14. Treasury Stock

Treasury stock is the term that is used to describe shares of a company's own stock that it has reacquired. A company may buy back its own stock for any number of reasons. The most frequently cited reason is a belief by the officers and directors that the market value of the stock is unrealistically low. As such, the decision to buy back stock is seen as a way to support the stock price and utilize corporate funds to maximize the value for shareholders who choose not to sell back stock to the company. Other times, a company may buy back public shares as part of a reorganization that contemplates the company "going private" or delisting from some particular stock exchange market. Further, a company might buy back shares, and in turn issue them to employees pursuant to some employee stock award plan. And, a company might buy back stock from a dissident shareholder who is making overtures to overthrow the current board (sometimes called "greenmail" since cash is extracted from the company in exchange for shares and a "standstill" agreement with the dissident).

Whatever the reason for a treasury stock transaction, the company is to account for the shares as a purely equity transaction, and no gains and losses are reported in income (except in the case of "greenmail" where some expense may be recorded for any premiums paid to "quiet" the dissident). Procedurally, there are several ways the record the "debits" and "credits" associated with treasury stock.

I will focus on the "cost method" as it is very direct and perfectly acceptable in each case. Under this approach, acquisitions of treasury stock are accounted for by debiting Treasury Stock and crediting Cash for the cost of the shares reacquired:

4-1-X1	Treasury Stock		1,000,000	
	Cash			1,000,000
	To record acquisition of 40,000 treasury shares at $25 per share			

Treasury Stock is a contra equity item. It is not reported as an asset; rather, it is subtracted from stockholders' equity. The presence of treasury shares will cause a difference between the number of shares issued and the number of shares outstanding. On the following page is Embassy Corporation's equity section, modified (see highlights) to reflect the treasury stock transaction portrayed by the entry.

The effect of treasury stock is very simple -- cash goes down and so does total equity by the same amount. This result occurs no matter what the original issue price was for the stock. Accounting rules do not recognize gains or losses when a company issues its own stock, nor do they recognize gains and losses when a company reacquires its own stock. This may seem odd, because it is certainly different than the way you or I think about stock investments. But remember, this is not a stock investment from the company's perspective -- it is instead an expansion or contraction of its own equity.

Stockholders' Equity			
Capital stock:			
Preferred stock, $100 par value, 8% cumulative, 500,000 shares authorized, 200,000 shares issued and outstanding	$20,000,000		
Common stock, $1 par value, 2,000,000 shares authorized, 400,000 shares issued, and 360,000 shares outstanding	400,000	$20,400,000	
Additional paid-in capital			
Paid-in capital in excess of par -- preferred stock	$ 1,000,000		
Paid-in capital in excess of par -- common stock	35,000,000	36,000,000	
Total paid-in capital			$56,400,000
Retained earnings			6,600,000
			$63,000,000
Less: Treasury stock, 40,000 shares at cost			(1,000,000)
Total stockholders' equity			$62,000,000

Corporations in the United States are taxable entities, and their income is subject to taxation. This "income tax" is problematic as it oftentimes produces double taxation. This effect occurs, because when shareholders receive cash dividends on their corporate investments, they must include the dividends in their own calculation of taxable income. Thus, a dollar earned at the corporate level is reduced by corporate income taxes (at a rate that is likely about 35%); to the extent the remaining after-tax profit is distributed to shareholders as dividends, it is again subject to taxes at the shareholder level (at a rate that will vary in the 15% to 35% range). So, as much as half or more of the profits of a dividend-paying corporation are apt to be shared with governmental entities because of this double taxation effect. Governments are aware that this double-taxation outcome can limit corporate investment and be potentially damaging to the economic wealth of their nation. Within the United States, various measures of relief are sometimes available, depending on the prevailing political climate (including "dividends received deductions" for dividends paid between affiliated companies, lower shareholder tax rates on dividends, and S-Corporation provisions that permit closely held corporations to attribute their income to the shareholders thereby avoiding one level of tax). Outside of the United States, some countries adopt "tax holidays" that permit newer companies to be exempt from income taxes, or utilize different approaches to taxing the value additive components of production by an entity.

7-1-X2	Cash		400,000	
	Treasury Stock			250,000
	Paid in Capital in Excess of Par			150,000
	To record reissue of 10,000 treasury shares at $40 per share			