Common Stock

Common stockholders are the owners of a corporation. They share cash flow rights with holders of other types of securities issued by the firm. They are sometimes called the "residual claimants" because they have the last claim on the cash flows generated by the firm. Interest and principal repayment obligations owed to bondholders and other lenders are paid first. Then preferred stockholders receive dividends.

If cash flows remain after paying the lenders and preferred stockholders, then the common stockholders either receive dividends or the cash is reinvested in the firm. If managers reinvest in positive NPV projects, the common stock price may increase. This generates capital gains for common stockholders.

In addition to the cash flow rights, common stockholders also enjoy the preemptive rights that offer them the first shot at new stock issue at their discretion in order to maintain their fractional ownership if desired. Last but not least, common stockholders enjoy the voting rights that allow them to remain control of the firm. Unlike the cash flow rights that are shared among holders of all securities issued by the firm, the preemptive rights and voting rights are unique features of common stock.

- Let us turn to the review of accounting basics on the equity section of the balance sheet for a firm (in millions of $):

Common stock, $1 par value, authorized 3 million shares, issued 2.34 million shares	2.34
Capital in excess of par value (or capital surplus)	47.66
Retained earnings	34.32
Total equity	84.32

The common stock in this example has a book value of $84.32 million dollars. The book value per share is $36.03 per share ($84.32 million divided by 2.34 million shares.) The par value of common stock is its stated value. The par value per share is not important in an economic sense. And par value is not a market value. Some stocks today have no par value. Typically, stocks are issued for an amount well above their par value. The capital in excess of par, or capital surplus, is the capital raised in a common stock issuance over and above the par value.

Here, the firm has raised $50 million through the issuance of common stock in capital markets. This includes the $2.34 million in par value and the $47.66 million in capital surplus. The retained earnings is the income available to common stockholders after interest, principal, preferred stock dividends and common stock dividends are paid. This is the cumulative amount of earnings reinvested in the business over time.

It is important to realize that the market value of a firm's common stock is not related to its book value. The market value of a firm's common stock can be calculated if the stock price and the number of common shares outstanding are available. Suppose the market price per share of the common stock in the example above is $55 per share. The market value of the firm's common stock is $55 per share multiplied by 2.34 million shares, or $128.7 million.

Please reference Lecture Slides 11 - 15 for further information and additional numerical illustration.

Dividends are paid to common shareholders by a firm. Top management, along with the board of directors, makes the decision of whether or not to pay a dividend and how large the dividend will be. Shareholders receive two types of cash flows – dividends and capital gains. Please reference Lecture Slide 10 for further information.