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CHAPTER 12

Shareholders' Equity

KEY POINTS

The following key points are emphasized in this chapter:

- **The three forms of financing and their relative importance to major U.S. corporations.**
- **Distinctions between debt and equity.**
- **Economic consequences associated with the methods used to account for shareholders' equity.**
- **Rights associated with preferred and common stock and the methods used to account for stock issuances.**
- **Distinctions among the market value, book value, and par (stated) value of a share of common stock.**
- **Treasury stock.**
- **Cash dividends and dividend strategies followed by corporations.**
- **Stock dividends and stock splits.**

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General Electric announced in February of 2009 that it was cutting its cash dividends by 68 percent, reducing the quarterly payout from 31 to 10 cents per share, the first such drop in 71 years. GE estimated that the annual savings would amount to $9 billion. The company was not alone. The *Wall Street Journal* (2/28/2009) reported that stalwart names such as JPMorgan Chase, Dow Chemical, Pfizer, Textron, CBS, and Citigroup announced similar plans to reduce dividends and retain capital. In early 2009 very few companies were immune to the need to maintain their equity bases, as former high fliers, including Blackstone Group, either cut or eliminated their dividends. The shortage of capital became even more apparent when the federal government stepped in to inject equity into such well-known names as General Motors, Chrysler, insurance giant AIG, and most of the nation's top banking companies.

What is equity? What purpose does it serve? In what forms is equity disclosed on the financial statements, and how do companies account for changes in equity? These questions are covered in this chapter.

Companies generate assets from three sources: (1) borrowings, (2) issuing equity securities, and (3) retaining funds generated through profitable operations. Each of these sources is represented on the right side of the basic accounting equation (balance sheet), which is depicted in Figure 12–1.

FIGURE 12–1
The basic accounting equation

		SHAREHOLDERS' EQUITY	
Assets =	**(1) Liabilities +**	**(2) Contributed Capital +**	**(3) Earned Capital**
		Preferred stock	**Retained earnings**
		Common stock	**Accum. comp. income**
		Additional paid-in	

Chapters 10 and 11 were devoted to current and long-term liabilities, which represent the first of the three financing sources illustrated in Figure 12–1. This chapter focuses on shareholders' equity, which comprises the other two financing sources: (2) contributed capital and (3) earned capital. **Contributed capital,** which reflects contributions from a company's owners, consists of three components: preferred stock, common stock, and additional paid-in capital. The major component of **earned capital** is retained earnings, a measure of the assets that have been generated through a company's profitable operations and not paid to the owners in the form of dividends. **Accumulated comprehensive income** consists of all nonowner-related changes in shareholders' equity that do not appear on the income statement and are not reflected in the balance of retained earnings.[1] The total dollar amount of shareholders' equity represents the investment made by the shareholders in the company and is also referred to as **net assets, book value, or net worth.**

Under U.S. GAAP, companies must provide a description of the changes in comprehensive income during the year as either a separate statement or part of the statement of changes in shareholders' equity. Under IFRS, companies must also provide a description of the changes in comprehensive income, but as a separate statement or an extension of the income statement. Under IFRS, this statement is normally referred to as the statement of recognized income and expense (SORIE).

1. As discussed in Chapter 8 and again in Chapter 13, examples of accumulated comprehensive income include holding gains and losses due to price changes of available-for-sale securities and foreign currency translation gains and losses.

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Contributed and earned capital are important financing sources for many major U.S. companies. Funds used to acquire other companies, purchase machinery and equipment, finance plant expansion, pay off debts, and support operations are often generated by issuing preferred stock, issuing common stock, and retaining funds provided by profitable operations. Recent estimates indicate that new stock is issued in the United States at the rate of more than $200 billion per year.

THE RELATIVE IMPORTANCE OF LIABILITIES, CONTRIBUTED CAPITAL, AND EARNED CAPITAL

Figure 12–2 illustrates the relative importance of the three forms of financing (liabilities, contributed capital, and retained earnings) for our selected firms. Overall, liabilities (with a few exceptions) are the primary financing source. Interest costs are tax deductible, reducing the cost of borrowing, and as discussed before, leverage is a popular way to provide returns to shareholders without using their capital. Most Internet firms have not relied heavily on leverage for several reasons: (1) several years ago their stock prices were trading at huge premiums, which encouraged equity financing; (2) the speed of their growth created uncertainty associated with their future increased risks, discouraging debt capital providers; and (3) Internet firms had little collateral that could be used to secure loans. However, recently Cisco Systems has been issuing debt and repurchasing shares of its own stock. Its strong track record has opened up its borrowing ability.

FIGURE 12–2
The relative importance of liabilities, contributed capital, and retained earnings (percentage of total assets)

	Liabilities	Contributed Capital	Retained Earnings
Manufacturing:			
General Electric (Manufacturer)	.87	−.02	.15
Chevron (Oil drilling and refining)	.46	−.09	.63
Retail:			
Kroger (Grocery retail)	.78	−.10	.32
Lowe's (Hardware retail)	.45	.03	.52
Internet:			
Yahoo! (Internet search engine)	.22	.42	.36
Cisco (Internet systems)	.43	.51	.06
General Services:			
AT&T (Telecommunications services)	.64	.22	.14
Wendy's/Arby's (Restaurant services)	.49	−.59	−.08
Financial Services:			
Bank of America (Banking services)	.90	.06	.04
Goldman Sachs (Investment services)	.93	.02	.05

Note also that non-Internet firms rely very little on contributed capital; in fact, for GE, Chevron, and Kroger, the percent under contributed capital is negative. These companies are well-established, successful firms that have repurchased large amounts of their outstanding shares over the years at prices far exceeding the price at which the shares were originally issued. As we discuss later in the chapter, these transactions

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reduce the amount of contributed capital. Finally, the companies that rely heavily on retained earnings as a source of financing have had a history of high profitability and/or have chosen not to pay high levels of dividends. The negative retained earnings amount for Wendy's/Arby's was caused by a large loss reported by the company in 2008, the year when Wendy's merged with Arby's.

The 2008 annual report for Amazon.com, the Internet retailer, shows total assets of $8.314 billion and the following financing sources: current liabilities ($4.796 billion), long-term liabilities ($0.896 billion), contributed capital ($3.402 billion), and negative retained earnings ($0.730 billion). Explain what must have happened to create the company's capital structure since its inception in 1995.

DEBT AND EQUITY DISTINGUISHED

Chapters 10 and 11 presented the basic characteristics of the debt contracts between a company and its creditors. This section describes how the nature of this relationship differs from that between a company and its shareholders. As will be discussed later, such a distinction is important to investors, creditors, management, and auditors.

Characteristics of Debt

When a company borrows money, it establishes a relationship with an outside party, a *creditor* or *debtholder,* whose influence on the company's operations is defined by a formal legal contract containing a number of specific provisions. These provisions were discussed in Chapters 10 and 11, and they are summarized in Figure 12–3, along with characteristics of equity.

FIGURE 12–3
Characteristics of debt and equity

Debt	Equity
1. Formal legal contract	1. No legal contract
2. Fixed maturity date	2. No fixed maturity date
3. Fixed periodic interest payments	3. Discretionary dividend payments
4. Security in case of default	4. Residual asset interest
5. No direct voice in management; influence through debt covenants	5. Vote for board of directors
6. Interest is an expense.	6. Dividends are not an expense, but a distribution of retained earnings.

Characteristics of Equity

When a corporation raises capital by issuing stock, it establishes a relationship with an owner, often referred to as an *equity holder,* or *shareholder.* Unlike debt, an equity relationship is not evidenced by a precisely specified contract. There is no maturity date, because a shareholder is an owner of a company until it ceases operations or until the equity interest is transferred to another party. Dividend payments are at the discretion of the board of directors, and shareholders have no legal right to receive dividends until

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they are declared. In case of bankruptcy, the rights of the shareholders to the available assets are subordinate (secondary) to the rights of the creditors, who are paid in an order that can usually be determined by examining the terms in the debt contracts. The shareholders receive the assets that remain. That is, a corporation's owners have a **residual interest** in the corporation's assets in case of bankruptcy.

Shareholders, however, can exert significant influence over corporate management. Each ownership share of common stock carries a vote that is cast in the election of the board of directors at the annual shareholders' meeting. The board, whose function is to represent the interests of the shareholders, declares dividends, determines executive compensation, has the power to hire and fire management, and sets the general policies of the corporation. In addition, certain significant transactions, such as the issuance of additional stock, often must be approved by vote of the shareholders.

Finally, distributions by a corporation to the shareholders (dividends) are not considered operating expenses by either generally accepted accounting principles (U.S. or international) or the Internal Revenue Service. They are considered a return on the owners' original investments. Consequently, dividends are neither included as expenses on the income statement nor considered deductible expenses in the computation of taxable income. On the financial statements, dividends serve to reduce retained earnings without passing through the income statement.

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In its 2009 annual report, Fortune Brands, Inc. reported interest expense of $216 million and dividends of $152 million. The interest expense appeared on the income statement, while the dividends appeared on the statement of shareholders' equity. Describe the difference between interest and dividends and explain why they are treated differently on the financial statements.

Why Is It Important to Distinguish Debt from Equity?

It is important to distinguish debt from equity for a number of reasons, depending primarily on the perspective of the interested party: capital provider (investor or creditor), management, and accountant and external auditor.

DEBT VS. EQUITY: THE CAPITAL PROVIDER'S PERSPECTIVE

Capital providers include individuals and entities who hold debt and equity securities. Debt securities primarily include notes receivable and bonds, and equity securities include stocks. Active markets (e.g., the New York Stock Exchange) exist where such securities are purchased and sold.

EQUITY: HIGHER RISK. Owning an equity security is usually riskier than owning a debt security. The interest and principal payments associated with debt investments are backed by legal contracts and, in general, are more predictable and dependable than returns on equity investments. Debt contracts often include security provisions, and in case of bankruptcy, debtholders have higher priority claims to the existing assets than do equity holders, who are often left with nothing. As evidence of the riskier nature of equity securities, stock prices tend to be more volatile than bond prices on the major security exchanges.

EQUITY: HIGHER RETURNS. A characteristic of the additional risk associated with equity investments is that they can produce higher returns than debt investments. When companies perform exceptionally well, equity holders often receive exceedingly large returns, either in the form of dividends or price appreciation of their securities.

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Debtholders, on the other hand, are limited only to the interest and principal payments specified by the debt contract. During 2009, for example, Emerson Electric had an exceptional year; the price of its common stock increased by approximately 35 percent. In contrast, during that same year the company paid about a 5 percent return to its debtholders (i.e., interest rate on outstanding loans). Historically, annual equity returns have approximated 10–15 percent.

The Independent, a London newspaper, reported that "bonds have long been regarded as boring. Investors are only meant to buy them when they are too nervous of the excitement in the stock market." Explain the reasoning underlying this statement.

DEBT VS. EQUITY: MANAGEMENT'S PERSPECTIVE

The decision by management to raise capital by issuing debt or equity is complex. Factors such as present and future interest rates, the company's credit rating, the relative amount of debt and equity in the company's capital structure and balance sheet, the condition of the economy, and the nature of the company's operations are usually relevant.

DEBT: CONTRACTUAL RESTRICTIONS. Issuing debt limits a company in a number of important ways. Contractual interest and principal payments must be met in the future, and assets often must be pledged as security (collateral) during the period of the debt. At the end of 2009, for example, Macy's reported that lease obligations were expected to require future cash payments of approximately $2.8 billion. Additional debt may also lower a company's credit rating and reduce its ability to borrow in the future. Routinely, Standard & Poor's and Moody's Investors Service lower credit ratings of major U.S. companies when they incur large amounts of debt. Finally, the debt contract itself may restrict a company's future borrowing power, limit dividends, or require that certain accounting ratios be maintained at or above specified levels.

DEBT: LESS EXPENSIVE. On the other hand, raising capital by issuing debt is attractive because interest payments are *tax deductible.* General Electric, for example, saved over $4.3 billion in federal income taxes during 2008 because it was able to deduct for tax purposes the interest on its outstanding debts. Issuing debt, therefore, is generally considered less expensive than issuing equity, as dividend payments are not tax deductible. In general, if management can use debt capital to earn revenues that exceed the after-tax cost of the debt, it is using a concept called **leverage** to provide a return for the shareholders. As indicated in Figure 12–2, such a practice appears to be common in that many large U.S. corporations tend to rely more heavily on debt than on equity. The tax deductibility of interest, which significantly reduces the cost of issuing debt, is definitely one of the main reasons.

EQUITY: DILUTION OF OWNERSHIP. Another advantage of raising capital by issuing debt instead of equity is that issuing equity can dilute the ownership interests of the existing shareholders. Suppose, for example, that Mr. Jones owns 10 percent of XYZ Corporation, 1,000 of the 10,000 outstanding shares. If XYZ issues an additional 10,000 shares, and Mr. Jones purchases none, his ownership interest decreases from 10 percent to 5 percent (1,000/20,000).[2] Such **dilution,** if not accompanied by higher

2. Some stock certificates carry with them a preemptive right, which allows existing shareholders to share proportionately in any new issue of stock. Also, additional stock issuances sometimes require the approval of the existing shareholders.

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profits, can reduce both the future dividends paid to Mr. Jones and the market price of his shares. For example, a 450 million euro stock issuance by Rhodia, France's largest chemical maker, surprised some analysts because it did not depress the company's stock. However, whether the issuance produces capital that creates the basis for adequate future returns remains to be seen.

Dilution also reduces the proportionate control of the existing shareholders and, accordingly, can increase the likelihood of a **takeover** by an outsider. In a takeover, another company, an investor, or group of investors (sometimes called a *raider*) purchases enough of the outstanding shares to gain a controlling interest in the purchased company. If the takeover is "hostile," the voting power attached to the acquired shares is often used by the "raider" to elect a new board of directors. Such action can be followed by the replacement of existing management and substantial changes in the nature of the purchased company.

Corporate managers whose jobs are threatened by takeovers are understandably concerned about the dilutive effects of equity issuances. Many companies, such as Merck, PepsiCo, Citigroup, and Home Depot, have entered into programs of buying back their own previously issued shares. Such transactions, called **treasury stock** purchases because the acquired shares are often held in the corporation's treasury for reissuance at a later date, make a company less attractive as a takeover target by reducing its cash balance and increasing the proportionate control of the remaining shareholders. For example, the management of Safeway Stores, Inc. once purchased all of its publicly traded outstanding stock to elude a takeover attempt by Dart Group Corporation. In other words, the company *went private*—the only shares left outstanding were those held by shareholder-managers who withdrew them from the public markets.

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Over a 3-year period, the search engine company Google, Inc. made three equity issuances, raising over $7.5 billion, while taking on no additional debt. As of the end of that period, the company had contributed capital of $7.4 billion and no long-term debt. Explain some of the reasons that may have encouraged Google to rely on equity instead of debt financing.

DEBT VS. EQUITY: THE ACCOUNTANT'S AND AUDITOR'S PERSPECTIVE

The substantive differences between debt and equity give rise to different accounting treatments: (1) debt and equity issuances are disclosed in different sections of the balance sheet, and (2) debt transactions affect the income statement, while equity transactions do not.

Debt issuances are disclosed in the liabilities section of the balance sheet, while equity issuances are included in the shareholders' equity section. Proper classification is important because the debt/equity distinction affects a number of financial ratios, which are used by investors and creditors and in debt covenants and executive compensation agreements.

Interest payments on outstanding debts and book gains and losses, recognized when debt is redeemed, appear on the income statement and affect the computation of net income. In contrast, transactions involving equity securities, like dividends and the reissuance of treasury stock, do not enter into the computations of net income. Figure 12–4 summarizes why distinctions between debt and equity are important to investors and creditors, management, and accountants and auditors. These distinctions give rise to economic consequences that are discussed in the following section.

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FIGURE 12–4
Distinctions between debt and equity from different perspectives

Interested Party	Debt	Equity
Investors and Creditors	Lower investment risk Fixed cash receipts (contractual interest and principal)	Higher investment risk Variable cash receipts (discretionary dividends and stock appreciation)
Management	Contractual future cash payments Effects on credit rating Interest is tax deductible	Dividends are discretionary Effects of dilution/takeover Dividends are not tax deductible
Accountants and Auditors	Liabilities section of balance sheet Income statement effects from debt transactions	Shareholders' equity section of balance sheet No income statement effects from equity transactions

During 2008, Honeywell International paid $3.48 billion to capital providers—$456 million for interest, $754 million to reduce debt principal, $1.459 billion to repurchase outstanding common stock, and $811 million for dividends. Explain the effect of each payment on the basic accounting equation. Why are they accounted for differently?

THE ECONOMIC CONSEQUENCES ASSOCIATED WITH ACCOUNTING FOR SHAREHOLDERS' EQUITY

The economic consequences associated with accounting for shareholders' equity arise in part from the effects of financial ratios (e.g., return on equity) that include the dollar amount of shareholders' equity or its components. Such ratios affect a company's stock prices, credit rating, and any debt covenants that restrict additional borrowings, the payment of dividends, or the repurchase of outstanding equity shares (i.e., treasury stock purchases). We argued in Appendix 5A that return on equity (net income divided by shareholders' equity) is the most important indicator of whether management is creating value for the shareholders. Indeed, the ROE model is designed to explain why return on equity increases or decreases. Four of Dun & Bradstreet's fourteen key business ratios explicitly use the dollar value of shareholders' equity (net worth) in their calculations: (1) current liabilities/net worth, (2) total liabilities/net worth, (3) fixed assets/net worth, and (4) return on net worth. Dun & Bradstreet uses the values of these ratios to determine a company's credit rating, which in turn can affect the terms (e.g., market price, interest rate, security, restrictive covenants) of the company's debt issuances.

Many companies "manage" their debt/equity ratios to maintain or improve their credit ratings. In general, as a company's debt/equity ratio increases, its credit ratings fall. When American Stores, a supermarket and drugstore chain, acquired Lucky Stores, Inc., it raised additional capital, which it reported as debt on its balance sheet, increasing the company's debt/equity ratio. Moody's Investors Service responded by lowering the credit rating on American Stores' outstanding bonds, which was followed by a decrease in the market price of the company's stock.

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As companies reduce their reliance on debt and increase their reliance on equity issuances and especially retained earnings as sources of financing, their credit ratings tend to rise. General Motors claimed to "strengthen its balance sheet" when it announced plans to sell as much as $1 billion in stock. In its annual report, General Electric commented that during the year its debts were "substantially reduced," leading the major debt-rating agencies to evaluate the company's credit rating as being of the highest standing, *AAA.* Such a rating enabled General Electric to get the best possible terms on its debt issuances as well as maintain or increase the value of the company's outstanding debt securities.

Another important economic consequence associated with the shareholder equity section of the balance sheet relates to restrictions on dividend payments and the repurchase of previously issued, outstanding stock imposed by certain debt covenants. Such restrictions can be very significant. Under the terms of covenants with its debtholders, Turner Broadcasting System, Inc. (now part of Time Warner), for example, had been prohibited from paying cash dividends altogether. Similar restrictions may be less binding. A recent annual report of Owens Corning states, "As is typical for bank credit facilities, the agreements . . . contain restrictive covenants, including . . . limitations on . . . the payment of dividends and purchase of company stock."

Such restrictions protect the interest of creditors by keeping a company from paying all of its available cash to the shareholders through excessive dividends or stock repurchases. Note also that the methods used to account for stock issuances, dividends, treasury stock purchases, and retained earnings, which are covered later in the chapter, can determine whether such restrictions have been violated. Finally, recall that the methods used to account for assets and liabilities affect the recognition of expenses and revenues, which in turn affect retained earnings.

Some believe, as indicated above, that the most direct measure of value creation is return on shareholders' equity (net income/average shareholders' equity). During 2009, Procter & Gamble, the consumer products conglomerate, issued equity, bought back outstanding shares, and paid dividends. Assuming that these transactions all occurred at the end of the year, explain how each affected return on equity. How might these effects influence an analyst who considers return on equity an important metric of corporate performance?

ACCOUNTING FOR SHAREHOLDERS' EQUITY

The shareholders' equity section of a corporate balance sheet consists of two major components: (1) contributed capital, which primarily reflects contributions of capital from shareholders and includes preferred stock, common stock, and additional paid-in capital[3] less treasury stock, and (2) earned capital, which reflects the amount of assets earned and retained by the corporation and consists essentially of retained earnings and accumulated comprehensive income. An example of the shareholders' equity section of a corporate balance sheet appears in Figure 12–5. Spend a moment to review it because it provides an outline of the remaining discussion in this chapter. Note that most companies disclose treasury stock at the bottom of the shareholders' equity section even though it represents a reduction of contributed capital.

3. While the title *additional paid-in capital* is the most common, there is some variation across companies. For example, The New York Times Company uses *additional capital,* Goodyear Tire & Rubber uses *capital surplus,* and Chevron Texaco Corporation uses *capital in excess of par value.*

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FIGURE 12–5
Shareholders' equity section of balance sheet

Contributed capital:		
Preferred stock (authorized, issued, and outstanding shares, asset preference, dividend preference, par value, cumulative, nonparticipating)	**$ 3,000**	
Common stock (authorized, issued, and outstanding shares, par value/stated value/no par)	**15,000**	
Additional paid-in capital (preferred stock, common stock, treasury stock, stock dividends)	**86,000**	
Total contributed capital		**$104,000**
Earned capital:		
Retained earnings	**$120,000**	
Accumulated comprehensive income	**5,000**	
Total earned capital		**125,000**
Less: Treasury stock (cost method)		**(20,000)**
Total shareholders' equity		**$209,000**

Non-U.S. companies, many of which publish IFRS-based financial statements, use different terms to describe the shareholders' equity accounts. Unilever, for example, uses "share capital" and "share premium" to describe the stock and additional paid-in capital sections, "other reserves" to describe accumulated comprehensive income and treasury stock, and "retained profit" instead of retained earnings. In these cases it is often best to refer to the footnotes to ascertain exactly what is included in each account.

Preferred Stock

Preferred stock is so called because preferred shareholders have certain rights that are not shared by common shareholders. These special rights relate to the receipt of dividends and/or to claims on assets in case of liquidation. **Preferred stock as to dividends** confers the right, if dividends are declared by the corporation's board of directors, to receive dividends. **Preferred stock as to assets** carries a claim to the corporation's assets, in case of liquidation, with a higher priority than the claim carried by common stock. The exact characteristics and terms of preferred stock vary from one issue to the next. The following sections describe some of the more important features of preferred stock.

AUTHORIZED, ISSUED, AND OUTSTANDING PREFERRED SHARES

Authorized preferred shares are the number of shares a corporation is entitled to issue by its corporate charter. Additional authorizations must be approved by the board of directors and are often subject to shareholder vote.

Issued preferred shares have been issued previously by a corporation and may or may not be currently outstanding. Some issued shares may have been repurchased by the corporation and held as treasury stock. **Outstanding** preferred shares are the shares presently held by the shareholders. Issued shares less repurchased shares equal outstanding shares. *Accounting Trends and Techniques* (AICPA, 2009) reports that, of the major U.S. corporations surveyed, approximately 7 percent had outstanding preferred issuances.

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The number of authorized, issued, and outstanding preferred shares should be disclosed in the annual report. Priceline.com, for example, recently disclosed in its annual report that the shareholders had authorized and issued 80 million shares of preferred stock, of which over 13 million were presently outstanding.

Many major U.S. corporations have authorized preferred stock issuances but have chosen not to issue them. In such cases, the number of authorized shares should still be disclosed in the financial report. As of the end of 2008, for example, Goodyear Tire & Rubber Company (50 million shares), Hewlett-Packard (300 million shares), and Johnson & Johnson (2 million shares) disclosed authorized preferred shares, none of which had been issued.

During the 2008–2009 financial crisis, the U.S. government took unprecedented steps to shore up the capital positions of major banks by injecting them with equity capital. Many critics argued that the equity injections were a bad idea, stating that these companies should have been allowed to fail. Outlined below is an excerpt of the 2008 annual report of Citigroup, the holding company for Citibank (dollars in millions):

	2008	2007
Preferred Stock	$70,664	—

Based on the information provided above, discuss the mechanism used by the government to protect the banking system and the implications to Citigroup of having the U.S. government as a shareholder.

PREFERRED DIVIDEND PAYMENTS

The terms of preferred stocks usually include a specific annual dividend that is paid to the preferred shareholders before any payments are made to the common shareholders, assuming that a dividend is declared by the board. The remaining amount of the dividend is then paid to the common shareholders. The amount of the preferred annual dividend payment is normally expressed as either an absolute dollar amount or a percentage of a dollar amount referred to as the par value of the preferred stock.[4]

For example, if dividends are declared in a given year, the holder of one share of $5 preferred stock will receive a $5 dividend. The holder of one share of 4 percent preferred stock with a par value of $100 would receive a $4 (4% × $100) dividend. Agway, an agriculture co-op, had three kinds of preferred shares outstanding, differentiated by, among other characteristics, the per-share amount of the annual dividend payment: 6 percent, 7 percent, and 8 percent, all on a par value of $100.

To illustrate the allocation of a dividend between preferred and common stock, several years ago the board of directors of DuPont declared and paid a total dividend of $802 million. During the year, approximately 1.68 million shares of $4.50 preferred stock, 0.7 million shares of $3.50 preferred stock, and 240 million shares of common stock were outstanding. The dividend allocation to the preferred and common shareholders is shown in Figure 12–6.

4. The concept of par value is discussed more completely later in the chapter when we cover common stock. At that time, we point out that par value has little or no economic meaning. In the case of preferred stock, however, par value is meaningful in that it is sometimes used to determine the annual dividend payment to the preferred shareholders.

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FIGURE 12–6
Allocation of a dividend between preferred and common stock

Preferred dividend:		
$4.50 preferred stock × 1.68 million shares	**$7.55 million**	
$3.50 preferred stock × 0.7 million shares	**2.45 million**	**$ 10 million**
Common dividend ($3.30 × 240 million shares)		**792 million**
Total dividend		**$802 million**

CUMULATIVE PREFERRED STOCK

With **cumulative preferred stock,** when a corporation misses a dividend, **dividends in arrears** are created in the amount of the missed preferred dividend. In future periods, as dividends are declared, dividends in arrears are first paid to the preferred shareholders, who then receive their normal annual dividend. Finally, the common shareholders are paid from what remains. If the preferred stock is *noncumulative,* no dividends in arrears are created for missed dividends, and the preferred shareholders receive only their normal annual dividend in future periods as dividends are declared.

It is important to realize that dividends in arrears are not liabilities to the corporation and therefore are not listed on the balance sheet. They do not represent legal obligations to the preferred shareholders, because dividends are at the discretion of the board of directors. The liability is created at the time the dividends are declared and only in the amount of the dividends. However, the corporation must keep track of dividends in arrears because they must be clearly disclosed in the financial report. Such information is particularly interesting to creditors as well as potential and existing shareholders because it may signal a shortage of cash in the corporation. The amount of dividends in arrears may also affect the dividends that common shareholders can expect to receive in the future.

The following excerpt was taken from a recent Sears annual report:

In the event that dividends payable on preferred stock are in arrears for six quarterly periods, holders of such stock shall have the right to elect two additional directors of the Company until all cumulative dividends have been paid or set apart for payment. Additionally, dividends cannot be paid on the Company's common shares if dividends on preferred shares are in arrears.

Who would insist on such a policy and why?

Almost all preferred stock issuances are cumulative, and among major U.S. companies, dividends in arrears are relatively rare. Several years ago, however, Stelco (Canada's second-largest steelmaker) omitted dividends on its cumulative preferred stocks as it attempted to turn around its money-losing operations. Accordingly, the company disclosed dividends in arrears in its financial report. The company had not missed a dividend payment in seventy-five years.

PARTICIPATING PREFERRED STOCK

If preferred stock carries a **participating** feature, the preferred shareholders not only have a right to the annual dividend payment, but they also share in the remaining amount of the dividend with the common shareholders. The extent to which the preferred shareholders participate in the remaining dividend is often expressed as a percentage of the par value of the preferred stock. Nonparticipating preferred stock, which is much more common, carries no rights to share in the remaining dividend.

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PREFERRED STOCKS: DEBT OR EQUITY?

We have described how most preferred stocks (1) carry higher priority than common stocks in the event of liquidation, (2) specify annual dividend payments of a fixed amount, (3) are cumulative, and (4) do not contain a participation feature. In addition, preferred stocks normally do not carry a right to vote in the election of the board of directors, and many contain a call provision that allows the corporation to redeem the stock for a specified price after a specified date.

Recall the discussion earlier in the chapter on the characteristics of debt and equity (see Figure 12–3), and note how the features listed above closely resemble debt. In some cases the Internal Revenue Service has allowed corporations to deduct from taxable income the dividends paid on securities classified on the balance sheet as preferred stocks because such dividends were construed as interest. Preferred stocks are definitely hybrid securities, which have characteristics of both debt and equity. They are, therefore, difficult to classify on the balance sheet. In most cases, the preferred stock account is disclosed at the top of the shareholders' equity section, where it is located immediately below long-term liabilities. In some cases, however, preferred stocks are disclosed as debt. On its 2008 balance sheet, for example, The Washington Post Company reported $11.8 million in preferred stock in the long-term liabilities section of the balance sheet. Financial statement users interested in computing ratios that involve distinctions between debt and equity (e.g., debt/equity) may find it more useful to treat the preferred stock account as a long-term liability.

Classifying hybrid securities, like preferred stocks, is indeed a difficult area for accountants and auditors, primarily because the distinction between debt and equity is not always clear-cut. Also, the guidelines specified by generally accepted accounting principles are not very specific. In an article in *Forbes,* the national director of accounting and auditing at a major accounting firm noted: "The distinction between debt and equity has become so muddied that the accounting rules seem more arbitrary than ever . . . preferred stocks are clever ways to raise cash . . . simply [a form of] off-balance-sheet financing masquerading as equity."

Consequently, by issuing certain kinds of preferred stock, management can raise what is essentially debt capital without increasing the liabilities reported on the balance sheet. Because preferred stock carries no voting power, such a strategy also avoids the problems of dilution and possible takeover associated with issuing common stock. As noted in *Forbes:*

Companies anxious to protect their credit ratings, and unwilling to issue more [common] stock for fear of diluting earnings per share or inviting takeover bids, have turned to these ingenious instruments [preferred stocks] to lower the cost of raising money. But pity the poor accountant who must categorize these hothouse hybrids.

Energy company PG&E Corporation notes in its 2008 annual report that it is authorized to issue two types of preferred stock: 75 million shares of $25 par value preferred stock and 10 million shares of $100 par value preferred stock. The company specifies that 5.8 million shares of the $25 stock be nonredeemable without mandatory redemption. The remainder of the $25 stock and all of the $100 stock may be issued as either redeemable or nonredeemable. Furthermore, the company recently retired a third series of preferred stock; in 2005 the company redeemed the last of $25 par value preferred stock that was subject to mandatory redemption provisions. Why would a company authorize three different types of preferred stock? Where on the balance sheet should these shares be listed, as debt or as equity?

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Common Stock

Unlike preferred stock, common stock is typically not characterized by a wide variety of features that differ from issuance to issuance. Moreover, common stock is not designed to provide a fixed return over a specified period of time. Rather, as a true equity security, common stock is characterized by three fundamental rights: (1) the right to receive dividends if they are declared by the board of directors, (2) a residual right to the corporation's assets in case of liquidation, and (3) the right to exert control over management, which includes the right to vote in the annual election of the board of directors and the right to vote on certain significant transactions proposed by management (e.g., the authorization of additional shares, large purchases of outstanding shares, major acquisitions).

The value of the common stock issued by a corporation can be described in a number of different and often confusing ways. This section clarifies some of this confusion by differentiating among the market value, book value, and par value of a share of common stock.

Market Value

The **market value** of a share of stock, common or preferred, at a particular point in time is the price at which the stock can be exchanged on the open market. This amount varies from day to day, based primarily on changes in investor expectations about the financial performance and condition of the issuing company, interest rates, and other factors. The market prices of the common stocks of publicly traded companies must be disclosed in their financial reports. For example, the market price of JPMorgan Chase's common stock fluctuated from a low of approximately $16 per share to a high of over $47 during the year ending December 31, 2009.

Google, Inc. first sold shares of its stock to the public on August 19, 2004. The shares in the initial public offering (IPO) opened at $100. As of February 25, 2010, Google shares were trading for $526.43. Who received the $100 on the date of the initial sale? Who has received the trading profit of $426.43 in the six years since the company went public? Do companies benefit from an increase in stock price? Discuss.

Book Value

The *book value* of a share of common stock is determined by the following formula:

$$\textbf{Book Value of Common Stock} = \frac{\textbf{Shareholders' Equity} - \textbf{Preferred Capital}}{\textbf{Number of Common Shares Held by the Shareholders}}$$

It is simply the book value of the corporation (less preferred capital), as indicated on the balance sheet, divided by the number of common shares presently held by the shareholders. This value rarely approximates the market value of a common share, because the balance sheet, in general, does not represent an accurate measure of the market value of the company. As of December 31, 2009, the book value of JPMorgan Chase common stock was $39.84 per share, while the market value during 2009 ranged from $16 to $47 per share.

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Market-to-Book Ratio

Dividing the market value of a company's common stock by its book value (**market-to-book ratio**) provides a ratio that indicates the extent to which the market believes that the balance sheet reflects the company's true value. Ratios equal to 1 indicate that a company's net book value (as measured by the balance sheet) is perceived by the market to be a fair reflection of the company's true value. More commonly, market-to-book ratios are somewhat larger than 1, indicating that the balance sheet is perceived to be a conservative measure of the company's true value. Large ratios can be attributed to a number of reasons: Balance sheet assets are at cost, not fair market value; the financial statements report on past, not future, events; important intangibles are ignored on the balance sheet; and/or accounting methods are conservative.

High market-to-book ratios also indicate that investors expect high growth relative to the invested capital indicated on the balance sheet. Market-to-book ratios vary substantially across and within companies. As of the end of 2009, for example, JPMorgan Chase's market-to-book ratio was approximately 1.2:1, 3M's was 4.4:1, and the ratio for General Electric has ranged from 4:1 to almost 10:1 in recent years.

Par Value

The **par value** (sometimes called stated value) of a share of common stock has no relationship to its market value or book value and, for the most part, has little economic significance. At one time it represented a legal concept, instituted by some states, that was intended to protect creditors, but over time the concept proved to be largely ineffective.[5] It is not uncommon for corporations to issue either no-par common stock or common stock with extremely low par values. For example, the par value of JPMorgan Chase's common stock is only $1.00 per share.

While the par (stated) value of a share of common stock has limited legal or economic significance, these values do have financial accounting significance. As the next section demonstrates, under generally accepted accounting principles, these values are used in the journal entries to record certain common stock transactions. Many believe that attributing any significance, accounting or otherwise, to the par or stated value of common stock is unwarranted.

?

As discussed earlier, as of the end of 2009, there were large differences among the market value, book value, and par value of a share of JPMorgan Chase common stock. Discuss why they are so different.

ACCOUNTING FOR COMMON AND PREFERRED STOCK ISSUANCES

As with preferred stock, common stock issuances must be authorized in the corporate charter and approved by the board of directors and sometimes the shareholders. Similarly, the number of shares of common stock outstanding may differ from the number of common shares originally issued. As of December 31, 2008, for example, the corporate charter and shareholders of Johnson & Johnson had authorized over 4 billion

5. In some states the concept of stated value was substituted for par value, but like par value, this concept has limited economic meaning. Note, however, that state laws differ in this area.

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shares of common stock, over 3 billion shares had been issued, and over 2.7 billion shares were currently outstanding—approximately 350 million shares had been repurchased by the company and were held in the form of treasury stock.

The methods used to account for common stock issuances are essentially the same as those used for preferred stock. When no-par common or preferred stock is issued for cash, the cash account is debited for the proceeds and the common (or preferred) stock account is credited for the entire dollar amount. For example, when Apple Computer, Inc. issued 4.98 million shares of no-par common stock for an average price of $17.592 per share (total cash proceeds of $87.61 million), the company recorded the following journal entry (dollars in millions):

Cash (+A)	**87.61**	
Common Stock (+CC)		**87.61**
Issued no-par common stock		

When common or preferred stock with a par value is issued for cash, the cash account is debited for the total proceeds, the common (or preferred) stock account is credited for the number of shares issued multiplied by the par value per share, and the additional paid-in capital (common or preferred stock) account is credited for the remainder. The dollar amount credited to the additional paid-in capital account represents the difference between the total issuance price of the stock and the par value of the issuance. For example, when Coca-Cola Enterprises issued 71.4 million shares of $1 par value common stock for $15.62 per share, the company recorded the following journal entry (dollars in millions):

Cash (+A)	**1,115.27**	
Common Stock (+CC)		**71.40***
Additional Paid-In Capital, C/S (+CC)		**1,043.87***
Issued $1 par value common stock		

*71.4 million sh. × $1

When Weyerhaeuser Company issued 147,000 shares of $1 par value preferred stock for $11 per share, it recorded the following journal entry:

Cash (+A)	**1,617,000***	
Preferred Stock (+CC)		**147,000****
Additional Paid-In Capital, P/S (+CC)		**1,470,000**
Issued $1 par value preferred stock		

*147,000 sh. × $11
**147,000 sh. × $1

The discount airline JetBlue sold 15.2 million shares of common stock in its initial public offering for $12 per share. One year later the company sold an additional 4.5 million shares at $28.33 per share. The common stock has a par value of .01 per share. Explain how the two issuances affected the basic accounting equation.

Treasury Stock

Outstanding common stock is often repurchased and either (1) held *in treasury,* awaiting reissuance at a later date, or (2) retired.[6] Repurchases of this nature normally must

6. Repurchased preferred shares are normally retired and are not held as treasury stock. Most repurchased common shares, on the other hand, are held in treasury. Treasury shares have the status of authorized and unissued shares.

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be authorized and approved by the board of directors. On August 30, 2007, Ditech Networks offered to purchase for cash up to 9.1 million shares of common stock from its shareholders at a price not to exceed $5.50/share. At the time the shares were trading for about $5.00/share. Treasury stock carries none of the usual rights of common stock ownership. That is, while common shares are held in treasury, they lose their voting power and their right to receive dividends.

WHY COMPANIES PURCHASE TREASURY STOCK

Corporations purchase outstanding common shares and hold them in treasury for many reasons. Perhaps the most common is to support employee compensation plans. Johnson & Johnson, for example, purchased treasury stock in the amount of over $2.1 billion in 2009. During that time period, treasury stock in the amount of $1.4 billion was reissued as part of an employee compensation plan.

Other companies, such as Walt Disney, Avco, Gillette, and Safeway, have entered into common stock buy-back programs to fend off possible takeover attempts. We mentioned earlier that by purchasing its own outstanding common stock, a company can discourage takeovers by reducing its cash balance and increasing the proportionate control of the remaining shareholders. Gillette, for example, entered into a plan to purchase 11 million of its outstanding common shares. In doing so, the company blocked a takeover attempt by purchasing the 13.9 percent interest held at that time by the Revlon Group, Inc. Columbia Broadcasting System (CBS) once blocked a takeover attempt by Ted Turner (Turner Broadcasting System, Inc.) by repurchasing a substantial portion of its outstanding common stock.

Purchasing treasury stock may also be related to increases in the market price of a company's outstanding stock. Prudential Securities analyst Ed Keon reported in a study in *CFO.com* that companies that made large stock buy-backs outperformed the stock market average over the following year.

Treasury stock purchases are often viewed as a sign of financial strength. When stock prices dip, companies with strong cash positions, such as Merck, PepsiCo, and Home Depot, often take advantage of the reduced prices on the stock market by purchasing large quantities of their own shares. Many of these shares are reissued later at much higher prices.

Companies in a strong financial position often purchase treasury stock to maintain their levels of leverage without having to rely heavily on borrowing. During 2008, for example, Walt Disney purchased $4.5 billion of its own common stock while increasing its debt by only about $400 million. During the year the company's leverage level decreased by only 2 percent. Had the treasury stock not been purchased, its leverage would have decreased by 6 percent. Recall from Chapter 5 that leverage is a direct determinant of return on equity (ROE), an important indicator of shareholder value creation.

A treasury stock purchase can also serve to increase a company's earnings per share (net income/outstanding common shares). IBM's CFO once claimed that a series of large stock buybacks " has been an important contributor toward growing earnings per share."

Finally, treasury stock purchases are often made to return cash to shareholders. In this sense, it is much like a dividend, especially if the treasury stock purchase is proportionate across the shareholders. Consider, for example, a company that has 6,000 common shares outstanding, held in equal amounts of 2,000 shares by three shareholders. Each shareholder owns one-third of the company. If 1,000 common shares are repurchased from each shareholder for $2 per share, each receives $2,000

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and still maintains a one-third interest in the company—the exact result that would have occurred had the company paid a $1 per share dividend.

In both 2007 and 2008 the financing section of the statement of cash flows for Unilever Group, which publishes IFRS-based financial statements, showed share repurchases of 1.5 billion euros. Comment on why a company might want to enter into a share repurchasing program.

ACCOUNTING FOR TREASURY STOCK: THE COST METHOD

There are two methods of accounting for treasury stock: (1) the cost method and (2) the par value method. Although either method is acceptable under GAAP, the cost method is covered below because it is simpler and much more widely used.[7]

PURCHASING TREASURY STOCK. Under the cost method, when a company purchases its own outstanding common stock and holds it in treasury, a permanent account, called "treasury stock," is debited for the cost of the purchase.[8] This account is disclosed below retained earnings in the shareholders' equity section of the balance sheet (see Figure 12–5). For example, when Dell purchased treasury stock for a total cost of over $2.8 billion, it recorded the following journal entry (dollars in millions):

Treasury Stock (−CC)	**2,867**	
Cash (−A)		**2,867**
Purchased shares of treasury stock		

This transaction brought the total investment in treasury shares held by Dell to $28 billion, and the shareholders' equity section of Dell's fiscal 2008 balance sheet appeared as in Figure 12–7.

FIGURE 12–7
Disclosure of treasury stock

Dell Computer
Balance Sheet
Shareholders' Equity Section
January 30, 2009
(in millions of dollars)

Preferred stock	**$ 0**
Common stock	**11,189**
Retained earnings	**20,677**
Less: Cost of common stock in treasury	**(27,904)**
Comprehensive income (loss)	**309**
Total shareholders' equity	**$ 4,271**

7. *Accounting Trends and Techniques* (2009) indicated that 70 percent of the companies surveyed reported treasury stock, and 94 percent of those used the cost method.
8. If outstanding stock, preferred or common, is repurchased and then retired, the stock account is debited and the cash payment is credited. If the payment exceeds the stock account, which is frequently the case, additional paid-in capital and/or retained earnings is debited to balance the entry.

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Although treasury stock represents a reduction of contributed capital, the treasury stock account is disclosed immediately below retained earnings. In many states, dividends cannot legally exceed retained earnings less the cost of all shares held in treasury. Such laws are designed to protect creditors by keeping a corporation from distributing all of its cash to the shareholders in the form of dividends or stock repurchases. By subtracting the dollar amount in the treasury stock account from retained earnings, financial statement readers can determine the maximum amount of cash that legally can be paid to the shareholders as of the balance sheet date.[9]

From 2007 to 2009 Johnson & Johnson purchased $14.3 billion of its own common shares. During that time period its capital structure leverage (total assets/total shareholders' equity) stayed at 1.87. See below (dollars in billions):

	2009	2007
Total assets	$94.6	$80.9
Shareholders' equity	50.5	43.3
Capital structure leverage	1.87	1.87

Compute the change in the company's capital structure leverage had it chosen not to purchase the treasury shares and instead used the cash to increase assets. Briefly discuss how purchasing treasury shares can help to maintain leverage, and why a company might want to do it.

REISSUING TREASURY STOCK FOR MORE THAN ACQUISITION COST. Common stock held in treasury is often reissued at a later date. If it is reissued at a price greater than its acquisition cost, the cash account is debited for the proceeds, the treasury stock account is credited for the cost, and the difference is credited to the additional paid-in capital (treasury stock) account. For example, when PepsiCo, Inc. reissued 139,000 shares of treasury stock, which had an acquisition cost of $2.7 million, for a total of $5.3 million, the company recorded the following journal entry (dollars in millions):

Cash (+A)	**5.3**	
Treasury Stock (+CC)		**2.7**
Additional Paid-In Capital, T/S (+CC)		**2.6**
Reissued treasury stock		

REISSUING TREASURY STOCK FOR LESS THAN ACQUISITION COST. If treasury stock is reissued for less than the acquisition cost, the cash account is debited for the proceeds, the treasury stock account is credited for the acquisition cost, and additional paid-in capital (treasury stock) is debited for the difference, *if there is a sufficient balance in the account to cover this difference.* If the difference between the acquisition cost and the proceeds exceeds the balance in the additional paid-in capital (treasury stock) account, retained earnings is debited.

For example, when Eli Lilly and Company reissued 1.2 million treasury shares, with an acquisition cost of $68.5 million, for $44.5 million, the balance in the additional paid-in capital (treasury stock) account exceeded $24 million, the difference

9. Recently, some major companies (e.g., Wal-Mart) reduced retained earnings directly when outstanding stock was purchased and retired. This accounting treatment may be questioned in that it confuses the distinction between earned and contributed capital.

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between the cost and the proceeds. Thus, the following journal entry was recorded to reflect the transaction (dollars in millions):

Cash (+A)	**44.5**	
Additional Paid-In Capital, T/S (−CC)	**24.0**	
Treasury Stock (+CC)		**68.5**
Reissued treasury stock		

When the Pillsbury Company reissued 300,000 shares of treasury stock, which had an acquisition cost of $12.9 million, for a total of $11.7 million, the balance in the additional paid-in capital (treasury stock) account at the time was zero. Accordingly, the following journal entry was recorded (dollars in millions).

Cash (+A)	**11.7**	
Retained Earnings (−SE)	**1.2**	
Treasury Stock (+CC)		**12.9**
Reissued treasury stock		

Note that in all three preceding examples, an income statement gain or loss is not recognized when treasury stock is reissued for an amount more than or less than the acquisition cost. Reissuing treasury stock is a capital transaction and as such should not affect the income statement.

The 2008 annual report of Boston Scientific, a manufacturer of medical technology, reports a reissuance of treasury stock that decreased the treasury stock account by $142 million and decreased additional paid-in capital by $52 million. How much cash did Boston Scientific receive from the stock issuance, and was the reissuance price above or below the original cost of the treasury stock? How did the transaction affect the basic accounting equation, and was it reflected on the statement of cash flows?

THE MAGNITUDE OF THE TREASURY STOCK ACCOUNT

The dollar value of the treasury stock account on the balance sheets of major U.S. corporations is often quite significant. As indicated in Figure 12–8, it is not unusual for it to exceed the dollar value of the corporation's total contributed capital (preferred stock, common stock, and additional paid-in capital). This phenomenon can occur because treasury stock is often acquired at prices considerably higher than the original issuance prices of the shares.

FIGURE 12–8
The dollar value of treasury stock/total contributed capital (dollars in millions)

Company	Treasury Stock/ Contributed Capital
Amazon.com	$\frac{600}{4{,}002} = 0.15$
Dell	$\frac{27{,}904}{11{,}498} = 2.43$
Goodrich	$\frac{793}{2{,}243} = 0.35$
Eli Lilly	$\frac{99}{820} = 0.12$
Exxon Mobil	$\frac{148{,}098}{5{,}314} = 27.87$

Source: 2008 annual reports.

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Stock Options

Many corporate executives in the United States are compensated with **stock options.** These arrangements give executives an option to purchase company stock at a given price (e.g., $10/share) for a given period of time (e.g., five years). If the price of the stock increases during that time period (e.g., $15/share), the executive benefits by purchasing the stock at $10/share and then immediately selling it for $15/share, an instant profit of $5/share. If the stock price decreases, the executive simply chooses not to exercise the option. This form of compensation is very popular because it creates a financial incentive for executives to increase stock prices, which is consistent with shareholder goals, and requires no cash payment from the corporation. In addition, the executive enjoys great upside potential and little downside risk, and if structured correctly, stock option compensation can create tax advantages for both the executive and the corporation.

Accounting standard setters argue that options are costly to companies (and to shareholders) because they allow executives to buy stock at discounted prices. In the illustration just given, where the stock price rose from $10 to $15, the company would be issuing stock worth $15/share to executives for a discounted price of $10/share. Consequently, existing shareholders would be giving up some percentage of their ownership in return for a dollar amount less than the market believes it is worth. On this basis, accounting standard setters now require that compensation expense be recognized when stock options are issued.

Below we illustrate the entries associated with the recognition of stock option compensation expense, and the stock issuance when the options are exercised.

STOCK OPTION COMPENSATION EXPENSE

Assume that during 2010 options to purchase 100 shares of stock at the current market price ($10) are granted to executives, and the options can be exercised any time over the next two years. The options are valued, using an acceptable valuation formula, at $5 per share. The following adjusting entry would be made to record the 2010 compensation expense at year end.

Stock option compensation expense (E, −RE)	**500***	
Additional paid-in capital, S/O (+CC)		**500**

*100 shares × $5 per share

When stock option compensation expense is recognized, shareholders' equity is increased (additional paid-in capital − stock options). This treatment recognizes that the cost of the option is in the form of an investment made by the existing shareholders.

In the operating section of Target's 2008 statement of cash flows, share-based compensation expense of $72 million is added back to net earnings. Why?

EXERCISING STOCK OPTIONS

Assume that the stock price increases, and during 2011 the options are exercised to purchase 100 shares of stock for $10 per share; 100 shares of treasury stock (purchased previously at $8 per share) are issued to the executives.

Cash (+A) [100 shares × $10/sh]	**1,000**	
Additional paid-in capital, S/O (−CC)	**500**	
Treasury stock (+CC) [100 shares × $8/sh]		**800**
Additional paid-in capital, T/S (+CC) [plug]		**700**

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This entry recognizes the receipt of cash associated with the stock issuance and removes the additional paid-in capital established when the compensation expense was recognized. The issuance of treasury stock to support the options represents, as illustrated in the previous section, treasury stock issued for more than its acquisition cost. If the treasury stock had been purchased previously for more than $15 per share, the "plug" would reduce additional paid-in capital, T/S (i.e., appear on the left side of the entry).

In the financing section of Target's 2008 statement of cash flows, stock options exercised show a positive $43 million. Explain.

The above entries illustrate only the basics involved in accounting for stock option compensation. In reality, the entire amount of the expense is not recognized all at once, but is allocated instead over the service life of the employee, the period of time between when the options are granted and when the employee becomes eligible to exercise them. However, the dollar amount of the costs associated with issuing stock options can be very significant. While these costs are especially high in high-tech companies, where stock option compensation is a major form of executive compensation, a relatively recent study estimates that recognizing stock option compensation expense leads to large reductions in reported earnings for a number of well-known, traditional U.S. companies, including Lucent (20 percent); Kmart (13 percent); PepsiCo (12 percent); Morgan Stanley (12 percent); DuPont (9 percent); and Motorola (6 percent).

The value of the options is determined by a complicated and controversial formula, and many companies state in the footnotes to the financial statements that this formula is not well suited for valuing the options granted to their executives. These concepts are covered in intermediate financial accounting texts.

Backdating a stock option means that a corporation has reset the date at which the option was granted to the employee, picking an earlier date when the option price was lower and thus making the option more valuable to the employee. Regulators have accused several companies over the years of backdating options. In 2010 the *New York Times* news Web site listed several companies being investigated by the SEC for options backdating, including Engineered Support Systems, Broadcom, and KB Homes. In each case the government was concerned that the companies changed the date for the option price to a period when the stock was at its low point. If stock options are a form of employee compensation, how does backdating affect the financial statements? How would backdating affect the shareholders?

Retained Earnings

Retained earnings is a measure of previously recognized profits that have not been paid to the shareholders in the form of dividends. As indicated in Figure 12–2, major U.S. corporations rely heavily on internally generated funds as a source of capital. This section discusses two factors that affect the retained earnings balance: (1) dividends and (2) appropriations.

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DIVIDENDS

Dividends are distributions of cash, property, or stock to the shareholders of a corporation. They are declared by a formal resolution of the corporation's board of directors (usually quarterly), and the amount is usually announced on a per-share basis. Cash dividends represent distributions of cash to the shareholders. Property dividends (dividends in kind) are distributions of property, usually debt or equity securities in other companies.[10] **Stock dividends** are distributions of a corporation's own shares. Cash dividends are by far the most common. *Accounting Trends and Techniques* (AICPA, 2009) reported that of the major U.S. companies surveyed, 70 percent paid cash dividends during 2008, 1 percent paid property dividends, and zero paid dividends in the form of stock.[11]

As Figure 12–9 shows, three dates are relevant when dividends are declared: (1) the **date of declaration,** when the dividends are declared by the board; (2) the **date of record,** which determines who is to receive the dividend; and (3) the **date of payment,** when the distribution is actually made.

FIGURE 12–9
Important dividend dates

Date of Declaration	Date of Record	Date of Payment
Board of directors declares dividend and liability is established.	**Shareholders holding stock at this date receive the dividend when paid.**	**Dividend is paid to shareholders of record.**

A typical dividend announcement reads as follows:

The Board of Directors of Bennet Corporation, at its regular meeting of March 10, 2009, declared a quarterly dividend of $5 per share, payable on April 20, 2009, to shareholders of record on April 2, 2009.

In this announcement, March 10 is the date of declaration, April 2 the date of record, and April 20 the date of payment.

DIVIDEND STRATEGY. When and how much of a dividend to declare depends on a number of factors, such as the nature, financial condition, and desired image of the company, as well as legal constraints. If dividends are to be paid in cash, the board of directors must first be certain that the corporation has sufficient cash to meet the payment. Such a determination requires a projection of the operating cash flows of the company, including, for example, analyses of the company's current cash position, future sales, receivables, inventory purchases, and fixed-asset replacements, and the company's desired debt/equity ratio. It is usually wise to make sure that the company's operating cash needs and leverage goals can be met before cash dividends are paid.

The goals of a corporation and the nature of its activities may also have a bearing on dividend policy. Many young, fast-growing companies have adopted policies of paying no dividends. Such companies, often called growth companies, reinvest their earnings primarily to support growth without having to rely too heavily on debt and dilutive equity issuances. The shareholders receive their investment returns in the form of stock price appreciation. The following excerpt is from a recent annual report of Toys "R" Us, Inc., a company that pays no dividends:

The Company has followed the policy of reinvesting earnings in the business and, consequently, has not paid any cash dividends. At the present time, no change in this

10. Accounting for property dividends is normally covered in intermediate financial accounting.
11. Some companies distributed more than one kind of dividend, and others distributed no dividends of any kind.

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policy is under consideration by the Board of Directors. The payment of cash dividends in the future will be determined by the Board of Directors in light of conditions then existing, including the Company's earnings, financial requirements and condition, opportunities for reinvesting earnings, business conditions, and other factors.

More established companies, such as General Electric and Johnson & Johnson, normally pay quarterly dividends in the amount of 30–40 percent of net income and also attempt to consistently increase their dividend payments from year to year. This policy, which provides a consistent dividend while retaining some funds to finance available growth opportunities, tends to reflect an image of stability, strength, and permanence. The following excerpt is from an annual report of General Electric:

Based on past performance and current expectations, in combination with the financial flexibility that comes with a strong balance sheet and the highest credit ratings, we believe that we are in a sound position to grow dividends, continue making selective investments for the long-term growth, and continue to execute for $25 billion share repurchase program.

Dividend payments from 2007 to 2009 for Abbott Laboratories, a successful pharmaceutical company, are listed below (dollars in billions).

	2009	2008	2007
Dividend payment	$2.2	$2.0	$1.8
Percent of net income	46%	55%	105%

Comment on Abbott's dividend payment policy.

Some companies consistently increase dividends from year to year, but the distributions do not represent a consistent percentage of net income. Bristol-Myers Squibb, for example, increased its dividends each year since 1999. However, as a percentage of net income, dividend payments over that time period varied from less than 50 percent to well over 100 percent. Apparently, the boards of such companies believe that dividend payments should show consistent growth regardless of how well the company does from one year to the next.

State laws and debt covenants can also limit the payment of dividends. In most states, the dollar amount of retained earnings less the cost of treasury stock sets a limitation on the payment of dividends. In addition, the terms of debt contracts may further limit dividend payments to an even smaller portion of retained earnings. Several years ago, for example, Sears, Roebuck & Company had a balance of retained earnings of almost $9 billion. Yet, certain indenture agreements existing at the time limited dividend payments to a maximum amount of $8 billion.

Intel pays cash dividends consistently each year; Microsoft, after paying no dividends for many years, recently issued a huge special dividend to its shareholders; and Cisco Systems follows a policy of paying no dividends. Comment on these three dividend policies and what they may indicate about each company.

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ACCOUNTING FOR CASH DIVIDENDS. When the board of directors of a corporation declares a cash dividend, a liability in the amount of the fair market value of the dividend is created on the date of declaration. At this time, a cash dividend account is debited, and a current liability account, "dividends payable," is credited for a dollar value equal to the per-share amount multiplied by the number of outstanding shares. Cash dividend is a temporary account that is closed directly to retained earnings at the end of the accounting period. The dividends payable account is removed from the balance sheet when the dividend is paid on the date of payment. No entry is recorded on the date of record. The shareholders as of the date of record are simply the recipients of the dividend.

To illustrate, when the board of directors of Marriott Corporation declared a fourth-quarter cash dividend of $0.20 per share on 118.8 million common shares outstanding, the following journal entry was recorded (dollars in millions):

Cash Dividend (−RE)	**23.76**	
Dividends Payable (+L)		**23.76**
Declared a cash dividend (118.8 million sh. × $0.20/sh.)		

Marriott recorded the following entry on the date of payment (dollars in millions):

Dividends Payable (−L)	**23.76**	
Cash (−A)		**23.76**
Paid a cash dividend		

Unilever, a Dutch-based consumer-goods company that publishes IFRS-based financial statements, reported dividend payments of 2.09 billion euros on its 2008 statement of cash flows. That same year it reported dividends of 2.05 billion euros on its statement of shareholders' equity. Explain, and discuss whether this difference is due to the fact that Unilever reports under IFRS and not U.S. GAAP.

STOCK SPLITS AND STOCK DIVIDENDS. Corporations can distribute additional shares to existing shareholders by declaring either a stock split or a stock dividend. For practical purposes, there is very little difference between these two actions. In both cases, the existing shareholders receive additional shares, and in neither case are the assets or liabilities of the corporation increased or decreased.

In a **stock split,** the number of outstanding shares is simply "split" into smaller units, which requires the corporation to distribute additional shares. A 2:1 stock split, for example, serves to double the number of outstanding shares, which requires that the company distribute an additional share for each common share outstanding. A 3:1 stock split effectively triples the number of outstanding shares, which the company executes by distributing two additional shares for each one outstanding. In a 3:2 stock split, one additional share is issued for every two outstanding.

In a stock dividend, additional shares, usually expressed as a percentage of the outstanding shares, are issued to the shareholders. Large stock dividends have essentially the same effect as stock splits. Both a 100 percent stock dividend and a 2:1 stock split, for example, double the number of outstanding shares. Similarly, both a 50 percent stock dividend and a 3:2 stock split increase outstanding shares by 50 percent. Professional accounting standards recommend that relatively large stock dividends (over 25 percent) be referred to as **stock splits in the form of dividends.** Stock splits and stock splits in the form of dividends are not very common. *Accounting Trends and*

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Techniques (AICPA, 2009) reports that, of the major U.S. companies surveyed, only 2 percent reported a stock split or a large stock dividend during 2008. Relatively small stock dividends (less than 25 percent), which are even less common than either stock splits or stock splits in the form of dividends, are referred to as **ordinary stock dividends.**

> The Dow Jones News Service reported after long stock market "bull" runs: "Many companies have stock prices well into triple digits that are daunting to investors, particularly retail customers and individuals. When stock prices are perceived as too high, companies may consider stock splits." How do stock splits work, and why might a company want to lower the average market price of its shares? As of March 10, 2010, Google common shares were selling for $570 each. If it issued a 5:1 stock split, what would have happened to the per-share market price?

ACCOUNTING FOR STOCK DIVIDENDS AND STOCK SPLITS. Stock dividends and splits can be divided into three categories: (1) stock dividends (<25 percent), (2) stock splits in the form of dividends (>25 percent), and (3) stock splits. While each category is accounted for in a slightly different manner, it is important to realize that such actions affect neither the corporation's assets nor its liabilities. Only the accounts within the shareholders' equity section (i.e., common stock, additional paid-in capital, or retained earnings) are adjusted. Below, we cover ordinary stock dividends and stock splits.[12]

ORDINARY STOCK DIVIDENDS. When the board of directors of a corporation declares an ordinary stock dividend, a dividend account is debited for the number of shares to be issued multiplied by the fair market value of the shares, the common stock account is credited for the number of shares issued multiplied by the par value, and additional paid-in capital is credited for the remainder.[13]

To illustrate, assume that ATP International has 100,000 shares of $1 par value common stock outstanding, each with a fair market value of $25. The company would record the following journal entry if the board of directors decided to distribute 5,000 additional shares by declaring a 5 percent stock dividend:

Stock Dividend (−RE)	**125,000***	
Common Stock (+CC)		**5,000****
Additional Paid-In Capital, Stock Dividend (+CC)		**120,000**
Declared 5 percent stock dividend		

*(100,000 × .05) × $25/sh.
**5,000 sh. × $1/sh.

Note that no assets or liabilities are involved in the transaction; all of the activity takes place in the shareholders' equity section. Retained earnings is reduced after the stock dividend account is closed at the end of the accounting period, and common stock and additional paid-in capital (stock dividend) are both increased. In other words, retained earnings has been *capitalized.* Earned capital has been transferred to contributed capital. Note also that if the issued stock has a par value of zero, the entire amount of the stock dividend is credited to the additional paid-in capital account.

STOCK SPLITS. Under generally accepted accounting principles, no entry is recorded in the books when stock splits are declared. The corporation should simply record the fact that the par value of the issued stock has been reduced in proportion to the size of

12. We do not cover stock splits in the form of dividends because we believe, as many others do, that they are effectively stock splits and should be accounted for as such.
13. We assume here that the stock dividend is declared and issued on the same day.

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the split. A 3:1 split, for example, triples the number of outstanding shares and reduces the par value of each share to one-third of its original value. If the stock has no par value, the par value need not be adjusted.

To illustrate, when the board of directors of Procter & Gamble approved a 2:1 stock split, the company recorded no journal entry to reflect the action. The 1.35 billion outstanding shares, each with a par value of $2, were simply replaced by 2.7 (1.35 × 2) billion outstanding shares, each with a par value of $1 ($2/2). In other words, one additional share with a par value of $1 was distributed for each share outstanding.

WHY DO COMPANIES DECLARE STOCK DIVIDENDS AND STOCK SPLITS? To understand the reasons behind stock dividends and stock splits, it is important to realize that (1) such actions do not distribute additional assets to the shareholders and (2) their proportionate ownership of the company after the dividend or split is the same as it was before the dividend or split. For example, a shareholder who owns 10 of a company's 100 outstanding shares, each with a market value of $6, owns 10 percent of the company that has a theoretical value of $600 (100 shares × $6). After a 2:1 stock split, the shareholder will own 20 shares of stock, but each share should drop in value to $3 and the 20 shares will still represent only 10 percent of the 200 outstanding shares. Consequently, unlike cash or property dividends, corporations do not declare stock dividends or stock splits to distribute assets to the shareholders.

Perhaps the most popular reason for declaring a stock split or a large stock dividend is to reduce the per-share price of the outstanding shares so that investors can more easily purchase them. When IBM, for example, declared a 4:1 stock split, which quadrupled the number of outstanding shares, the per-share price of IBM stock immediately decreased from $300 to $75 ($300/4). The managements of many corporations believe that such an action encourages better public relations and wider stock ownership. It is also true that a company's stock price often increases after a stock split is announced. *Business Week* once noted: "As the market booms, companies are increasingly splitting their stock to both make it more affordable and boost the price."

While it is unclear why stock prices jump when stock splits are announced, many believe that such announcements signal to investors that company management believes that it can maintain the value of the stock in the future. Perhaps this signal provides investors with positive information about the company's prospects that was unavailable prior to the announcement.

The reasons for stock dividends are even less clear. Such distributions have a relatively small effect on the number of outstanding shares and thus do little to reduce per-share prices and broaden stock ownership. They do not place assets in the hands of shareholders, which is supported by the IRS position of not considering stock dividends received as taxable income. It is possible that cash-poor corporations distribute stock dividends instead of cash dividends so that shareholders are at least receiving something, but this strategy could be interpreted simply as a publicity gesture. It may satisfy shareholders, especially if they believe that they have received additional assets, but more likely, it may signal financial problems. Finally, corporations may issue stock dividends to capitalize a portion of retained earnings. By reducing retained earnings, a stock dividend places a more restrictive limitation on future dividend payments.

?

The same year that Hershey Foods declared a 100 percent stock dividend, Urban Outfitters and Knight Transportation declared 2:1 and 3:2 splits, respectively. Briefly explain how each transaction affected the basic accounting equation, and discuss why a company might declare a stock dividend or a stock split.

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APPROPRIATIONS OF RETAINED EARNINGS

An **appropriation of retained earnings** is a book entry that serves to restrict a portion of retained earnings from the payment of future dividends. It involves no asset or liability accounts and no shareholders' equity accounts other than retained earnings. Such entries are executed either at the discretion of the board of directors or in conformance with the terms of contracts (e.g., debt covenants).

Suppose, for example, that the board of directors of Rosebud Corporation plans to expand the company's main manufacturing plant. To save cash so that the expansion can be funded internally, the board has decided to place a restriction on the payment of future dividends. Accordingly, a resolution is passed stating that the company cannot pay dividends that reduce retained earnings below $300,000. Assuming that the balance in the company's retained earnings account before the appropriation was $500,000, the shareholders' equity section of Rosebud's balance sheet after the resolution would appear as in Figure 12–10.

FIGURE 12–10
Disclosing an appropriation of retained earnings

Rosebud Corporation
Balance Sheet
December 31, 2012

Shareholders' Equity		
Common stock		$1,200,000
Additional paid-in capital		2,500,000
Retained earnings:		
Restricted	$300,000	
Unrestricted	200,000	500,000
Total shareholders' equity		$4,200,000

Appropriations of retained earnings that result from contractual restrictions are disclosed in a similar manner. In practice, most companies simply disclose the existence, nature, and dollar amount of restricted retained earnings. Nordstrom, for example, once disclosed the following information about restricted retained earnings in its annual report and chose not to adjust the balance of retained earnings:

Senior Note Agreements contain restrictive covenants which . . . restrict dividends to shareholders to a formula amount (under the most restrictive formula, approximately $247,342 of retained earnings was not restricted).

NEGATIVE RETAINED EARNINGS: A MIXED SIGNAL

The retained earnings account becomes negative if a company's accumulated net losses plus its dividends from previous years exceeds the accumulation of its past profits. Negative retained earnings can indicate serious company problems in that it reflects previous losses. However, young and ultimately very successful companies often experience losses in the early years as they start up their businesses, and these companies frequently show negative retained earnings on the balance sheet. At no time in recent history has this phenomenon been more common than in this era of high technology and the Internet. Well-known Internet providers, such as Amazon.com and others, consistently showed losses in their earlier years, yet their stock prices remained extremely

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strong. Consider, for example, Priceline.com—recognized as a leading provider of online travel services. As of the end of 2009, the company had only recently posted consistent profits and still had an accumulated deficit in retained earnings (of over $450 million). Interestingly, the company's stock jumped from around $70 per share to over $200 by the end of 2009, not so much because the company showed a profit and reduced its retained earnings deficit, but because the market seemed to sense something (e.g., a strong future) not captured on the financial statements. By February 2010, the shares were up to $226 despite the deficit.

?

The 2002 balance sheet of Yahoo!, an Internet search engine, indicated an accumulated deficit in retained earnings of $7.5 million, down from a deficit of $50 million the previous year. By the end of 2003, retained earnings was a positive $230 million. How could a well-known company like Yahoo! accumulate a deficit in retained earnings, and what must have happened in 2002 and 2003 to reduce the deficit?

RETAINED EARNINGS AND PRIOR PERIOD ADJUSTMENTS

All items on the income statement are eventually transferred (closed) to retained earnings, so net income (loss) appears as an adjustment to retained earnings on the statement of shareholders' equity. We have noted that the financial effects of other events, such as the declaration of dividends, the appropriation of retained earnings, and the sale of treasury stock for an amount less than its acquisition cost, are also booked directly to the retained earnings account.

In addition to these items, generally accepted accounting principles require that the financial effects of several rather unusual events be booked directly to retained earnings. One is the correction in the current period of an accounting error made in a previous period. When such a correction is made, a journal entry is recorded to correct the misstated asset or liability and the other half of the entry serves to increase or decrease retained earnings directly. Another is the effect of a change in accounting method in cases when it is not practical for the company to determine the effects of the change on prior years' financial statements. These entries are called **prior period adjustments.**

THE STATEMENT OF SHAREHOLDERS' EQUITY

Generally accepted accounting principles require that the changes during the period in the dollar balances of the separate accounts comprising the shareholders' equity section be disclosed in the financial report. A company can disclose such changes either in the footnotes or in a separate financial statement called the **statement of shareholders' equity.** The consolidated statement of shareholders' equity for Emerson Electric Company appears in Figure 12–11.

INTERNATIONAL PERSPECTIVE: THE RISE OF INTERNATIONAL EQUITY MARKETS

We have referred many times in this text to the New York and American Stock Exchanges and the important roles they play in the buying and selling of equity securities in the United States. As the world of business has become internationalized, however, stock

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FIGURE 12–11
Consolidated statements of shareholders' equity

Consolidated Statements of Stockholders' Equity
Emerson Electric Co. & Subsidiaries
Years Ended September 30
(Dollars in millions, except per share amounts)

	2007	2008	2009
Common stock			
Beginning balance	$ 238	477	477
Adjustment for stock split	239	—	—
Ending balance	477	477	477
Additional paid-in capital			
Beginning balance	161	31	146
Stock plans and other	31	115	11
Adjustment for stock split	(161)	—	—
Ending balance	31	146	157
Retained earnings			
Beginning balance	11,314	12,536	14,002
Net earnings	2,136	2,412	1,724
Cash dividends (per share: 2007, $1.05; 2008, $1.20; 2009, $1.32)	(837)	(940)	(998)
Adjustment for stock split	(77)	—	—
Adoption of FIN 48	—	(6)	—
Adoption of FAS 158 measurement date provision (net of tax of $7)	—	—	(14)
Ending balance	12,536	14,002	14,714
Accumulated other comprehensive income			
Beginning balance	306	382	141
Foreign currency translation	459	(30)	(104)
Pension and postretirement (net of tax of: 2007, $(1); 2008, $51; 2009, $334)	2	(144)	(568)
Cash flow hedges and other (net of tax of: 2007, $29; 2008, $51; 2009, ($29))	(56)	(67)	35
Adoption of FAS 158 liability provisions (net of tax of $193)	(329)	—	—
Ending balance	382	141	(496)
Treasury stock			
Beginning balance	(3,865)	(4,654)	(5,653)
Purchases	(849)	(1,128)	(695)
Issued under stock plans and other	60	129	51
Ending balance	(4,654)	(5,653)	(6,297)
Total shareholders' equity	$8,772	9,113	8,555
Comprehensive income			
Net earnings	$2,136	2,412	1,724
Foreign currency translation	459	(30)	(104)
Pension and postretirement	2	(144)	(568)
Cash flow hedges and other	(56)	(67)	35
Total	$2,541	2,171	1,087

See accompanying Notes to Consolidated Financial Statements.

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exchanges outside the United States have become increasingly important. The stock of JCPenney, for example, is traded not only on the New York Exchange, but also on exchanges in Antwerp and Brussels; General Electric is traded in New York, London, and Tokyo; Coca-Cola is traded in Frankfurt in addition to five different exchanges in Switzerland; and American Express stock is listed on no less than fifteen stock exchanges, eleven of which are outside the United States. It is also true that many companies outside the United States list their equity securities on U.S. exchanges. Approximately 50 percent of Sony's equity is held in New York, and each year billions of dollars are raised through equity issuances on U.S. stock exchanges by non–U.S. companies. A "world stock exchange" seems to be emerging. In the words of Neil Osborn, author of *The Rise of the International Equity:* "It is quite possible to trade in a Japanese stock with a buyer in Saudi Arabia, a seller in London, and a U.S. broker without the transaction going near Tokyo."

The increasing level of international equity trading has important implications for accountants who must provide the financial reports necessary to support this investment activity. Each stock exchange, for example, establishes its own reporting requirements, and issuing companies must prepare their financial statements and supporting disclosures in a manner that conforms to those requirements. To date, the requirements of the U.S. exchanges have been the most difficult to meet, which, in turn, has discouraged many companies from listing their securities on the U.S. exchanges. The *Wall Street Journal* once noted that "the major roadblock to foreign companies listing their overseas stock on U.S. exchanges has long been the big difference between accounting standards in the United States and abroad."

But as we have noted many times before, IFRS are becoming increasingly important and the U.S. exchanges now accept them. As a result, IFRS-based financial statements are becoming more and more common, and U.S. investors now have to contend with the challenges associated with comparing company financial statements prepared on different sets of reporting standards.

ROE EXERCISE: RETURN ON EQUITY AND VALUE CREATION

The ROE model, introduced and illustrated in Appendix 5A, provides a framework linking the management of a company's operating, investing, and financing activities to its return on the shareholders' investment (return on equity). The balance in the shareholders' equity section of the balance sheet represents the investment made by the shareholders, and it is management's responsibility to provide a return on that investment exceeding the return the shareholders could have generated if they chose to invest their funds in other equally risky investments. If this objective is achieved, management has "created value" for the shareholders. If return on equity (ROE) is 20 percent in a particular year, for example, and in that year other equally risky investment alternatives generate a return, on average, of 15 percent, management has achieved **value creation.**

Transactions that influence the shareholders' equity balance have a direct influence on ROE (net income ÷ average shareholders' equity) because they directly affect the denominator used in its calculation. A stock issuance, for example, increases the shareholders' investment, which immediately reduces ROE, placing pressure on management to manage the cash collected from the issuance in a way that generates a return that more than offsets the drop in ROE. Similarly, reported net income increases shareholders' equity, and if retained in the business, represents an additional investment made by the shareholders, providing management with additional capital through which a return must be generated. Dividend payments and treasury stock

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purchases, on the other hand, have the opposite effect. By returning cash to the shareholders, these transactions reduce the shareholders' investment and decrease the capital available to management that can be used to generate shareholder returns.

ROE ANALYSIS

An important part of ROE analysis involves assessing the level and changes in the shareholders' investment (equity) as well as the returns generated by management on the capital provided or used by those changes. Access the Web site http://wiley.com/college/pratt and conduct ROE analyses on Biogen Idec, Inc. versus Baxter and/or International Paper versus Mead Westvaco Corporation, paying special attention to changes in ROE and transactions that affect shareholders' equity.

REVIEW PROBLEM

The following data pertain to the shareholders' equity transactions of Pike Place Corporation over its first three years of operations: 2010, 2011, and 2012. Transactions are described and followed by the appropriate journal entries. The shareholders' equity section of the balance sheet is shown for each of the three years.

2010

(1) The company issued 1,000 shares of $1 par value stock for $70 per share.

Cash (+A)	**70,000***	
Common Stock (+CC)		**1,000****
Additional Paid-In Capital, C/S (+CC)		**69,000**
Issued common stock		

*1,000 sh. × $70/sh.
**1,000 sh. × $1 par value/sh.

(2) The company issued 500 shares of no par value, cumulative preferred stock for $50 per share.

Cash (+A)	**25,000**	
Preferred Stock (+CC)		**25,000**
Issued preferred stock (500 sh. × $50/sh.)		

(3) Net income during the year = $2,000
Dividends = $0

Pike Place Corporation
Balance Sheet
December 31, 2010

SHAREHOLDERS' EQUITY	
Preferred stock (500 sh., no par value)	**$25,000**
Common stock (1,000 sh. @ $1 par value)	**1,000**
Additional paid-in capital (C/S)	**69,000**
Retained earnings	**2,000**
Total shareholders' equity	**$97,000**

Note: Dividends in arrears on cumulative preferred stock = $2,500 (500 sh. × $5/sh.)

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2011

(1) The company purchased 200 treasury (common) shares for $60 per share.

Treasury Stock (−CC)	**12,000**	
Cash (−A)		**12,000**
Acquired treasury stock (200 sh. × $60/sh.)		

(2) Net income for the year = $20,000
Dividends = $6,600: $5,000 for preferred shareholders [$2,500 dividends in arrears and $2,500 (500 sh. × $5/sh.)] for 2011, and $1,600 for the common shareholders (800 outstanding sh. × $2/sh.). The dividends were declared and paid.

Preferred Dividends (−RE)	**5,000**	
Common Dividends (−RE)	**1,600**	
Dividends Payable (+L)		**6,600**
Declared dividends		

Dividends Payable (−L)	**6,600**	
Cash (−A)		**6,600**
Paid dividends		

Pike Place Corporation
Balance Sheet
December 31, 2011

SHAREHOLDERS' EQUITY	
Preferred stock (500 sh., no par value)	**$25,000**
Common stock (1,000 sh. @ $1 par value)	**1,000**
Additional paid-in capital (C/S)	**69,000**
Retained earnings	**15,400***
Less: Treasury stock (200 sh. × $60/sh.)	**(12,000)**
Total shareholders' equity	**$98,400**

****$2,000 + $20,000 − $6,600***

2012

(1) The company reissued 100 treasury shares for $65 each.

Cash (+A)	**6,500***	
Treasury Stock (+CC)		**6,000****
Additional Paid-In Capital, T/S (+CC)		**500**
Reissued treasury stock		

*100 sh. × $65/sh.
**100 sh. × $60/sh.

(2) The company reissued 50 treasury shares for $40 each.

Cash (+A)	**2,000***	
Additional Paid-In Capital, T/S (−CC)	**500**	
Retained Earnings (−CC)	**500**	
Treasury Stock (+CC)		**3,000****
Reissued treasury stock		

*50 sh. × $40/sh.
**50 sh. × $60/sh.

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(3) The company declared a 10 percent stock dividend. There were 950 common shares outstanding at the time of the split, each with a fair market value of $5.

Stock Dividend (−RE)	**475***	
Common Stock (+CC)		**95****
Additional Paid-In Capital (+CC)		**380**
Declared stock dividend		

*Closed to Retained Earnings
**95 sh. × $1 par value/sh.

(4) The company entered into a debt covenant that required a minimum retained earnings balance of $30,000. The board of directors voted to restrict retained earnings of $30,000.
(5) Net income at the end of the year = $35,000
Dividends = $4,590: $2,500 to preferred shareholders and $2,090 to common shareholders (1,045 sh. outstanding × $2/sh.). The dividends were declared but unpaid at year-end.

Preferred Dividends (−RE)	**2,500**	
Common Dividends (−RE)	**2,090**	
Dividends Payable (+L)		**4,590**

Pike Place Corporation
Balance Sheet
December 31, 2012

SHAREHOLDERS' EQUITY		
Preferred stock (500 sh., no par value)		**$ 25,000**
Common stock (1,045 sh. @ $1 par value)		**1,045[a]**
Additional paid-in capital		**69,380[b]**
Retained earnings:		
Restricted	**$30,000**	
Unrestricted	**14,835**	**44,835[c]**
Less: Treasury stock		**(3,000)[d]**
Total shareholders' equity		**$137,260**

[a] *$1,000 + $45*
[b] *$69,000 + $500 − $500 + $380*
[c] *$15,400 − $500 − $475 + $35,000 − $4,590*
[d] *50 sh. × $60/sh. or $12,000 − $6,000 − $3,000*

SUMMARY OF KEY POINTS

- *The three forms of financing and their relative importance to major U.S. corporations.*

Companies can generate assets from three sources: (1) borrowings, (2) issuing equity securities, and (3) retaining funds generated through profitable operations. Borrowings are represented by liabilities on the balance sheet, equity issuances are represented by contributed capital (preferred stock, common stock, and additional paid-in capital), and retaining funds are represented by earned capital (retained earnings). Major U.S. corporations generally rely more heavily on

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liabilities as a form of financing than on the combined total of contributed and earned capital. Earned capital is typically more important than contributed capital. The additions of contributed and earned capital represent the shareholders' investment in the company.

- *Distinctions between debt and equity.*

Debt involves a contractual relationship with an outsider. The contract usually states a fixed maturity date, interest charges, security in case of default, and additional provisions designed to protect the interests of the debtholders. Interest is an expense on the income statement and is deductible for tax purposes. In case of liquidation, creditors have rights to the company's assets before owners. Creditors do not vote in the annual election of the board of directors.

Equity involves a relationship with an owner. There is no legal contract, fixed maturity date, or periodic interest payment. Dividends are at the discretion of the board of directors. They are not considered an expense on the income statement and are not tax deductible. Equity holders have lower asset priority than debtholders in case of liquidation, but they have a direct voice in the operation of the company, primarily through voting power over the board of directors.

Distinguishing debt from equity is important to investors and creditors because equity investments are generally riskier than debt investments but offer the potential for higher returns. From the company's perspective, issuing debt involves the commitment of future cash outflows, but interest is tax deductible. Issuing equity, while avoiding fixed contractual cash outflows, dilutes the ownership of the existing shareholders and makes it easier for outside investors to gain significant control. From the accountant's perspective, debt and equity are classified in different sections of the balance sheet, and unlike interest payments and debt redemptions, exchanges of equity are never reflected on the income statement.

- *Economic consequences associated with the methods used to account for shareholders' equity.*

The economic consequences associated with accounting for shareholders' equity arise from the effects of financial ratios that include the dollar amount of shareholders' equity or its components on a company's stock prices, credit rating, or any debt covenants that restrict additional borrowings, the payment of dividends, or the repurchase of outstanding equity shares. Such ratios are also commonly used to define restrictions in debt covenants imposed on management. The use of financial ratios in these ways can encourage management, for example, to structure debt financing in a way that resembles equity so that additional debt need not be reported on the balance sheet. Issuing certain forms of preferred stock and other hybrid securities may represent such a strategy.

- *Rights associated with preferred and common stock and the methods used to account for stock issuances.*

Stock that is preferred as to dividends carries the right, if dividends are declared by the board, to receive a certain specified dividend payment before the common shareholders receive a dividend. If the preferred stock is cumulative and the corporation misses a dividend, dividends in arrears are created in the amount of the missed preferred dividend. In future periods, as dividends are declared, dividends in arrears are paid first to the preferred shareholders, the preferred shareholders are then paid their normal, annual dividend, and finally, the common shareholders are paid from what remains. If the preferred stock carries a participating feature, the preferred shareholders not only receive their initial specified amount, but they also share in the remaining dividends with the common shareholders. Stock that is preferred as to assets carries a claim to the corporation's assets, in case of liquidation, that has higher priority than the claim carried by common stock. In many ways preferred stock resembles debt.

Common stock is characterized by three fundamental rights: (1) the right to receive dividends if they are declared by the board, (2) a residual right to the corporation's assets in case of liquidation, and (3) the right to exert control over corporate management, which is exercised primarily by voting in the election of the board at the annual shareholders' meeting.

When preferred or common stock with no par value is issued for cash, the cash account is debited for the proceeds, and the stock account is credited for the entire dollar amount. When stock with a par (or stated) value is issued for cash, the cash account is debited for the total proceeds, the stock account is credited for the number of shares issued multiplied by the par value per share, and the additional paid-in capital account is credited for the remainder.

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- *Distinctions among the market value, book value, and par (stated) value of a share of common stock.*

  The market value of a share of stock is the price at which the stock can be purchased and sold on the open market. The book value of a share of stock is equal to the book value of the corporation, as indicated on the balance sheet (shareholders' equity or net assets), less preferred capital and divided by the number of common shares outstanding. The par (stated) value of a share of stock has no relationship to its market value or book value and, for the most part, has limited economic significance.

- *Treasury stock.*

  Outstanding common stock is often repurchased by companies. Such stocks are either (1) held in treasury, to be reissued at a later date, or (2) retired. Treasury stock purchases normally must be authorized and approved by the company's board of directors and shareholders. While held in treasury, stock shares carry none of the usual rights of ownership.

  Companies purchase treasury stock to support employee compensation plans, to fend off possible takeover attempts, to prepare for merger activity, to increase the market price of the company's outstanding stock, to maintain leverage levels, to increase the company's earnings per share (net income/outstanding common shares), and to distribute cash to the shareholders. In general, treasury stock purchases reduce the scale of a company's operations.

  When a company purchases its own outstanding common stock under the cost method, a permanent account, called treasury stock, is debited for the cost of the purchase. This account is disclosed below retained earnings in the shareholders' equity section of the balance sheet. If treasury stock is reissued at a price greater than its original cost, the cash account is debited for the proceeds, the treasury stock account is credited for the cost, and the difference is credited to the additional paid-in capital (treasury stock) account. If treasury stock is reissued at an amount less than the original cost, the cash account is debited for the proceeds, the treasury stock account is credited for the original cost, and additional paid-in capital (treasury stock) is debited for the difference, if there is a sufficient balance in the account to cover the difference. If the difference between the cost and the proceeds exceeds the balance in the additional paid-in capital account, retained earnings is debited.

- *Cash dividends and dividend strategies followed by corporations.*

  Cash dividends represent distributions of cash to the shareholders. When a cash dividend is declared, a cash dividend account is debited and a current liability account, dividends payable, is credited on the date of declaration. The dollar amount is equal to the cash dividend per share multiplied by the number of outstanding shares. The dividend account is a temporary account that is closed directly to retained earnings at the end of the accounting period. On the date of record, no entry is made in the books of the corporation. The shareholders as of this date are the recipients of the dividends. On the date of payment, the cash dividend is paid, and the dividends payable liability is removed from the balance sheet.

  When to declare a dividend and how much to declare depend on the nature, financial condition, and desired image of the company, as well as legal constraints. If dividends are to be paid in cash, the board of directors must first be certain that the corporation has sufficient cash to meet the payment. Some companies have adopted policies of paying no dividends. Such companies reinvest their earnings primarily to support growth without having to rely too heavily on debt and equity financing. Other companies pay quarterly dividends at the rate of a relatively fixed percentage of net income and also attempt to increase their dividend payments consistently from year to year. Some companies consistently increase dividends from year to year, but the distributions do not represent a consistent percentage of net income.

- *Stock dividends and stock splits.*

  In a stock split, the number of outstanding shares is simply split into smaller units, which requires the corporation to distribute additional shares. In a stock dividend, additional shares, usually expressed as a percentage of the outstanding shares, are issued to the shareholders. Professional accounting standards recommend that relatively large stock dividends (over 25 percent)

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be referred to as stock splits in the form of dividends and that relatively small stock dividends (less than 25 percent) be referred to as ordinary stock dividends.

Stock splits or stock dividends in the form of splits are often declared to reduce the per-share price of the outstanding shares so that investors can more easily purchase them. The reasons for small stock dividends are less clear. Such distributions have a relatively small effect on the number of outstanding shares and do little to reduce per-share prices and broaden stock ownership. Corporations that are short of cash may distribute stock dividends instead of cash dividends so that the shareholders are at least receiving something. Corporations may also issue stock dividends to capitalize a portion of retained earnings, rendering them unavailable for future dividends. In any case, the issuance of a stock split or stock dividend does not involve a distribution of assets to the shareholders.

KEY TERMS

Note: Definitions for these terms are provided in the glossary at the end of the text.

Accumulated comprehensive income (p. 540)
Appropriation of retained earnings (p. 566)
Authorized (shares) (p. 548)
Book value (of company/share) (p. 540)
Contributed capital (p. 540)
Cumulative preferred stock (p. 550)
Date of declaration (p. 561)
Date of payment (p. 561)
Date of record (p. 561)
Dilution (p. 544)
Dividends in arrears (p. 550)
Earned capital (p. 540)
Issued (shares) (p. 548)
Leverage (p. 544)
Market-to-book ratio (p. 553)
Market value (of stock) (p. 552)
Net assets (p. 540)
Net worth (p. 540)
Ordinary stock dividends (p. 564)
Outstanding (shares) (p. 548)
Par value (p. 553)
Participating (preferred stock) (p. 550)
Preferred stock as to assets (p. 548)
Preferred stock as to dividends (p. 548)
Prior period adjustments (p. 567)
Residual interest (p. 543)
Statement of shareholders' equity (p. 567)
Stock dividends (p. 561)
Stock options (p. 559)
Stock split (p. 563)
Stock splits in the form of dividends (p. 563)
Takeover (p. 545)
Treasury stock (p. 545)
Value creation (p. 569)

ETHICS in the Real World

Two years in a row, Hampton Industries, a men's clothing manufacturer that relies heavily on low-cost labor in Third-World countries, declared 10 percent stock dividends. Although no assets were transferred to shareholders, millions of dollars were transferred from retained earnings to the common stock and paid-in capital accounts. More recently, the company faced some very difficult times, violating debt covenants and entering into a plan to liquidate assets. Some have speculated that the board of directors declared the stock dividends to mislead the shareholders into believing that the company was still able to distribute something of value even though profits were down and falling fast, perhaps in an attempt to delay an inevitable stock price collapse.

ETHICAL ISSUE Does a stock dividend represent something of value? Was the board of directors acting ethically if it attempted to delay an inevitable stock price collapse by issuing a stock dividend?

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INTERNET RESEARCH EXERCISE

Kellogg Company manufactures products on six continents, and these products are sold in more than 160 countries. Review the company's most recent annual report, specifically the statement of shareholders' equity, which can be found via www.kelloggs.com. Briefly describe the main transactions between the company and its shareholders over the previous three-year period. Has the company issued stock, declared stock splits, purchased its own shares, or declared dividends, and have the company's executives exercised any stock options?

BRIEF EXERCISES

REAL DATA
BE12–1
Inferring shareholders' equity transactions

The following information was taken from the 2008 statement of shareholders' equity of The Home Depot (dollars in millions).

	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock
Beginning balance	**$85**	**$5,800**	**$1,388**	**($314)**
Net income			**2,260**	
Shares issued under				
employee stock plans,		**369**		
stock options, other		**248**		
Repurchase of common stock				**(58)**
Cash dividends			**(1,533)**	

a. What portion of net income was paid out in dividends during the year?
b. Explain how the issuance of shares affected the basic accounting equation.
c. Explain how the purchase of treasury stock affected the basic accounting equation.
d. How much cash was distributed to the company's shareholders during the year?
e. What was the balance sheet value of the retained earnings account at the end of the year?

REAL DATA
BE12–2
Stock splits and market values

When Tandy (RadioShack) Corporation announced a 2:1 stock split, the company had 97 million shares outstanding, trading at $100 per share.

a. Estimate the number of shares outstanding and market price per share immediately after the split.
b. Estimate the company's overall market value, and explain whether you expect the company's overall market value to change due to the split.

REAL DATA
BE12–3
Treasury stock purchases

The following information was taken from the 2009 annual report of Coca-Cola (dollar and share amounts in millions).

	Treasury Shares	Dollar Amount
2007 Share repurchases	**34**	**$1,756**
2008 Share repurchases	**18**	**1,044**
2009 Share repurchases	**26**	**1,484**

a. At what average price did the company repurchase its shares in 2007?
b. At what average price did the company repurchase its shares in 2008?

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c. The December 31, 2009, balance in treasury stock was ($25,398). If Coca-Cola reissues treasury shares in the amount of $1,200 to support 2010 employee compensation plans, what will be the December 31, 2010 balance in the treasury stock account?

EXERCISES

E12–1

The effects of transactions on shareholders' equity

The following are possible transactions that affect shareholders' equity:

1. A company issues common stock above par value for cash.
2. A company declares a 3-for-1 stock split.
3. A company repurchases 10,000 shares of its own common stock in exchange for cash.
4. A company declares and issues a stock dividend. Assume that the fair market value of the stock is greater than the par value.
5. A company reissues 1,000 shares of treasury stock for $75 per share. The stock was acquired for $60 per share.
6. A company pays a cash dividend that had been declared fifteen days earlier.
7. A company generates net income of $250,000.

For each transaction above, indicate the following:

a. The accounts within the shareholders' equity section that would be affected.
b. Whether these accounts would be increased or decreased.
c. The effect (increase, decrease, or no effect) of the transaction on total shareholders' equity.

E12–2

Debt, contributed and earned capital, and the classification of preferred stock

The balance sheet of Lamont Bros. follows:

ASSETS		LIABILITIES AND SHAREHOLDERS' EQUITY	
Current assets	**$ 85,000**	**Current liabilities**	**$ 52,000**
Noncurrent assets	**315,000**	**Long-term note payable**	**35,000**
		Preferred stock	**50,000**
		Common stock	**80,000**
		Additional paid-in capital:	
		Preferred stock	**50,000**
		Common stock	**100,000**
		Retained earnings	**113,000**
		Less: Treasury stock	**(80,000)**
Total assets	**$400,000**	**Total liabilities and shareholders' equity**	**$400,000**

a. What portions of Lamont's assets were provided by debt, contributed capital, and earned capital? Reduce contributed capital by the cost of the treasury stock.
b. Compute the company's debt/equity ratio. Compute the debt/equity ratio if the preferred stock issuance was classified as a long-term debt.
c. In most states, to what dollar amount of dividends would the company be limited?

E12–3

Authorizing and issuing preferred and common stock

Deming Contractors was involved in the following events involving stock during 2012:

1. Authorized to issue: (a) 100,000 shares of $100 par value, 8 percent preferred stock; (b) 150,000 shares of no-par, $5 preferred stock; and (c) 250,000 shares of $5 par value, common stock.
2. Issued 10,000 shares of $5 par value common stock for $30 per share.
3. Issued 25,000 shares of the $100 par value preferred stock for $150 per share.
4. Issued 50,000 shares of no-par preferred stock for $50 each.

Prepare entries, if appropriate, for each event, describe how each event affects the basic accounting equation, and explain the economic significance of par value.

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REAL DATA

E12–4

Effects of treasury stock purchases on financial ratios

Before the merger of Wendy's and Arby's, Wendy's made a huge purchase of its own shares and in total bought back over 26 million shares for approximately $1 billion. Before the purchase, 125.5 million shares were outstanding, and the financial statements appeared as follows (dollars in millions).

INCOME STATEMENT	
Revenue	**$2,439**
Expenses	**2,345**
Net income	**94**

BALANCE SHEET	
Assets	**$3,060**
Liabilities	**$1,048**
Shareholders' equity	**$2,012**

a. Provide the journal entry for the treasury stock purchase.
b. Compute the ratio of total liabilities to shareholders' equity before and after the purchase.
c. Compute earnings per share before and after the purchase.
d. Comment on why a company might choose to purchase treasury stock.

E12–5

Reissuing treasury stock

Twin Lakes incorporated on April 1, 2012, and was authorized to issue 100,000 shares of $5 par value common stock and 10,000 shares of $8, no-par preferred stock. During the remainder of 2012, the company entered into the following transactions.

1. Issued 25,000 shares of common stock in exchange for $500,000 in cash.
2. Issued 5,000 shares of preferred stock in exchange for $60,000 in cash.
3. Purchased 3,000 common shares for $15 per share and held them in the form of treasury stock.
4. Sold 1,000 treasury shares for $18 per share on the open market.
5. Issued 1,000 treasury shares to executives who exercised stock options for a reduced price of $5 per share.

The company entered into no other transactions that affected shareholders' equity during 2012.

a. Prepare entries for each of the transactions.
b. Assume that Twin Lakes generated $500,000 in net income in 2012 and did not declare any dividends during 2012. Prepare the shareholders' equity section of the balance sheet as of December 31, 2012.

E12–6

Reissuing treasury stock

The shareholders' equity section of Rodman Corporation as of December 31, 2011, follows:

Common stock	**$ 80,000**
Additional paid-in capital (C/S)	**10,000**
Retained earnings	**60,000**
Total shareholders' equity	**$150,000**

During 2012, the company entered into the following transactions:

1. Purchased 1,000 shares of treasury stock for $60 per share.
2. As part of a compensation package, reissued half of the treasury shares to executives who exercised stock options for $20 per share.
3. Reissued the remainder of the treasury stock on the open market for $66 per share.

a. Provide the journal entries for each transaction, and prepare the shareholders' equity section of the balance sheet as of December 31, 2012. Rodman Corporation generated $20,000 in net income during 2012 and did not declare any dividends.
b. What portion of the additional paid-in capital account is attributed to treasury stock transactions?

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E12–7

Treasury stock exceeds contributed capital

In 2002, Stuart Corporation began operations, issuing 100,000 shares of $1 par value common stock for $25 per share. Since that time, the company has been very profitable. The shareholders' equity section as of December 31, 2011, follows:

Common stock	**$ 100,000**
Additional paid-in capital (C/S)	**2,400,000**
Retained earnings	**4,500,000**
Total shareholders' equity	**$7,000,000**

In 2012, the company entered into a program of buying back some of the outstanding shares. During the year, the company purchased 30,000 outstanding shares at $95 per share.

a. Prepare the journal entry to record the purchase of the treasury shares.
b. Assuming that net income of $350,000 was earned and dividends of $50,000 were declared during the year, prepare the shareholders' equity section of the balance sheet as of the end of 2012.
c. Explain how the dollar value of the treasury stock account can be larger than the dollar amount of contributed capital.

REAL DATA

E12–8

Book value per share, stock issuances, and treasury stock purchases

The condensed 2008 balance sheet of Honeywell International follows (dollars in millions):

Assets	**$35,490**	**Liabilities**	**$28,303**
		Shareholders' equity	**7,187**
Total assets	**$35,490**	**Total liabilities and shareholders' equity**	**$35,490**

Seven hundred thirty-five million shares of common stock and no preferred stock were outstanding. The following requirements are independent:

a. Compute the book value per common share.
b. Compute the book value per common share if the company issues 50 million shares of common stock at $32 per share.
c. Compute the book value per common share if the company issues 50 million shares of common stock at $20 per share.
d. Compute the book value per outstanding share of common stock if the company purchases 50 million shares of treasury stock at $32 per share.
e. Compute the book value per outstanding share of common stock if the company purchases 50 million shares of treasury stock at $20 per share.
f. What effect does issuing stock have on the book value of the outstanding shares? Upon what does this effect depend?
g. What effect does purchasing treasury stock have on the book value of the outstanding shares? Upon what does this effect depend?

E12–9

Inferring equity transactions from the statement of shareholders' equity

The following information was taken from the statement of shareholders' equity of Chinook Furs:

	2012	2011
Preferred stock (no par)	**$ 700**	**$400**
Common stock ($1 par value)	**1,000**	**900**
Additional paid-in capital:		
Common stock	**40**	**20**
Treasury stock	**10**	**—**
Less: Treasury stock	**130**	**150**

Provide the journal entries for the following:

a. The issuance of preferred stock during 2012.
b. The issuance of common stock during 2012.
c. The sale of treasury stock during 2012.

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E12–10

Inferring equity transactions from the statement of shareholders' equity

The following information was taken from the statement of shareholders' equity of Zielow Siding as of December 31, 2012. The par value of the Zielow stock is $5, and as of the beginning of 2012, the company held 400 shares in treasury.

	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock
Beginning balances	$10,000	$25,000	$34,000	$ 8,000
Acquisition of Timeco	5,000	23,000		
Treasury share purchases				4,000
Exercised stock options	1,000	800		
Net income			5,600	
Cash dividends			(3,520)	
Ending balances	$16,000	$48,800	$36,080	$12,000

a. Zielow issued common stock at one time prior to 2012. How many shares were issued and at what price per share?
b. Zielow purchased treasury stock at one time prior to 2012. How many shares were purchased and at what price?
c. During 2012, Zielow acquired Timeco and issued its own shares as payment in the transaction. How many shares were issued, and what was the market value of Timeco at the time of the acquisition?
d. At what price were the stock options exercised, and how did that price compare to the market value of Zielow stock at the time?
e. Compute the per-share dividend rate paid by Zielow during 2012. Assume that treasury shares acquired in 2012 were purchased at the same price per share prior to 2012.

E12–11

Inferring equity transactions from the statement of shareholders' equity

The following information was taken from the statement of shareholders' equity of Kidd Sports as of December 31, 2012. The par value of Kidd stock is $1, and as of the beginning of 2012, the company held 1,500 shares in treasury.

	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock
Beginning balances	$8,000	$32,000	$27,000	$18,000
Exercised stock options			(2,750)	(3,000)
Net income			5,600	
Cash dividends			(3,500)	
Stock dividend	700	9,800	(10,500)	
Ending balances	$8,700	$41,800	$15,850	$15,000

a. Kidd issued common stock at one time prior to 2012. How many shares were issued and at what price per share?
b. Kidd purchased treasury stock at one time prior to 2012. How many shares were purchased and at what price?
c. At what price were the stock options exercised, and how did that price compare to the market value of Kidd stock at the time? Assume that the stock options were exercised immediately prior to the issuance of the stock dividend, which was recorded at market value.
d. Compute the per-share dividend rate paid by Kidd during 2012, assuming that the cash dividends were declared prior to the stock dividend but after the stock options were exercised.

E12–12

Issuing cash dividends on outstanding common stock

The board of directors of Enerson Manufacturing is in the process of declaring a dividend. The company is considering paying a cash dividend of $12 per share. Enerson Manufacturing is authorized to issue 800,000 shares of common stock. The company has issued 375,000 shares to date and has reacquired 50,000 shares. These 50,000 shares are held in treasury.

a. How many shares of common stock are eligible to receive a dividend?
b. Assume that the board declares the dividend. Prepare the appropriate journal entries on the (1) date of declaration, (2) date of record, and (3) date of payment.

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E12–13

Cumulative preferred stock and dividends in arrears

The shareholders' equity section of Mayberry Corporation, as of the end of 2012, follows. Mayberry began operations in 2008. The 5,000 shares of preferred stock have been outstanding since 2008.

Preferred stock (10,000 sh. authorized, 5,000 issued, cumulative, nonparticipating, $5 dividends, $10 par value)	**$ 50,000**
Common stock (500,000 sh. authorized, 200,000 sh. issued, 50,000 held in treasury, no par value)	**1,600,000**
Additional paid-in capital (P/S)	**140,000**
Retained earnings	**110,000**
Less: Treasury stock	**(80,000)**
Total shareholders' equity	**$1,820,000**

The company has paid the following total cash dividends since 2008:

2008	**$ 0**
2009	**30,000**
2010	**80,000**
2011	**15,000**
2012	**40,000**

a. Compute the dividends paid to the preferred and common shareholders for each of the years since 2008.
b. Compute the balance of dividends in arrears as of the end of each year.
c. Should dividends in arrears be considered a liability? Why or why not?

E12–14

Stock dividends and stock splits

The shareholders' equity section of Pioneer Enterprises as of December 31, 2012, follows:

Common stock (10,000 shares issued @ $6 par)	**$ 60,000**
Additional paid-in capital (C/S)	**100,000**
Retained earnings	**60,000**
Less: Treasury stock (2,000 shares @ $12)	**(24,000)**
Total shareholders' equity	**$196,000**

Prepare journal entries for the following *independent* transactions:

a. The company declares and distributes a 2 percent stock dividend on the outstanding shares. The market price of the stock is $70 per share.
b. The company declares a 3:2 stock split on the outstanding shares.
c. The company declares a 10 percent stock dividend on the outstanding shares. The market price of the stock is $80 per share.
d. The company declares a 2:1 stock split on the outstanding shares.
e. Compute the ratio of contributed capital to earned capital after independently considering each of the four actions listed above. Reduce contributed capital by the cost of the treasury stock. Comment on the difference between a stock dividend and a stock split.

E12–15

Why do companies declare stock dividends?

The December 31, 2011, balances in retained earnings and additional paid-in capital for Railway Shippers Company are $135,000 and $50,000, respectively. Five thousand $10 par value common shares are outstanding with a market value of $85 each. The company's cash position at year-end is lower than usual, so the board of directors is considering issuing a stock dividend instead of the normal cash dividend. They are considering the following options.

Option 1: A 10 percent stock dividend: 500 new shares would be issued.
Option 2: A 20 percent stock dividend: 1,000 new shares would be issued.
Option 3: A 2:1 stock split: 5,000 new shares would be issued.

a. Prepare the journal entries for Options 1 and 2, and comment on why these alternatives may not be attractive. Why do companies issue stock dividends?
b. What effect would Option 3 have on the financial statements?
c. Why do companies split their stock?

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E12–16
Appropriating retained earnings

Taylor Manufacturing entered into a borrowing arrangement that requires the company to maintain a retained earnings balance of $500,000. The company also wishes to finance internally a major plant addition in the not-too-distant future. Accordingly, the board of directors has decided to appropriate $350,000 of the retained earnings balance. Prior to the board's action, the balance in the retained earnings account was $800,000.

a. Why would the board of directors appropriate retained earnings in the situation described above, and why might an auditor insist that it be done?
b. Show how retained earnings would be disclosed on the balance sheet after the appropriation.
c. Discuss the constraints with respect to dividend payments that have been imposed on the board by the debt covenant and the appropriation.

PROBLEMS

P12–1
Hybrid securities and debt covenants

Lambert Corporation issued 1,000 shares of $100 par value, 8 percent, cumulative, nonparticipating preferred stock for $100 each. The stock is preferred to assets, redeemable after five years at a prespecified price, and the preferred shareholders do not vote at the annual shareholders' meeting. The condensed balance sheet of Lambert prior to the issuance follows:

Assets	**$580,000**	**Liabilities**	**$250,000**
		Shareholders' equity	**330,000**
Total assets	**$580,000**	**Total liabilities and shareholders' equity**	**$580,000**

Lambert has entered into a debt agreement that requires the company to maintain a debt/equity ratio of less than 1:1.

REQUIRED:
a. Provide the journal entry to record the preferred stock issuance, and compute the resulting debt/equity ratio, assuming that the preferred stock is considered an equity security.
b. Compute the debt/equity ratio, assuming that the preferred stock is considered a debt security.
c. What incentives might the management of Lambert have to classify the issuance as equity instead of debt? Do you think that the issuance should be classified as debt or equity? What might Lambert's external auditors think?

P12–2
The effects of treasury stock transactions on important financial ratios

The balance sheet of Alex Bros. follows:

Assets	**$840,000**	**Liabilities**	**$300,000**
		Preferred stock	**50,000**
		Common stock	**300,000**
		Additional paid-in capital (C/S)	**100,000**
		Retained earnings	**130,000**
		Less: Treasury stock	**(40,000)**
Total assets	**$840,000**	**Total liabilities and shareholders' equity**	**$840,000**

Of the 200,000 common shares authorized, 50,000 shares were issued for $8 each when the company began operations. There have been no common stock issuances since; 45,000 shares are currently outstanding, and 5,000 shares are held in treasury. Net income for the year just ended was $45,000.

REQUIRED:
a. Compute the par value of the issued common shares.
b. Compute the book value of each common share.

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c. At what average price were the treasury shares purchased?
d. Alex is considering reissuing the 5,000 treasury shares at the present market price of $10 per share. What effect would this action have on the company's debt/equity ratio, book value per outstanding share, and earnings-per-share ratio?

P12–3

The significance of par value

Several independent transactions are as follows.

1. 10,000 shares of no-par common stock are issued for $50 per share.
2. 10,000 shares of $1 par value common stock are issued for $40 per share.
3. 10,000 shares of $10 par value common stock are issued for $30 per share.
4. 5,000 shares of no-par preferred stock are issued for $80 per share.

REQUIRED:

a. Prepare journal entries for each transaction.
b. What is the significance of par value from a financial accounting standpoint? Is par value significant in any economic sense?

P12–4

Cash and stock dividends

Royal Company is currently considering declaring a dividend to its common shareholders, according to one of the following plans:

1. Declare a cash dividend of $15 per share.
2. Declare a 10 percent stock dividend. Royal Company would distribute one share of common stock for every 10 shares of common stock currently held. The company's common stock is currently selling for $50 per share.

Royal Company is authorized to issue 100,000 shares of $10 par value common stock. To date, the company has issued 55,000 shares and is currently holding 8,000 shares in treasury stock.

REQUIRED:

a. How many shares of common stock are eligible to receive a dividend?
b. Prepare the entries necessary on the date of declaration, date of record, and date of payment for the cash dividend.
c. Prepare the entry to record the stock dividend, assuming that the dividend is declared and issued on the same date.
d. Describe how each dividend would affect Royal's debt/equity ratio.
e. Which of the two dividends would you, as a shareholder, prefer to receive? Why?

P12–5

Dividend payments and preferred stock

The following information was extracted from the financial records of Maverick Corporation:

Preferred stock: 15,000 shares outstanding, 10 percent, $50 par value
Common stock: 50,000 shares outstanding, $15 par value

Maverick began operations on January 1, 2006. The company has paid the following amounts in cash dividends over the past seven years:

2006	**$ 65,000**
2007	**100,000**
2008	**70,000**
2009	**50,000**
2010	**125,000**
2011	**110,000**
2012	**99,000**

REQUIRED:

Prepare a sheet to contain the following schedule.

Year	Total Dividends Declared	Dividends to Preferred	Dividends to Common	Dividend per Share (Preferred)	Dividend per Share (Common)

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a. Complete this schedule for each year from 2006 through 2012, assuming that the preferred stock is noncumulative and nonparticipating.
b. Complete this schedule for each year from 2006 through 2012, assuming that the preferred stock is cumulative and nonparticipating.

P12–6
The maximum dividend

The following selected financial information was extracted from the December 31, 2011, financial records of Cotter Company:

	Debit	Credit
Cash	**25,000**	
Short-term investments (2,500 shares of Oreton Corporation)	**80,000**	
Common stock ($10 par value, 100,000 shares authorized, 50,000 issued)		**500,000**
Additional paid-in capital (C/S)		**100,000**
Retained earnings (before closing)		**245,000**
Net income for 2011		**43,000**

The company's board of directors is currently contemplating declaring a dividend. The company's common stock is presently selling for $40 per share.

REQUIRED:
a. Given the present financial position of Cotter Company, how large a cash dividend can the board of directors declare?
b. How large a stock dividend can the board legally declare?
c. Assume that the dividends are declared and issued on the same day. Prepare the journal entry to record the maximum dividend in each case above.
d. If the company sold its short-term investments, how large a cash dividend could it declare and pay? The current selling price of Oreton Corporation is $50 per share.

P12–7
Stock splits and stock dividends

Stevenson Enterprises is considering the following items:

1. The company may declare a 10 percent stock dividend, issuing an additional share of common stock for every ten shares outstanding; the common stock is currently selling for $25 per share.
2. The company may issue a 2:1 stock split.

Prior to these events, Stevenson Enterprises reports the following:

Common stock ($6 par value, 650,000 shares authorized, 70,000 issued, 60,000 outstanding, and 10,000 held as treasury stock)	**$ 420,000**
Additional paid-in capital (C/S)	**525,000**
Retained earnings	**695,000**
Less: Treasury stock	**(100,000)**
Total shareholders' equity	**$1,540,000**

REQUIRED:
a. Assume that Stevenson Enterprises declares the stock dividend but not the stock split. Prepare the necessary journal entry. Prepare the shareholders' equity section of the balance sheet to reflect the stock dividend.
b. Assume that Stevenson Enterprises declares the stock split but not the stock dividend. Prepare the shareholders' equity section of the balance sheet to reflect the stock split.
c. Assume that Stevenson Enterprises declares the stock dividend and then the stock split. Prepare the necessary journal entries. Prepare the shareholders' equity section of the balance sheet to reflect both actions.

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d. Assume that Stevenson Enterprises declares the stock split and then the stock dividend. Prepare the necessary journal entries. Prepare the shareholders' equity section of the balance sheet to reflect both actions. Assume that the market price of Stevenson's stock drops to $12.50 per share following the stock split.

REAL DATA

P12–8

Stock issuances

The 2008 statement of shareholders' equity of Starbucks, the coffee shop retailer, included the following information concerning common stock (dollars in thousands):

	Shares	Dollar Amount
2007:		
Exercised stock options	**6,600**	**$77,400**
Sale of common stock	**2,800**	**41,900**
Repurchase of stock	**12,200**	**194,500**
2008:		
Exercised common stock	**4,900**	**35,900**
Sale of common stock	**2,500**	**26,800**

REQUIRED:

a. Compute the average prices at which the shares in 2007 and 2008 were issued and purchased.
b. Were the shares to exercise the stock options issued at a higher or lower price than the shares issued for the sale of common stock? Explain how the two sets of shares could be issued for different purposes. What does the repurchase indicate about the stock price trend?

P12–9

Miscellaneous shareholders' equity transactions

The shareholders' equity section of Rudnicki Corporation contained the following balances as of December 31, 2011:

Preferred stock (10%, $10 par value, cumulative)	**$1,000**
Preferred stock (12%, $10 par value, noncumulative)	**1,500**
Common stock ($1 par value, 5,000 shares authorized, 3,500 issued and 400 held in treasury)	**3,500**
Additional paid-in capital:	
Preferred stock (10%)	**1,050**
Preferred stock (12%)	**1,275**
Common stock	**2,345**
Retained earnings	**4,256**
Less: Treasury stock	**(5,750)**
Total shareholders' equity	**$9,176**

During 2012, Rudnicki Corporation entered into the following transactions affecting shareholders' equity:

1. On May 13, the company repurchased 50 shares of its common stock in the open market at $20 per share.
2. On September 26, the company issued 200 shares of its 10 percent preferred stock at $19 per share.
3. On October 19, the company reissued 30 shares of the stock held in treasury. They sold for $22 per share; all of the shares reissued were purchased prior to May 13 for $12 per share.
4. On December 2, the company declared a cash dividend of $750, which was paid on December 27. The company has not declared a dividend since 2010. (Rudnicki Corporation uses a separate dividend account for each type of stock.)
5. On December 27, the company pays the dividend declared on December 2.
6. On December 29, the company declares a 2:1 stock split on the company's common stock.

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REQUIRED:

a. Prepare the necessary entries for each transaction.
b. Assume that Rudnicki Corporation earned net income of $899 during 2012. Prepare the shareholders' equity section as of December 31, 2012.

P12–10

Inferring transactions from the balance sheet

The shareholders' equity section of Buzytown Industries' balance sheet reports the following:

	2012	2011
Preferred stock (9%, $100 par value)	**$ 200,000**	**$ 110,000**
Common stock ($10 par value, 750,000 shares authorized, 90,000 issued, and 5,000 held in treasury)	**900,000**	**750,000**
Additional paid-in capital:		
Preferred stock	**150,000**	**35,000**
Common stock	**465,000**	**298,000**
Retained earnings	**575,000**	**495,000**
Less: Treasury stock	**(110,000)**	**—**
Total shareholders' equity	**$2,180,000**	**$1,688,000**

REQUIRED:

a. How many shares of preferred stock were issued during 2012? What was the average issue price?
b. How many shares of common stock were issued during 2012? What was the average issue price?
c. Prepare the entry to record the repurchase of the company's own stock during 2012. What was the average repurchase price?
d. Assume that the treasury shares were purchased on the last day of 2012. Did the purchase increase or decrease the book value of the outstanding shares? By how much?

P12–11

Inferring shareholders' equity transactions from information on the balance sheet

Tracey Corporation reports the following in its December 31, 2011, financial report:

	2011	2010
Cumulative preferred stock (10%, $100 par value)	**$ 400,000**	**$ 400,000**
Common stock ($10 par value, 11,000 shares authorized, issued, and outstanding)	**110,000**	**70,000**
Additional paid-in capital:		
Common stock	**625,000**	**500,000**
Treasury stock	**124,000**	**55,000**
Retained earnings	**975,000**	**250,000**
Less: Treasury stock	**(84,000)**	**(105,000)**
Total shareholders' equity	**$2,150,000**	**$1,170,000**

The total balance in treasury stock on December 31, 2010, represents the acquisition of 1,500 shares of common stock on March 3, 2009.

REQUIRED:

a. Compute the number of shares of common stock issued during 2011.
b. Compute the average market price of the common shares issued during 2011.
c. Assume that Tracey Corporation earned net income of $2 million during 2011. Compute the amount of dividends that were declared during 2011.
d. If Tracey Corporation did not declare or pay any dividends during 2010, and again assuming a net income during 2011 of $2 million, compute the amount declared as dividends to common stockholders during 2011.
e. Prepare the entry that would have been necessary on March 3, 2009, to record the purchase of the treasury stock.

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f. Assume that all shares of treasury stock reissued during 2011 were reissued at the same time and at the same price. Prepare the entry to record the reissuance of the treasury stock.
g. At what per-share price was the treasury stock reissued?

P12–12

Shareholders' equity over a four-year period

Aspen Industries became a corporation in the state of Colorado on March 23, 2009. The company was authorized to issue 1 million shares of $6 par value common stock. Since the date of incorporation, Aspen Industries has entered into the following transactions that affected contributed and earned capital:

1. On March 23, 2009, the company issued 50,000 shares of common stock in exchange for $15 per share.
2. On December 5, 2009, the company issued a 10 percent stock dividend. The market value of the stock is $18 per share.
3. On May 6, 2010, the company issued 60,000 shares of common stock in exchange for $22 per share.
4. On September 24, 2010, the company repurchased 15,000 shares of its own stock for $25 per share.
5. On December 1, 2010, the company reissued 5,000 shares held in treasury for $27 per share.
6. On February 14, 2011, the company declared a 3:1 stock split and adjusted the par value of the stock. (*Hint:* Consider the effect of the stock split on treasury stock.)
7. On August 19, 2011, the company reissued 8,000 shares held in treasury for $10 per share.
8. On December 27, 2011, the company declared a cash dividend of $50,000.
9. On January 3, 2012, the company paid the dividend declared on December 27, 2011.
10. On October 31, 2012, the company reissued 2,000 shares held in treasury for $15 per share.

REQUIRED:

a. Prepare the necessary journal entries to record these transactions.
b. Prepare the shareholders' equity section of Aspen's balance sheet as of December 31, 2012. Assume that net income for 2009, 2010, 2011, and 2012 was $400,000, $100,000, $100,000, and $20,000, respectively.

P12–13

Blocking takeovers and treasury stock purchases

Five shareholders together own 35 percent of the outstanding stock of Edmonds Industries. The remaining 65 percent is divided among several thousand shareholders. There are 400,000 shares of Edmonds stock currently outstanding. A condensed balance sheet follows:

ASSETS		LIABILITIES AND SHAREHOLDERS' EQUITY	
Cash	**$ 3,150,000**	**Liabilities**	**$ 1,250,000**
Other current assets	**4,200,000**	**Common stock**	**8,000,000**
Noncurrent assets	**8,220,000**	**Retained earnings**	**6,320,000**
Total assets	**$15,570,000**	**Total liabilities and shareholders' equity**	**$15,570,000**

It has become known that Vadar, Inc. is planning to take over Edmonds by purchasing a controlling interest of the outstanding stock. Vadar hopes to gain enough control to elect a new board of directors and replace Edmonds's current management. The current board of directors, on which the five major shareholders serve, is considering how to block the apparent takeover attempt.

REQUIRED:

a. Describe how the company might be able to block the takeover attempt through a program of treasury stock purchases. How many shares would the company need to purchase to concentrate ownership enough to keep Vadar from acquiring a controlling interest? Assume that the other members of the board own no stock.

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b. The current market price of the outstanding stock is $45, but the board feels that any major buyback would have to be at a premium—approximately $50 per share. How much cash would Edmonds need to purchase enough shares to block the takeover attempt?
c. Assume that Edmonds was able to borrow $4 million and used the cash to buy back the necessary number of shares. Prepare the balance sheet of Edmonds after stock had been purchased.
d. Compute the debt/equity ratio for Edmonds both before and after the treasury stock purchase. Comment on the effect of the purchase on the company's financial position.

P12–14

Bankruptcy and protecting the interests of the creditors

The balance sheet of Natathon International is as follows:

ASSETS		LIABILITIES AND SHAREHOLDERS' EQUITY	
Current assets	**$200,000**	**Liabilities**	**$400,000**
Fixed assets	**500,000**	**Common stock**	**150,000**
		Additional paid-in capital	**50,000**
		Retained earnings	**100,000**
Total assets	**$700,000**	**Total liabilities and shareholders' equity**	**$700,000**

Although the balance sheet appears reasonably healthy, Natathon is on the verge of ceasing operations. Appraisers have estimated that, while current assets are worth $200,000, the fixed assets of the company can be sold for only $450,000. There are 1,000 outstanding shares of common stock owned by ten shareholders, each with a 10 percent interest (i.e., 100 shares). Before ceasing operations, the board of directors, which is composed primarily of the major shareholders, is considering several alternative courses of action.

1. Liquidate the assets, declare a $250-per-share dividend, and distribute the remaining assets to the creditors.
2. Liquidate the assets, declare a $400-per-share dividend, and distribute the remaining assets to the creditors.
3. Liquidate the assets, purchase the outstanding shares for $250 each, and distribute the remaining assets to the creditors.
4. Liquidate the assets, and purchase the outstanding shares for $650 each.

REQUIRED:

a. Prepare the journal entry to reflect the write-down of the fixed assets.
b. Prepare the journal entry to accompany each alternative course of action.
c. Comment on the legality of each of the board's proposals, and explain how the assets should be distributed after liquidation.

ISSUES FOR DISCUSSION

REAL DATA

ID12–1

Do stock dividends represent economic exchanges between a corporation and its shareholders?

When Hershey Foods declared a 100 percent stock dividend, 149.5 million of its shares were outstanding. Assume that the stock dividend was declared and paid on the same day.

REQUIRED:

a. How many shares of stock were outstanding after the dividend?
b. The market price of the stock was approximately $46 per share, and the par value was $1 per share on the day the dividend was declared and paid. Provide the journal entry to record the distribution.
c. Compute the value of Hershey if all outstanding shares, prior to the stock dividend, could have been sold for $46 each. Using this value, compute the per-share value of the company's outstanding shares after the stock dividend.

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d. Assume that Mr. Jones owned 1 million shares prior to the stock dividend. How many shares did Mr. Jones own after the stock dividend? What percentage of the company did Mr. Jones own before and after the stock dividend? What was the value of Mr. Jones's total shareholdings before and after the stock dividend based on the amounts from part (c)?
e. Does a stock dividend actually represent an economic exchange between a corporation and its shareholders? Why or why not?
f. Provide several reasons why a company would issue a stock dividend.

REAL DATA
ID12–2
Dividend strategy

When companies cut dividends, it is usually a bad sign for the stock. But apparently not at Monsanto. Several years ago, the company cut its dividend and the stock price went up.

REQUIRED:
Explain how a dividend cut could lead to increasing stock prices.

REAL DATA
ID12–3
Economic consequences of treasury stock purchases and cash dividends

The *Wall Street Journal* once reported, "Philip Morris Cos., in an aggressive move to boost its stock price, announced a $6 billion stock buyback plan and raised its quarterly dividend nearly 20%. . . . The announcement, which came after a regularly scheduled board meeting, raised the company's stock to a 52-week high. . . . Separately, rating agencies Standard & Poor's Rating Group and Moody's Investors Service Inc. confirmed their ratings on Philip Morris's debt. While both agencies said Philip Morris is continuing to generate strong cash flow, Moody's . . . placed Philip Morris at the low end of its current rating level."

REQUIRED:
Explain how this announcement can increase the stock price of Philip Morris (now known as Altria Group) while at the same time reduce its credit rating.

REAL DATA
ID12–4
Treasury stock purchases

In an article entitled "Buybacks or Giveaways," *CFO.com* reported that "large repurchase programs require a whole lot of capital. Critics of buybacks contend that companies can put their cash to better use. They also point out that investors are more likely to reward a company that attempts to grow its business—rather than artificially inflate its stock price." The article goes on to quote an investment banker as saying that "[stock repurchase programs] can be a sign that a company can't find anything better to do with its cash."

REQUIRED:
a. Describe some other uses for a company's cash. How could these uses benefit shareholders more than a stock repurchase?
b. Why might the stock market interpret a company's purchase of its own shares as a way to "artificially inflate" its stock price?
c. If the stock market is trading at very high levels, what risks do companies face with their stock repurchasing plans?

REAL DATA
ID12–5
Debt or equity?

Preferred stock is often seen as a hybrid security as it has characteristics of both debt and equity. The *Wall Street Journal* once reported two new securities used by companies going public: income deposit securities and enhanced income securities, both of which carry characteristics of both debt and equity. The securities are sold to investors, who will receive two payments from the company—one based on the company's equity shares and one based on the company's outstanding debt. The securities are being underwritten and marketed by such investment banking firms as Canadian Imperial Bank of Commerce, Goldman Sachs, and Lehman Brothers.

REQUIRED:
a. What is a hybrid security, and how should it be reflected on the balance sheet, income statement, statement of cash flows, and statement of shareholders' equity?
b. Describe some reasons why an investor might want to purchase a hybrid security and some reasons why a company might want to issue a hybrid security.

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c. What are some characteristics that would make these securities look more like debt? More like equity?

REAL DATA
ID12–6
Contracts based on net worth

For twenty years, Westinghouse Electric Corp. used PCBs in the manufacture of electrical capacitors at its plant in Bloomington, Indiana. A federal consent decree has ordered the company to be prepared to build an incinerator in the future to destroy the PCB-contaminated materials. The decree, with which Westinghouse agrees, contains a clause stating that if Westinghouse's net worth (balance sheet assets less balance sheet liabilities) drops to $1.9 billion, the company is required to place in escrow (set aside) $325 million to ensure that funds will be available if and when the incinerator is built.

A pronouncement from the FASB required that Westinghouse, as well as other companies, change the way in which they account for certain employee retirement costs. After adopting this mandated change, Westinghouse's net worth plunged to $1.85 billion, which is below the dollar amount indicated in the consent decree. According to the agreement, therefore, Westinghouse should transfer $325 million to an escrow account. Westinghouse has refused to make the payment, however, claiming that the reduction in net worth was due to a new accounting standard not in effect at the time the agreement was signed.

REQUIRED:

Discuss this issue from the perspective of the following:

a. An executive of Westinghouse
b. A representative of the federal government
c. A resident of Bloomington, Indiana

REAL DATA
ID12–7
Shareholder returns, dividends, and buy-backs

The *Wall Street Journal* reported (April 13, 2007) that shareholders of Kraft Foods "can afford to give management more time to improve its brands, sales margins, and earnings" because of the dividends paid by the company and the share buy-back program. Kraft Foods has been losing market share in its cheese and processed-meat product categories and has not been keeping up with private-label competition, as well as new food offerings in healthy snacks and foods. However, due to the dividends and buy-backs, share price appreciation is not the only form of return to the investors.

REQUIRED:

a. How does a shareholder receive a return on his or her investment in a company?
b. Do companies that pay dividends have creation advantage over companies that do not pay dividends and choose to retain all earnings?
c. What signs will investors look for to see if Kraft's management is successful in its strategy? Where in the financial statements will this evidence be presented?

REAL DATA
ID12–8
Market value vs. book value

The stock in Dow Jones & Co., Inc. (the publisher of the *Wall Street Journal*) has a book value (shareholders' equity per share) of approximately $6. Prior to a buyout offer, the stock had been trading (market value) for $36 per share. Rupert Murdoch and his News Corporation made an unsolicited offer of $60 per share during the summer of 2007. As of August 14, 2007, the market value was $58.60 per share.

REQUIRED:

a. What are the differences between book value and market value? How are these values determined?
b. Calculate the price-to-book ratio for Dow Jones.
c. Why would News Corporation offer to pay $60 per share (for a total of $5 billion) to buy a stock trading for $36 per share?
d. The *Wall Street Journal,* similar to other newspapers, has struggled against competition posed by the Internet and other electronic outlets. Discuss the effect that macroeconomic factors can have on the value of a stock.

REAL DATA
ID12–9
Common stock issuances

The following information was taken from Google, Inc.'s statement of cash flow in the company's 2006 annual report (amounts in millions):

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	2004	2005	2006
Net proceeds from public offerings	**$1,161**	**$4,287**	**$2,064**

The following information was taken from Google's statement of shareholders' equity (amounts in millions):

	Class A and B Common Stock Number of Shares
2004	
Issuance of common stock in connection with IPO	**17.0**
2005	
Issuance of common stock	**14.9**
2006	
Issuance of common stock	**7.7**

REQUIRED:

a. What is meant by "net proceeds" on the statement of cash flow? What is the difference between "net" and "gross"?
b. What happened with the share price of Google from 2004 to 2006? Discuss your calculations.
c. List some reasons for the trend in share price.

REAL DATA
ID12–10
Equity issuances

Bloomberg News Service reported that Rhodia, SA, France's largest specialty chemicals company, announced plans to sell 450 million euros in shares, in addition to a 600 million euro bond issue, to raise cash to prevent a liquidity crisis. Rhodia had posted losses for the three previous years and projected losses for the next two. Rhodia's largest shareholder, the French drug firm Aventis, will subscribe to the new offering to maintain its ownership stake at 15.3 percent.

Segway, LLC, the much-publicized manufacturer of the Segway scooter, raised $31 million in new equity to augment $100 million previously raised. The *Wall Street Journal* reported that the original funds have been depleted because "operating expenses were exceeding revenue."

REQUIRED:

a. Both companies had similar reasons for the equity issuance. On which financial statement would the reasons be evident? How would the influx of funds after the issuances be reflected on the financial statements?
b. Why would Aventis want to purchase additional shares in a company in which it already has a significant investment? Would the holders of the $100 million in equity in Segway have similar issues?
c. Imagine you are an investor interested in these two offerings. What evidence would you have to observe before making this investment?

REAL DATA
ID12–11
Stock split and stock prices

When Walt Disney Co. declared a 4:1 split of its common stock, the announcement boosted the entertainment company's shares up by $3.50 per share.

REQUIRED:

a. What is a 4:1 stock split, and how did it affect the financial statements of Walt Disney Co.?
b. Why should the market value of Disney's stock rise?
c. The *Wall Street Journal* once reported that the stock split was "a psychological boost and an indication that management has confidence in their performance and that the stock price can be sustained." Explain how this explanation could account for the stock price increase.

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REAL DATA
ID12–12
Share repurchases during volatile economic periods

During the 2008–2009 financial crisis, stock prices fluctuated wildly. The S&P 500 Index was 1,549.38 in October 2007, then dropped all the way to 735.09 in February 2009, and then rebounded to 1,104.49 by February 2010. Companies that actively repurchased their own stock shares were buyers in this volatile market. Movie rental company Netflix, for example, repurchased $130 million of its own stock in the third quarter of 2009 and publicly stated that it would borrow additional money to continue the buy-backs. Amazon.com's board of directors authorized a $2 billion stock buy-back, despite the fact that its shares were trading at 45 times the company's projected 2010 earnings. Sears spent $134 million by August 1, 2009, to repurchase 2.7 million shares. Apple, Inc., on the other hand, did not repurchase any of its shares during this time period.

REQUIRED:

a. What is meant by a stock price selling for "45 times" its earnings?
b. What does a volatile stock market do to a company with an announced plan to repurchase its own shares?
c. Explain how repurchases followed by stock issuances affect the financial statements.
d. Netflix borrowed to finance share repurchases. How would this sequence of events affect its leverage position?
e. If companies reissue previously purchased treasury stock at prices that differ from the costs of the repurchases, are gains and losses recognized on the income statement? Why or why not?

REAL DATA
ID12–13
Stock option expense

In July 2005 Microsoft adopted SFAS 123 (R), *Share-based Payment,* which required companies to recognize expenses related to stock options. In the company's 2009 annual report, Microsoft reported net income of $14.6 billion, 17.7 billion, and $14.1 billion in 2009, 2008, and 2007, respectively. It also reported "stock-based compensation expense" on the statement of shareholders' equity of $1.7 billion, $1.5 billion, and $1.6 billion for 2009, 2008, and 2007, respectively.

REQUIRED:

a. Explain the nature of stock-based compensation expense.
b. Why would it appear on the statement of shareholders' equity, and on what other financial statement would it also appear?
c. Would you consider stock option expense to be material for Microsoft, and why?
d. Explain why many companies resisted SFAS 123 (R).

REAL DATA
ID12–14
Statement of shareholders' equity

Refer to the statement of shareholders' equity reported by Emerson Electronics located at the end of the chapter.

REQUIRED:

Describe Emerson's dividend and treasury stock transactions and policies over the three-year period 2007–2009.

REAL DATA
ID12–15
Different treasury stock strategies

Hewlett-Packard and Apple, Inc., two very successful technology firms, show no investment in their own shares (treasury stock) on their 2008 balance sheets. Bear Stearns, on the other hand, was reported in a 2004 edition of the *Wall Street Journal* to have launched a $1 billion stock repurchase plan. By 2008 the share price of Bear Stearns had dropped from $133 to $10, the price at which the company was acquired by JPMorgan Chase. From 2006 to early 2010 Apple shares increased from $75 to over $200 per share, while HP increased from $30 to $50 per share.

REQUIRED:

a. Discuss the implications of the corporate strategy of repurchasing outstanding shares of stock.
b. Compare and contrast the outcomes of this financial strategy among the three companies above.
c. Discuss the various methods companies can employ to create wealth for their shareholders.

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REAL DATA
ID12–16
Comprehensive income—U.S. GAAP vs. IFRS

Unilever Group, a Dutch-based consumer-goods company that publishes IFRS-based financial statements, reported a net profit on its 2008 income statement of 5.3 billion euros. That same year the company reported "total recognized income and expense" of only 1.1 billion euros, and on its 2008 balance sheet it reported accumulated recognized income and expense of 1.8 billion euros.

Johnson & Johnson, a U.S. consumer-goods company that publishes U.S. GAAP-based financial statements, reported net profit on its 2008 income statement of $12.2 billion. It reported 2008 comprehensive income of $14.1 billion, and accumulated comprehensive income in the shareholders' equity section of the 2008 balance sheet of $70.3 billion.

REQUIRED:

a. Explain the difference between net profit and comprehensive income, which is referred to as total recognized income and expense under IFRS.
b. Explain the difference between comprehensive income for a given year and accumulated comprehensive income, which appears on the balance sheet as of the end of that year.
c. On which financial statement could you find a reconciliation of the beginning and ending balances of comprehensive income (or total recognized income and expense) for a given period of time?

REAL DATA
ID12–17
The SEC Form 10K of NIKE

The SEC Form 10K of NIKE is reproduced in Appendix C.

REQUIRED:

Review the NIKE 10K, and answer the following questions.

a. What percentage of NIKE's total assets were provided by liabilities, contributed capital, and retained earnings?
b. How many shares of common stock had been authorized, issued, and outstanding as of May 31, 2009?
c. How much cash did the company use to purchase its outstanding common stock and pay dividends over the past three years? Are those amounts growing or decreasing? Discuss.
d. Why does NIKE list redeemable preferred stock as a liability?
e. Explain why stock-based compensation appears on the statement of cash flows.
f. Within what ranges did NIKE's market price fall over the last two years, and what amount of dividends per share were paid during that period?
g. At what average prices did the company issue stock in support of exercised stock options over the past three years?
h. What is NIKE's accumulated balance of comprehensive income as of May 31, 2009? What does the balance primarily consist of, and what was the comprehensive income amount for the year? Was it greater than or less than net income?