

# LECTURE NOTES: BUSINESS ORGANIZATION

## Corporate Financial Structure

**Capitalization.** *A corporation's capital, or working cash, can come from sale of equity securities, or from debt financing. Much of the capital gets "turned over," that is, the cash is used to buy inventory, then the inventory is sold to produce cash, which is used again to buy inventory, and so forth. The plan is to sell the inventory for more than it cost, thereby making a profit. If every time cash capital is turned over there is a profit, then a company attempts to turn over its cash capital as many times a year as possible. For example, if \$1.00 worth of inventory can be sold for \$1.50, and if you turn over the cash and inventory 4 times a year, \$1.00 can generate 4 times \$.50 profit, or \$2.00 in a year. As long as there is a continuing demand for the product, more cash means more inventory can be rolled over. Getting working cash is important.*

*Capital from equity securities is "equity capital." Capital that the corporation borrows is "debt capital." Money raised from equity securities does not need to be repaid, but the shareholder expects some share of the earnings of the corporation after taxes, in the form of dividends. On the other hand, debt must be repaid out of the earnings after taxes. Any interest paid on the debt is a business expense. Money spent on expenses is spent before taxes are calculated, that is, expenses are "tax free." Money received by a creditor to repay the debt is return of the creditor's money and is not taxed to the creditor. But money paid to the creditor as interest is taxed as earned income. Money paid to a shareholder as a dividend on a share of stock is what is left after the corporation pays its income taxes. Then, that dividend income is treated as ordinary taxable income to the shareholder. When the shareholder "cashes out" the equity by selling his shares to somebody, thereby getting the investment back, any gain over the price the shareholder originally paid for the stock is taxed as a capital gain, but if the stock sells at a loss, the difference is treated as a capital loss.*

Equity Financing: *Sale of common or preferred stock for cash*

### I. AUTHORIZED AND ISSUED STOCK

A. Original authority comes when the Articles of Incorporation are approved. The shares must still be registered as securities before they can be sold. The corporation may only sell the number of shares authorized. If there is only one class of stock, it must be common stock. The original articles might call for several different classes of stock, all of which can be authorized. When a share of stock is purchased from the corporation, that share is "issued". Only issued shares earn dividends and vote.

#### B. Common Stock

##### 1. Classes of common stock

## 2. Voting rights:

- a) Generally, common stock is voting stock. Each share is a vote. Exceptions?
- b) Liquidation rights. All shares within a class of shares must be treated equally within the class, on liquidation. Liquidation is settling all liabilities out of the assets, then distributing the assets equally among the shareholders on a per share basis.

## C. Preferred stock

1. Defined: Preferred stock is given some priority or favored treatment as compared to the treatment given to the common stock of the company. Frequently preferred stock is issued with "better" features than the corporation's common stock, so that the corporation can compete with its own shares being sold on the open market. Depending on the language of the share issue, preferred shares may enjoy one or more priorities over common stock in the following categories:

- a) Voting rights
- b) Liquidation rights: Assets remaining after paying all liabilities are distributed first to preferred shareholders, and only afterwards is any remaining assets given to the owners of common shares.
- c) Redemption rights: The corporation buys back shares according to some price plan.
- d) Conversion: Preferred shares may be converted to common shares according to some ratio or proportion.
- e) Priority on dissolution (see liquidation rights)
- f) Priority to dividends

2. Series of preferred shares

3. Purposes of preferred shares.

## II. Par Value

### A. Elimination

B. Consideration

C. Accounting

### III. Consideration for Shares

### IV. Issuance of Stock

A. Certificates

1. Endorsement
2. Stated Restrictions on transfer
3. Share journals and ledgers

B. Lost or Stolen

C. Fractional Shares and Scrip (How do you vote a fraction?)

### V. Redemption

A. Defined: The repurchase of corporate shares by the corporation

B. Treasury Shares:

### VI. Dividends

A. Availability of Funds

B. Type of Dividends

1. Cash
2. Stock
3. Other Property

C. Declaration of Dividends

1. Preferred dividends
2. Cumulative dividends

3. Authority to declare dividends

D. Right to Receive Dividends

VII. Splits (distinguish from a stock dividend)

VIII. Debt Financing *Borrowing money*

A. Authority for financing

B. Bank loans

C. Individual Loans

D. Bonds    Bonds are corporate "IOUs" that can be bought and sold much like stocks are bought and sold. There is the opportunity to make money in the form of capital gains. Typically, bonds trade for a discounted price as compared to the face value of the bond.

1. Discounted bonds

2. Premium bonds

3. Conversion rights

4. Redemption/coupons