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Management of Equity Securities

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ABSTRACT

This study aims at discussing the management of equity securities and their preference over debt capital in business firms. The Kenyan domestic capital market has few financial instruments and does not have the capacity to incorporate new financial instruments in the context of the current legal, regulatory and institutional framework. In Kenya, a boost in management and dealing in equity securities happened in January 1995, when restrictions on investment by foreigners in shares and government securities were removed. The Kenyan CMA (Capital Market Authority) Act was amended in the same year to allow foreign equity participation of up to 40% of listed companies, while individuals were allowed to own up to 5% of listed companies. This brought about some liberation in the financial market. It was realized that there is need to speed up regional integration. The regulatory authorities should address the current legal, regulatory, and institutional framework and explore new financial instruments to consolidate the current gains realized by the capital markets so far.

Key words; *Capital Market Authority, Equity, Equity Securities*

Introduction

Equity is the financial word for ownership: to have equity in something is to have financial ownership of it .In the real estate markets, equity is the difference between the value of the property and the owner's debt against the property. In the securities market, equity refers to ownership in companies. Security refers to an investment of money in the form of a contract, which itself has a monetary value and can be traded in a marketplace.

According to Campbell, T., (1988), an equity security represents financial ownership in a publicly traded company. Equity securities are most commonly issued, purchased and traded in the form of common stock and preferred stock. Each share of stock represents a portion of ownership in the issuing company, and is therefore called equity. The main features of equity securities are:

i. They are claims by shareholders on the net worth of the relevant corporation.
ii. They are either listed on a stock exchange or unlisted.
iii. They are issued on a specific issue date with a specific issue price.
iv. They don't usually have a stated maturity.
v. They are usually issued in the national currency.

Equity securities generate income in the form of dividends. Dividends can be either cash dividends as the name suggests paid in cash or stock dividend where securities can be distributed to shareholders after reserves and retained earnings have been converted into equity capital.

Research Methodology

This study has been carried out using secondary data. In this research design the researcher seeks to describe the existing conditions as pertaining to equity securities in the financial markets.

Discussion

Characteristics of Securities

- Securities are tradable and represent a financial value.
- Securities are fungible.

Classification of Securities

- **Debt Securities:** These are tradable assets which have clearly defined terms and conditions are called debt securities. Financial instruments sold and purchased between parties with clearly mentioned interest rate, principal amount, maturity date as well as rate of returns are called debt securities.
- **Equity Securities:** These are financial instruments signifying the ownership of an individual in an organization. An individual buying equities has an ownership in the company's profits and assets.

The various types of equity securities

- Common Stock

Common stocks are shares which enjoy the normal rights associated with share ownership, with no difference in their legal or economic provisions. If a company has not issued any preference shares, then the equity capital consists only of common stock. They are also referred to as ordinary shares.

Ordinary shares have the last (residual) claim on the assets of a company. In the event of liquidation of the company they receive what has been left after all other creditors have been paid. They are entitled to a pro rata share in the profits of the company in the form of dividends.

- Preference Shares.

In contrast to common stock, preference shares have certain priority rights. The rights can confer additional membership or asset rights. Preference shares are classified into different categories which include;

a. Cumulative preference shares: Holders are entitled to receive a fixed dividend ahead of ordinary shares and retain the right to any accumulated preferred dividends that may have been built up.
b. Non-cumulative preference shares: Holders are not entitled to accumulated preferred dividends.
c. Participating preferred shares: Holders are entitled to participate in the profits of a corporation over and above fixed dividends, by means of an additional fluctuating dividend, if the corporation is successful. They also participate in the distribution of the residual value of a corporation on dissolution.

d. Non-participating preferred shares: Holders are entitled to receive a fixed dividend, but do not participate in the distribution of the residual value of a corporation on dissolution.
e. Redeemable preferred shares: These can be redeemed at the request of either the corporation or the shareholder at a fixed price on a specified date or during a specified period of time.
f. Straight perpetual preferred shares: These have no maturity date and pay fixed dividends for as long as they remain outstanding.
g. Employee Shares: These are shares that are issued to the employees of a company. The employee stockholder has the same rights as the other shareholders of the company. The goal of issuing employee shares is to document the solidarity of the employees with the company. The employees should thereby be more deeply interested in the company's welfare, something which also exerts a positive influence on their motivation. The preferential price they pay for the shares represents a kind of bonus for their loyalty.

Importance of Equity securities

Equity markets are important parts of the economy because they provide funding sources for companies. Equity provides the economic fuel on which companies rely to run thriving businesses and to finance operating activities in both the short and long terms.

In modern economies, all organizations including nonprofit institutions, government agencies and businesses seek funding by issuing debt and equity instruments in financial markets. These markets are also known as securities exchanges.

Similarities between equity and debt securities

Debt securities are distinct from equity instruments, but both assets often interrelate in the financial marketplace. In fact, investors who are interested in debt-equity products can purchase hybrid instruments, such as convertible bonds and preferred shares. These instruments allow an investor to benefit from positive market developments in equity or debt sectors. For example, convertible bondholders can exchange their debt assets with equity products if stock market profits are expected to be higher than what bonds offer. In a nutshell, both debt and equity securities are financial instruments that assist companies to finance their operations.

The difference between debt securities and equity securities?

According to Campbell T. (1988), debt securities are legal obligations to repay borrowed funds at a specified maturity date and provide interim interest payments as specified in the agreements. The examples include commercial papers, bonds, loans, debentures, and treasury bills among others. The benefits of issuing debt securities of companies are that the interests paid are tax-deductible that is they are expensed so that companies pay less tax; they protect companies from losing control over operations; and also help discipline management. Debt securities increase the probability of bankruptcy and expected bankruptcy costs reduce financial flexibilities due to negative covenants among others.

On the other hand, equity securities represent an ownership stake in a company, such as common and preferred shares. Shareholders are entitled to dividends from post-tax earnings which are taxed at a lower rate than interest payments received for bonds. However they receive dividends only after all creditors have been paid.

Equity securities should not be confused with debt security, or debt investment, which is a loan to a company or organization in exchange for interest payments and the return of the principal. Unlike equity securities, debt securities do not confer ownership. Debt securities are most commonly issued by corporations, municipalities, and the government.

Characteristics of equity securities

Sale of shares is also attractive to management, at least in part, because it has more control over the firm due to the diffusion of ownership. The holder of a share does not have a direct voice in the management of the enterprise, but has an indirect control through the election of the members of the board of directors, who in turn choose the management of the firm. Voting for directors may be through simple majority voting or through cumulative voting. In the majority system, each investor may cast one vote per position for each share held, and the director receiving more than 50% of the votes wins. Under majority voting, a group holding more than 50% of the voting stock could lock out minority groups. In the cumulative system, each investor receives one vote per position for each share held, but may "cumulate" the votes received by casting them all for one candidate. Under cumulative voting fewer shares are required to guarantee election of a director, so that excluding minority stockholder groups is more difficult.

Managements of firms that are takeover targets or are facing challenges from stockholders prefer to be under majority voting. Even under cumulative voting mounting a successful dissident drive faces formidable hurdles, however, since management may dominate the board of directors and controls the assets of the firm. If there is a disagreement with management the conventional wisdom of Wall Street has been to sell the stock rather than mount a challenge. This conventional wisdom has changed somewhat in recent times because of a willingness of stockholders to take on the role of activists. Also, large positions held by institutions such as mutual fund or pension funds make challenges to management easier to pursue.

Graham, Benjamin; Dodd, David L. (1934) explains, ‘‘the cash flows to an equity investor are not specified in advance. They depend on the success of the enterprise, are uncertain or risky, and are properly described in terms of probability distributions.’’ As part owner of the firm, the owner shares in the success or failure of the firm in two ways. The first way is through returns from capital gains and capital losses, increases or decreases in the value of the stock. The second way is through cash flows arising from the distribution of earnings in the form of dividends. The distribution of earnings through dividends is not automatic. Dividends are not obligation, but instead are "declared" at the discretion of the board of directors. In practice, dividends are usually not just a function of earnings. Dividends are thought to be a signal to investors as to firm performance. Management prefers to present positive signals, "smoothing" dividends by avoiding decreases and increasing dividends only if it is likely that the higher level can be maintained. In some cases, firms have raised funds in the capital markets so as to maintain the dividend. An exception is the extraordinary dividend, so labeled by management as a sign that the increase is not permanent.

In case of bankruptcy, common stock has limited liability. Legally, the firm is considered to be an individual, able to assume its own liabilities separately from the shareholders. As a result, liability is separated from ownership. The investor is not liable for the debts of the firm, and should the firm fail the investor's loss will be limited to no more than the amount invested. In bankruptcy the various claims on the firm follow a well-defined priority, with common stockholders assigned the lowest priority. It is for this reason that the common stockholders are sometimes called the residual owners of the firm. Limited liability is very important to investors, and is considered a major factor in the development of the corporate form of business.

There are other characteristics of equity that are less universal, and there are other exceptions to these general properties of equity securities. Some firms have multiple classes of stock with different voting power and/or share of dividends. Other stock may be restricted as to trading. Common stocks are traded in several exchanges and over the counter. The size of the underlying firm and the trading volume of the stock vary widely. Consequently, the liquidity and the amount of information available on a stock also vary widely.

Managing equity securities

Brokers and investment advisors have extraordinary depth of knowledge on matters related to securities products, transfers, e-finance, financial process and regulation, and they advise financial institutions and corporate entities in connection with the issuance of bonds, notes and other capital market instruments. They help manage legal and business concerns for issuers and underwriters on all aspects of debt and equity offerings and other capital-raising activities; assist in executing public offerings, private placements, stock exchange listings and multijurisdictional, multi-language due diligence.

Equity securities are shares of stock held by investors as reported on a company's balance sheet. A company issues equity securities as a means to raise capital in the financial markets for a major event, such as an expansion or merger or for product development. By purchasing equity, shareholders are obtaining a partial ownership stake in that company. Equity issuance is an alternative to issuing bonds, which are a form of debt, in the public markets.

The stream which deals with managing various securities and creating an investment objective for individuals is called portfolio management. Portfolio management refers to the art of selecting the best investment plans for an individual concerned which guarantees maximum returns with minimum risks involved. Portfolio management is generally done with the help of portfolio managers who after understanding the client’s requirements and his ability to undertake risks design a portfolio with a mix of financial instruments with maximum returns for a secure future.

The first time that a company issues equity securities into the financial markets is known as its initial public offering (IPO). A company typically will raise large sums of money in this transaction, because investors often flock to new issues to obtain a piece of a promising opportunity. The number of equity securities issued in an IPO depends on financial documents filed by the company with the regulatory body in a region. A company is permitted to sell a certain number of shares within a particular price range on the day of its IPO. Once shares are issued in the public markets, the equity price will rise and fall depending on investor demand.

Ownership in a company is determined by the number of shares a person owns divided by the total number of shares outstanding. For example, if a company has 1000000 shares of stock outstanding and a person owns 100000 of them, then he/she owns 10% of the company. Most stock also provides voting rights, which give shareholders a proportional vote in certain corporate decisions. Only a certain type of company called a corporation has stock; other types of companies such as sole proprietorships and limited partnerships do not issue stock i.e. equity or stock or corporate stock.

Typically, a company will not issue the whole of its available shares in one offering. Instead, a number of shares usually are reserved for a subsequent offering at a future date, known as a secondary or follow-on offering. A company's management team does this because they anticipate needing to raise capital again to fund future growth plans.

A downside to issuing equity securities in the financial markets is that the more shares that become available for investors to purchase, the more that existing shareholders see the percentage of their equity ownership diluted. For example, a large holder of equity securities might own a number of shares that represents 10 percent of a company's total shares available to trade. If the company decides to increase the number of total shares available for trading, that shareholder's equity ownership instantly decreases as a percentage of total outstanding shares.

Some equities pay dividends to shareholders from the company’s earnings. There are two types of equity classes: common stock and preferred stock. Preferred shares receive dividends prior of common stock. If a company is liquidating, preferred shares have seniority over common stockholders.

Companies raise equity capital by issuing equity securities. This is most commonly in the form of ordinary shares. Ordinary shares usually have equal voting rights to all other ordinary shares (one share, one vote), and are entitled to equal dividends.

The other common type of shares are preference shares, which have some characteristics that make them more akin to bonds, although they are legally (and therefore for tax purposes) shares. Some companies also have classes of share that have fewer rights than ordinary shares, most commonly non-voting shares, but there are also various types of deferred shares. These are typically entitled to the same share of profits as ordinary shares, but do not give the shareholder who holds one any voting rights. Again, these are becoming less common.

Investors are generally very wary of companies that voting rights structured to distribute control differently from economic interests in the company. This usually means that a particular group of shareholders can run the company or very strongly influence its running to suit them.

According to Stulz, R., (1999); A company's articles define the rights of different classes of shareholders and endless variations on the above are possible. Changes to the rights of different classes of shareholders usually require the agreement of the majority of shareholders of each class of shares affected, even if these are non-voting shares.

If a company decides not to issue equity, debt securities are the other primary option. Debt securities are bonds issued into the public marketplace by a corporation or a government. By purchasing a debt instrument, investors become instant creditors to an issuer. The primary downside for issuing debt is even though selling bonds does not give shareholders part ownership of the entity, the issuer must make ongoing interest payments to those shareholders over the life of a contract.

Accounting for Equity Securities

There are two methods for accounting for equity securities. This includes,

Cost method

The cost method of accounting for stock investments records the acquisition costs in an asset account, “Equity Investments.” As with debt investments, acquisition costs include commissions and fees paid to acquire the stock.

Equity method

The equity method of accounting for stock investments is used when the investor is able to significantly influence the operating and financial policies or decisions of the company it has invested in. Given this influence, the investor adjusts the value of its equity investment for dividends received from, and the earnings or losses of the corporation whose stock has been purchased. The dividends received are accounted for as a reduction of the investment value because dividends are a partial return of the investor's investment.

Book value of Equity securities

The book value of equity will change in the case of the following events:

- Changes in the firm's assets relative to its liabilities. For example, a profitable firm receives more cash for its products than the cost at which it produced these goods, and so in the act of making a profit, it is increasing its assets.
- Depreciation - Equity will decrease, for example, when machinery depreciates, which is registered as a decline in the value of the asset, and on the liabilities side of the firm's balance sheet as a decrease in shareholders' equity.
- Issue of new equity in which the firm obtains new capital increases the total shareholders' equity.
- Share repurchases, in which a firm gives back money to its investors, reducing on the asset side its financial assets, and on the liability side the shareholders' equity. For practical purposes, share repurchasing is similar to a dividend payment, as both consist of the firm giving money back to investors. Rather than giving money to all shareholders immediately in the form of a dividend payment, a share repurchase reduces the number of shares (increases the size of each share) in future income and distributions.
- Dividends paid out to preferred stock owners are considered an expense to be subtracted from net income.

Managing equity security risk

J. Irwin, & Douglas A. (December 1991) explains to us that, just as equity prices can move in your favor, they can also turn against you. Whether you have equity exposure on the asset or liability side of your balance sheet, the objectives for managing equity risks are the same. In both circumstances, you can minimize the impact that a change in prices can have on your financial stability. It is important to minimize the impact of volatile equity markets by determining the right strategies that can help:

- Protect equity value.
- Enhance equity returns.
- Increase borrowing capacity.

Conclusion

Management of equity securities in an organization is very essential as it shapes the performance of an entity. Proper mix of equity securities and debt securities should be held by an entity after careful analysis to ensure maximum return for the organization.

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