

## CHAPTER 8: EQUITY SECURITIES: COMMON AND PREFERRED SHARES

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### COMMON SHARES

- Common shares represent ownership. A company issues shares in return for capital. The value of the shares at any point in time reflects the real or perceived worth of the company.
- Thus, a company that has increased its worth will see its common shares increase in value. The opposite also holds true.
- Shares are rarely issued in the name of the shareholder. Instead they are issued as street certificates in the name of a securities firm in order to be easily traded.
- Shareholders also benefit from dividends that are issued by approval of the board of directors. Dividends represent earnings that are returned to the company owners, the shareholders.
- Earnings may also be retained in the company instead of being used for dividends. For instance, Warren Buffett's company Berkshire Hathaway has never paid a dividend despite share values topping \$150,000 per share.
- CDS Clearing and Depository Services Inc facilitates trading by offering a computer-based registration system for securities.

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#### **Common Shares**

*Common shares represent ownership in a corporation in the proportion of shares owned to the number of shares issued. Typically, public corporations, issue millions of common shares.*

### Benefits of Common Share Ownership

- The advantages of common share ownership:
  - dividends (though dividends are not guaranteed)
  - increase in value of the shares.
  - favourable tax treatment of dividends and capital gains
  - the right to vote at shareholders' meetings
  - the right to receive annual and quarterly reports and the right to view some company documents (e.g., by-laws or the register of shareholders)

- the ease with which shares of most public companies can easily be bought or sold
- limited liability

### Capital Appreciation

- A common share increases in value when:
  - earnings are retained. Shares with higher equity command a higher price.
  - profitability increases the earnings multiple, also known as the price-earnings ratio that is used by investors as a measure of value.
  - an increased dividend rate improves the stock's yield and its price.

### Dividends

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**Dividends**  
*Paid, usually quarterly, to share owners from current or retained earnings. Can be given as cash or stock.*

- Not all earnings must be paid as dividends or retained by the company. Some may be paid and some retained.
- Payout ratios for dividends depend on the company, the industry, and how long the company has been in business.
- The board of directors sets dividend policy.
- Just as profitability may enhance the dividend rate so too will a loss of profitability see dividends diminished.
- Often the trust deed requires that a level of working capital be maintained before common share dividends can be paid.

### Regular and Extra Dividends

- A regular dividend is a set amount paid annually.
- An extra dividend is paid in addition to the regular dividend at the end of the year.
- An annual yield calculation should be based only on the regular dividend, unless there is a strong indication the extra dividend will be paid again.

**Declaring and Claiming Dividends**

- A company is not contractually obliged to pay dividends on common shares.
- Dividends can be paid quarterly, semi-annually, or annually. The board of directors will announce the amount and the date of payment prior to the payment date.
- Cheques are mailed directly to the registered owners, or for street certificates, the funds go to the client’s securities firm and are deposited to the investor’s account.

**Ex-Dividend/Cum Dividend**

- The **dividend record date** is the date used to determine who is entitled to receive dividends.
- The stock begins trading **ex-dividend** (without dividends) on the **second business day** prior to the record date, because transactions on or after this date will not settle until **after** the dividend record date. This is because trades in shares settle **three business days** following the day of the trade (called T + 3).
- When a share trades ex-dividend, the dividend will be paid to the seller because the seller is the owner of the share on the dividend record date.
- Dividend announcements are published by the stock exchanges in daily releases to securities firms as follows:

<b>Company</b>	<b>Payment</b>	<b>Payment Date</b>	<b>Dividend Record Date or Shareholders of Record</b>	<b>Ex-Dividend Date</b>
TCB Inc.	.30	August 21	July 29	July 27
SEY Inc.	.20	November 27	November 7	November 5

- When a share begins trading ex-dividend, the stock price usually declines by the amount of the dividend.
- If a share is trading **cum dividend** (with dividend), the purchaser will receive the declared dividend. The last day a stock trades cum dividend is the **third business day** before the dividend record date.

### *Dividend Reinvestment Plans*

- In these plans, dividends are reinvested in the company, so that the shareholder receives additional shares instead of cash.
- Such dividends are taxed the same as cash dividends.
- The shareholder benefits because:
  - commissions are not paid to acquire the additional shares
  - the reinvestment of small or fractional amounts increase shareholdings with the advantage of **dollar cost averaging**.
- Some companies allow occasional cash contributions to the dividend reinvestment plan.

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#### **Dollar cost averaging**

*Purchasing shares at regular intervals as the market price fluctuates, thereby reducing the average cost.*

### *Stock Dividends*

- A company can issue a dividend of additional shares instead of paying cash.
- The stock dividends are recorded on the company's Statement of Retained Earnings, the same as cash dividends.
- Issuing stock dividends benefits a company that needs cash for operations.
- For tax purposes, a stock dividend is treated the same as a cash dividend.

### **Voting Privileges**

- The right to vote at annual and general meetings provides common shareholders with a degree of corporate control because questions can be asked of management during shareholders' meetings.
- Issues voted on include election of directors and approvals for financial statements and auditor's reports.
- Voting privileges and dividend policies vary according to the class of share (e.g., Class A, Class B).

### *Restricted Shares*

- Restricted shares give unlimited participation in earnings and assets on liquidation, but not full voting rights.
- **Non-voting** shares generally do not have voting rights.

- **Subordinated voting** shares have less voting rights than other classes of shares in the company.
- **Restricted voting** shares have a limit to how many or what percentage of shares may be voted on by a person, company, or group.
  - Some investors have become concerned about companies reorganizing to issue restricted shares. The Canadian securities regulators have created policies addressing these issues.

#### *Rights and Benefits of Restricted Shares*

- Owners of restricted shares participate in the company's earnings and, in the event of liquidation, in its assets.
- However, they have no control over the management of the company and are not entitled to rights or remedies accorded to voting shareholders.
- Thus, they do not participate in many activities including:
  - electing directors
  - approving financial statements
  - approving fundamental changes to the company and its operations
- Rights and benefits of all shares are found in a company's charter.

#### *Stock Exchange Regulations Regarding Restricted Shares*

- Stock exchanges have regulated restricted shares to protect shareholders:
  - Restricted shares should be properly identified and coded in the financial press.
  - Restricted shareholders should receive all material such as information circulars and financial statements that voting shareholders receive. These documents must spell out the voting right restrictions on restricted shares.
  - Any dealer or advisor that releases and confirms trades must describe these shares as restricted.
  - Restricted shareholders must be invited to shareholder meetings and given the right to speak.

- Before additional restricted shares can be created, minority approval must be given.

### **Tax Treatment**

- Tax benefits for Canadian investors in common shares include:
  - A ***dividend tax credit*** on dividends paid by taxable Canadian companies.
  - An exemption of 50% of capital gains from tax.
  - Stock savings plans whereby an investor receives incentives to purchase shares of certain companies within his or her province.

### ***Dividends from Taxable Canadian Corporations***

- Dividends from Canadian corporations are taxed at a lower rate than interest due to the dividend tax credit.
- Dividends from foreign corporations and non-taxable Canadian corporations do not receive dividend tax credits.
- For tax purposes, dividends are ***grossed-up*** by 45% to determine the ***taxable amount of dividend*** and then a 19% tax credit is claimed on this amount.

For example:

If \$100 of dividend income is received from a Canadian corporation, a taxpayer must include \$145 in net income for tax purposes (the \$45 is called the ***gross-up***):

\$145 becomes the ***taxable amount of dividend***.

Federal tax is calculated on the taxable dividend income, including the grossed-up amount. The federal tax rate is 29%:

$\$145 \times 29\% \text{ federal tax} = \$42.05$  ***Federal tax payable***