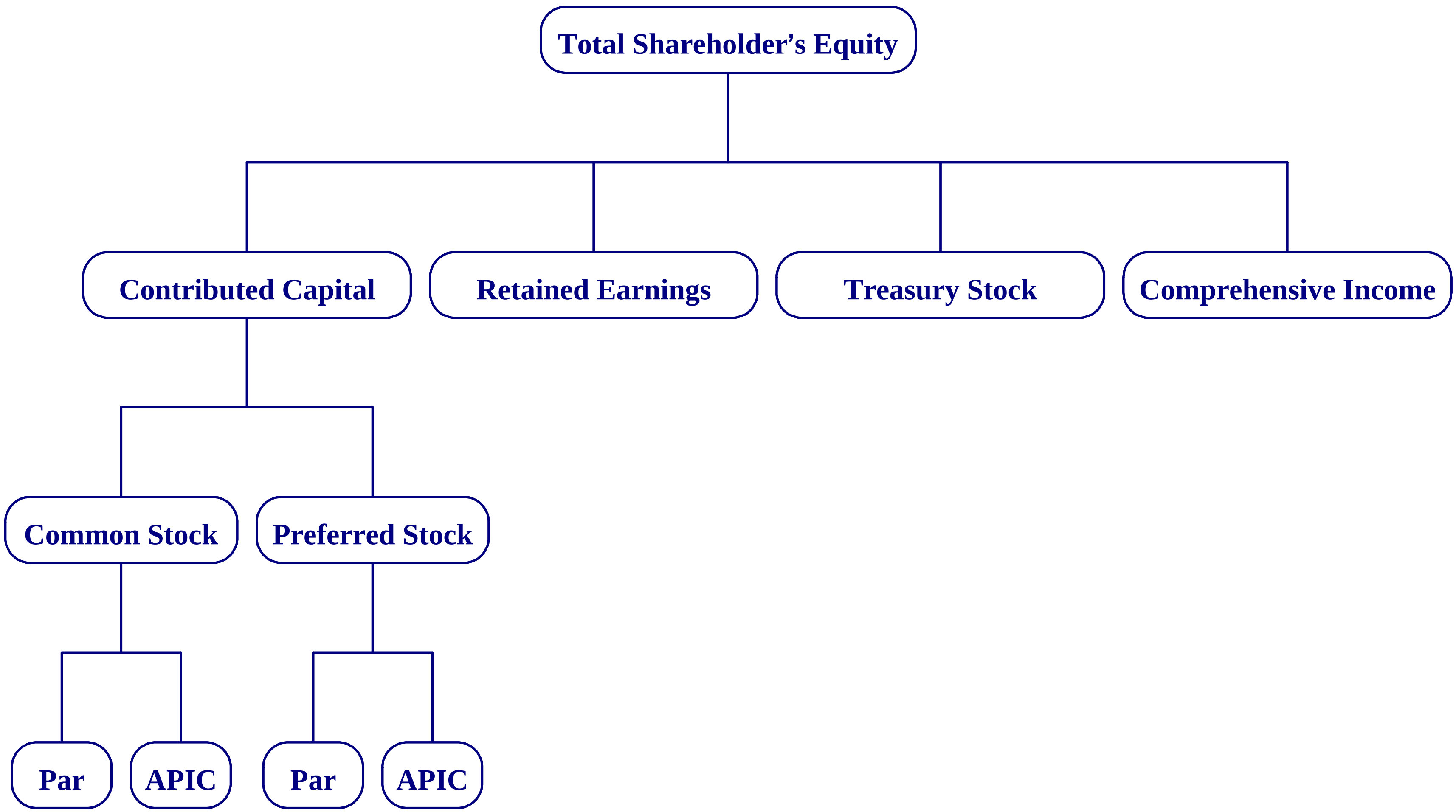
Shareholder's Equity

Objectives

- Gain a better understanding of components of SE
  - Contributed Capital (stock issuance, common and preferred stock)
  - Treasury Stock (stock repurchases)
  - Comprehensive Income

- Provide an overview of other events that affect SE
  - Stock Options
  - Stock Splits
  - Dividends

Flowchart of Owners' Equity



Contributed Capital: Share Types

- *Common Stock* - Basic residual ownership share in the corporation. Holders have the right to any residual value in the firm after the stated obligations are met and can vote on certain corporate issues.

- *Preferred Stock* - General term for a class of (usually nonvoting) stock. These stocks have different rights and/or preferences than Common Stock. These preferences *may* include:
  - Dividends – a pre-specified dividend stated when shares are issued
  - Cumulative – unpaid dividends accumulate and must be paid before common shareholders can receive dividends
  - Participating – receive a portion of income in addition to stated dividend
  - Convertible – can be converted in common shares at a pre-specified rate
  - Callable – can be retired by management at pre-specified price
  - Redeemable - can be retired by holder at pre-specified price

Other Terminology Related to Stock

- Authorized – Amount that can be issued as stated in the corporation's Articles of Incorporation. Authorization comes from the Securities Exchange Commission
- Issued - number of shares sold to shareholders
- Outstanding – Number of shares actually owned by shareholders
  [Issued ≥ Outstanding because of share repurchases]
- Par Value – Legal term (largely ceremonial) - no economic importance
- Additional Paid In Capital – Amount of value received in excess of par value at issuance

Stock Issuance - Some Examples

1. Assume 235 shares having par value of $1.00 were issued for total cash received of $3,720.

Cash = Liab. + Common Stock at Par + APIC

2. Same facts but non-par stock

Stock Splits

Companies will occasionally "split" their shares. For example, in a 2 for 1 split, shareholders receive 2 shares for each share they own.

This will generally have no economic effect. The number of shares, the par value and the price per share will change.

Example: SloanCo has 1,000 shares outstanding with $1 par value and a price of $120. What happens when the company executes a 2 for 1 Stock Split?

Accounting for Dividends

Example: Suppose a firm has 1,000 shares outstanding and declares a $2 dividend.

Cash	=	Dividends Payable	+	APIC	+	RE

Dividend payments in common stock instead of cash, i.e. stock dividends, are economically similar to stock splits. However, the accounting treatments differ. See any advanced accounting textbook for details.

Treasury Stock

- Treasury Stock (Share Repurchases): stock which has been repurchased by the company.

- Companies will repurchase their own shares for a variety of reasons:
  - to meet option requirements
  - to increase EPS
  - because managers believe the stock is "undervalued"
  - as an alternative to dividends (for tax reasons)

- The accounting treatment of a stock repurchase is to reduce cash and to reduce Shareholders Equity. Thus treasury stock is *not* an asset.

Treasury Stock: An Example

Suppose SloanCo purchases 100 shares at $5 per share.

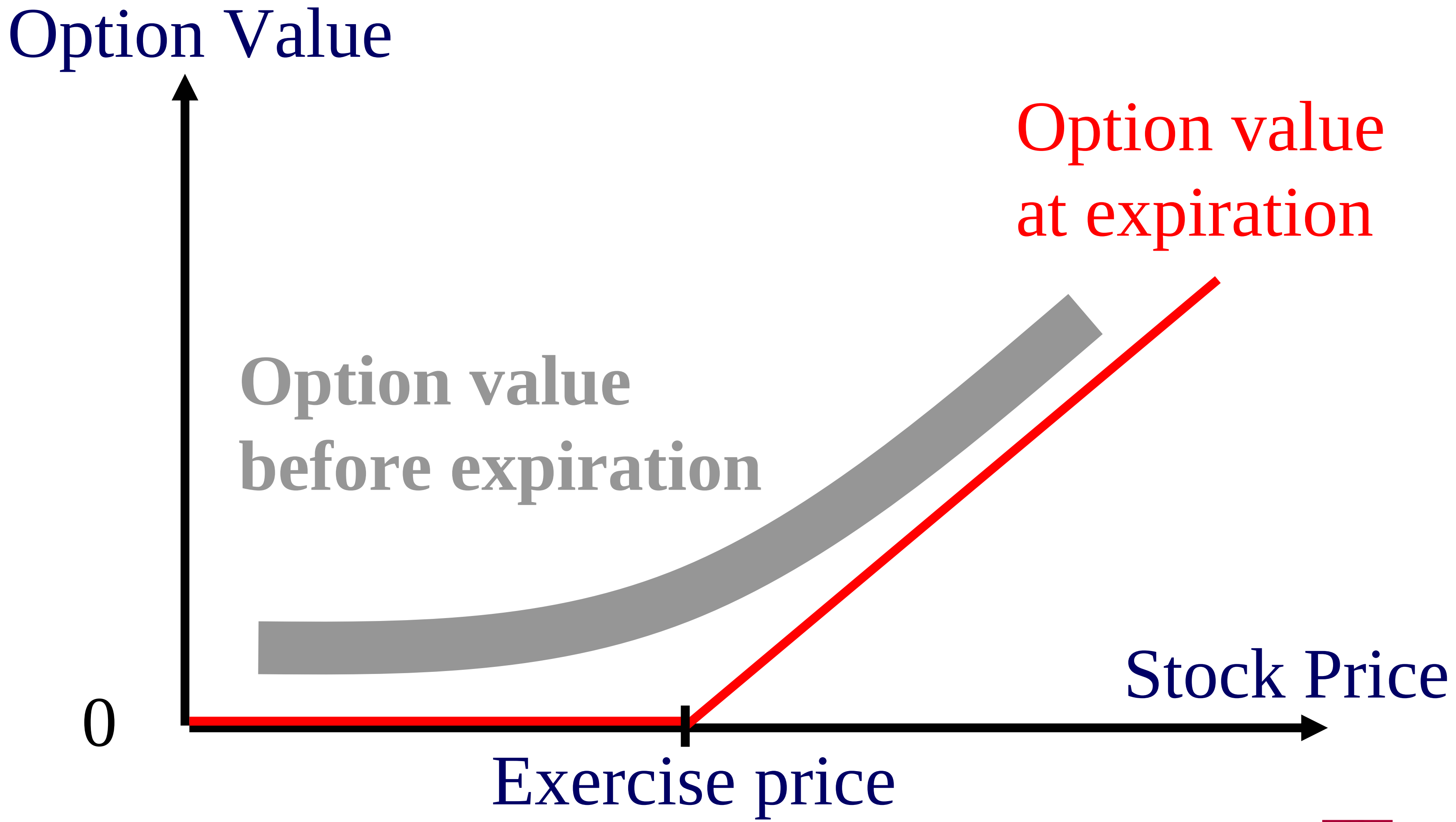
Cash	=	PIC	+	RE	-	Treasury Stock

Treasury stock may also be retired. Asssume $1 par, and APIC=$2.

Stock Options

- Stock options are often granted to employees as part of their compensation package.
- Options give the holder the right to purchase the underlying stock at a specified price (exercise price) for a specified period of time.
- Accounting when granted: Currently two alternatives 1) recognize expense for the value of the options or 2)
  - If the exercise price = fair market value of underlying stock at grant date, no expense is recorded.
  - If the exercise price < fair market value at grant date, some compensation expense may be recorded.
  - Disclose amount of grant in footnote

Key Accounting Question: What is the Value of Options Granted?



Current Accounting Rules for Options: FAS 123

The FASB tried to require companies to record compensation expense when stock options were granted with an exercise price greater than or equal to the current stock price, under the idea that modern option pricing theory (Black-Scholes) would suggest that these options have value. Companies revolted and a compromise was reached under FAS 123 allowing companies to continue to account for options as before (no expense) but disclose in a footnote what this expense would be.

Future Accounting Rules for Options

Companies will be forced to treat stock options as an expense for fiscal years beginning after December 15, 2003.

101 of the 500 largest companies currently (voluntarily) treat options as an expense.

Examples of effects of expensing:
Dell says its profits would be cut by about 33% if options are expensed. MSFT says its profits would be about 30% lower.

Comprehensive Income

Some revenues/gains/expenses/losses are given accounting treatment that excludes them from the measurement of firm performance (net income) for that period. They are included as a separate component of equity. Because of the increasing number of these items that "bypass" the income statement, the FASB came out with SFAS 130 – "Reporting Comprehensive Income". This requires firms to report "Comprehensive" Income i.e., income including all of these items.