

3. Large institutional investors may watch more closely the company’s activities than smaller investors in a public issue.

4. Large institutional investors are more capable of obtaining voting control of the company.

Methods of study. Study is made by analysis and comparison of information. Theoretical basic of study are:

- information – analytical editions;
- information on pages of economic literature and Internet recourses of this problem.

Results of study. Preferred stock may be issued when the cost of common stock is high. The best time to issue preferred stock is when the company has excessive financial leverage and an issue of common stock might create control problems for the owners. Many utilities offer preferred stock. Preferred stock is a more expensive way to raise capital than a bond issue because the dividend payment is not tax-deductible.

Preferred stock may be cumulative or noncumulative. *Cumulative* preferred stock means that if any previous year’s dividend payments have been missed, they must be paid before dividends can be paid to common stockholders. If preferred dividends are in arrears for a long period of time, a company may find it difficult to resume its dividend payment to common stockholders. With *noncumulative* preferred stock, the company need not pay missed preferred dividends. Preferred stock dividends are limited to the rate specified, with is based on the total par value of the outstanding shares.

Participating preferred stock means that if declared dividends exceed the amount normally given to preferred stockholders and common stockholders, the preferred and common stockholders will participate in the excess dividends. Unless stated otherwise, the distribution of the excess dividends will be based on the relative total par value.

Preferred stock may be callable, which means that the company can buy it back at a later date at a specified call price. The call provision is advantageous when interest rates decline, since the company has the option of discontinuing payment of dividends at a rate that has become excessive by buying back preferred stock that was issued when bond interest rates were high. Unlike bonds, preferred stock rarely

has a maturity date associated with it. However, if preferred stock has a sinking fund associated with it, this, in effect, establishes a maturity date for repayment.

In the event of corporate bankruptcy, preferred stockholders are paid after creditors and before common stockholders. In such a case, preferred stockholders receive the par value of their shares dividends in arrears, and the current year's dividend. Any asset balance then goes to the common stockholders.

The cost of preferred stock can be determined by the dividend payment by the net proceeds received.

The company should estimate the amount it will receive per share and the number of shares it must sell in order to finance the business.

To a company, a preferred stock issue has the following advantages:

1. Preferred dividends do not have to be paid, whereas interest on debt must be paid.

2. Preferred stockholders cannot force the company into bankruptcy.

3. Preferred stockholders do not share in unusually high profits of the company.

4. A growth company can generate better earnings for its original owners by issuing preferred stock having a fixed dividend rate than by issuing common stock.

5. Preferred stock issuance does not dilute the ownership interest of common stockholders in term of earning participation and voting rights.

6. The company does not have to collateralize its assets as it may have to do if bonds are issued.

To a company, a preferred stock has the following disadvantages:

1. Preferred stock requires a higher yield than bonds.

2. Preferred dividends are not tax deductible.

To an investor, a preferred stock offers the following advantages:

1. Preferred stock usually provides a constant return in the form of a fixed dividend payment.

2. Preferred stockholders come before common stockholders in the event of corporate bankruptcy.

To an investor, the disadvantages of a preferred stock are:

1. The return is limited because of the fixed dividend rate.

2. There is greater price fluctuation with preferred stock than with bonds because of the nonexistence of a maturity date.

3. Preferred stockholders cannot require the pay dividends if the firm has inadequate earnings.

The owners of a corporation are called stockholders. They elect the board of directors, who in turn select the officers of the firm. When the election occurs, management sends proxy statements, which ask stockholders to give management the right to vote their stock. Effective control of the corporation can exist with the less than 50 percent common stock ownership since many stockholders do not

bother to vote. Stockholders have limited liability in that they are not personally liable for the debts of the company.

Authorized shares represent the maximum amount of stock the company can issue according to the corporate charter. *Issued shares* represent the number of authorized shares which have been sold by the firm. *Outstanding shares* are the issued shares actually being held by the investing public. *Treasure stock* is stock that has been reacquired by the firm. It is not retired but, rather, held for possible future resale, a stock option plan, to use in purchasing another company, or to prevent a takeover by an outside group. Outstanding shares are therefore equal to the issued shares less the treasury shares. Dividends are based on the outstanding shares.

The p*ar value* of a stock is a stock is a stated amount of value per share specified in the corporate charter. The firm typically cannot sell stock at a price below par value stockholders would be liable to creditor for the difference between par value and the amount received.

A closely held corporation is one having only a few stockholders. They keep full control and are not require to publicly disclose financial information about the company. However, a company having 500 or more stockholders must file an annual financial statement with the Securities and Exchange Commission.

A company may issue different classes of common stock. Class A is stock issued to the public and usually has no dividends specified. However, it does have voting right. Class B stock is usually kept by the company's organizers. Dividends are typically not paid on it until the company has generated sufficient earnings.

Common stockholders enjoy the following rights:

1. The right to receive dividends.
2. The right to receive assets upon the dissolution of the business.
3. The right to vote.
4. The preemptive right to buy new shares of common stock prior to their sale to the general public. In this way, current stockholders can maintain their proportionate percentage ownership in the company.
5. The receipt of a stock certificate which evidences ownership in the firm. The stock certificate may then be sold by the holder to another in the secondary security market.

Also exists cumulative voting, which allows for multiple votes for a particular director. Cumulative voting is designed to allow a minority group to be able to elect one director.

A number of option exist for equity financing in the case of small businesses, including:

1. Venture capital (investor) groups.
2. Issuances directly to institutional investors.
3. Issuances to relatives or friends.

4. Issuances to major customers and suppliers.

A determination of the number of shares that must be issued to raise sufficient funds to meet the capital budget may be required.

When the degree of financial leverage is excessive, the company would be better off financing with an equity issue.

Financing with common stock has the following advantages:

1. There is no requirement to pay dividends.
2. There is no repayment date.
3. A common stock issue improves the company's credit rating relative to the issuance of debt.

Financing with common stock has the following disadvantages:

1. Dividends are not tax-deductible.
2. Ownership interest is diluted. The additional voting rights could vote to take control away from the current ownership group.
3. Earnings and dividends are spread over more shares outstanding.
4. The flotation costs associated with a common stock issue are higher than with preferred stock and debt financing.

Conclusion. It is always cheaper to finance operation from internally generated funds. Financing out of retained earnings involves no flotation costs.

Stockholders are generally better off when a firm cuts back on its dividends rather than issuing common stock as a source of needed additional funds. First, when earnings are retained rather than new stock issued, the market price per share of existing stock will rise, as indicated by higher earnings per share. Second, if stock is held for more than 6 months and then sold at a gain, the investor will get a tax advantage with a capital gain deduction. The capital gain deduction is 40 percent; which means that only 40 percent of the gain is taxable. However, cash dividends are fully taxable. Thus, there is a tax benefit to investors, which a reduction in dividends. One caution, however: lower dividends payments may be viewed negatively in the market and may result in a reduction in the market price of stock due to psychological factors.

The view that a cut in the dividend is a bad news and will lead to a tall in stock price, while the converse applies in the case of an increase in the dividend, is so commonplace that it might almost be referred to as the «commonsense» view of dividend policy. The reason for this is that the investor lives in a world of unknowns and uncertainty.

Therefore a change in the dividend policy may signal information previously known only to the firm and unknown to the market. When, as in this case, there is a cut in dividend, the market quickly revises down its expectation of future income and future dividends.

There are many theories of dividend policy that suggest large variation in financing by preferred and common stock. It is very important especially today

because capital markets are close to perfect, or for the practical reason that firms carefully plan dividends to ensure smoothness and continuity.

Literature:

1. John-Paul Marney, Heather Tarbert. Corporate Finance for Business, Oxford University Press, 2011.
2. Mary Carey, Cathy Knowles, Jane Towers-Clark. Accounting: A Smart Approach, 2010.
3. Jr., William Perreault, Joseph Cannon,E. Jerome McCarthy. Essentials of Marketing, Irwin Press, 2009.
4. Ray Garrison, Eric Noreen, Peter Brewer**.** Managerial Accounting. Irwin Press, 2007.
5. Melville A. (2009) International Financial Reporting, A Practical Guide, 2nd edition, FT Prentice Hall.
6. International Accounting Standard1. From www.iasplus.com/standard/iasOI.htm/
7. Marks, R. Robbins, L. Fernandez, G and Funk-houser (2008). The Handbook of Financing Growth: Strategies, Capital structure, and Transactions, Wiley Finance.
8. Akerlut, (1970), G. market for "lemons": quality uncertain by and the market mechanism Quarterly Journal of Economics, 84(3).