

Stockholder's Equity

Pratt, Financial Accounting 7e, Chapter 12

Debt vs. Equity

Debt	Equity
Formal Legal Contract	No Legal Contract
Fixed Maturity Date	No Fixed Maturity Date
Fixed Periodic Interest Payments	Discretionary Dividend Payments
Security in Case of Default	Residual Asset Interest
No Direct Voice in Management, Limited Influence via Debt Covenants	Vote for Board of Directors and Other Significant Decisions
Interest is an Expense	Dividends are NOT an Expense, But are a Distribution of Retained Earnings

Hybrid Debt/Equity Securities:

- Convertible Bonds
- Mandatorily Redeemable Preferred Stock

Components of Stockholders' Equity:

- Contributed Capital
 - Preferred Stock
 - Common Stock
 - Additional Paid-in Capital
- Earned Capital
 - Retained Earnings
 - Accumulated Other Comprehensive Income
- Treasury Stock (Contra Equity)

Common Stock

- Basic rights:
 - Right to receive dividends when declared
 - Right to receive assets in liquidation
 - Right to vote on composition of the Board of Directors and other matters
- Common Stock Values
 - Par or Stated Value
 - Market Value
 - Book Value

$$\text{Book Value} = \frac{\text{Stockholders' Equity} - \text{Preferred Capital}}{\text{Number of Common Shares Outstanding}}$$

Transactions to record issuance of common stock:

1. Issuance of 1,000 shares of \$1 par common stock for \$15 per share in cash.
2. Issuance of 1,000 shares of \$1 stated value common stock for \$15 per share in cash.
3. Issuance of 1,000 shares of no par, no stated value common stock for \$15 per share in cash.

Accounts	Debit	Credit
Cash	15,000	
Common Stock		1,000
Additional Paid-in Capital – C/S		14,000
Cash	15,000	
Common Stock		1,000
Additional Paid-in Capital – C/S		14,000
Cash	15,000	
Common Stock		15,000

Preferred Stock

- Typically carry no voting rights, but include various preferences
- Common preferences
 - Dividend preferences
 - Fixed rates - \$ or % of par
 - Cumulative
 - Participating
 - Liquidation preferences
 - Convertible
 - Callable

Treasury Stock

- Shares of stock that have been originally issued and bought back by the company
- In recent years cash paid out in share repurchase programs have equaled or exceed dividend payments
- Motives
 - Provide “cheap” shares for stock incentive plans
 - Increase earnings per share
 - Signal financial strength to the market
 - Provide a tax efficient distribution of cash to shareholders

Treasury Stock Transactions

1. A company repurchases 100 shares of its \$1 par value common stock for \$20 per share.
2. 50 shares previous repurchased are reissued for \$25 per share.

Accounts	Debit	Credit
Treasury Stock	2,000	
Cash		2,000
Cash	1,250	
Treasury Stock		1,000
Additional Paid-in Capital – T/S		250

Dividends

- Can be cash, property, or stock
- Dates:
 - Date of declaration
 - Date of record
 - Date of distribution
- Number of shares:
 - Authorized
 - Issued
 - Outstanding

Transactions:

The Board of Directors of Medina Corporation declared on December 1, 2008 a \$1 per share cash dividend to be paid to shareholders of record on December 15 and to be distributed on December 31. At that time Medina had the following:

1. Common stock authorized: 1,000,000 shares
2. Common stock issued: 400,000 shares
3. Common stock in treasury: 100,000 shares

Date	Accounts	Debit	Credit
12/1	Cash Dividend	300,000	
	Dividends Payable		300,000
12/31	Dividends Payable	300,000	
	Cash		300,000

Stock Dividends and Stock Splits

- Stock Dividends
 - Issuing additional shares of stock to existing shareholders
 - In general has no economic substance
 - If dividend rates are maintained can have substance
 - Can be used to accomplish a stock split
 - Size
 - Small < 25%
 - Large > 25%
- Stock Splits
 - Used to adjust the number of shares outstanding
 - Often used to manage price per share in order to appeal to certain clientele
 - Can be accomplished with large stock dividends – a 2 for 1 split can be accomplished with a 100% stock dividend
 - Require no entry, but will change the par value, if any, and the number of shares issued and outstanding

Transactions:

The Board of Directors of Vargas Corporation declared on December 1, 2008 a 10% stock dividend to be paid to shareholders of record on December 15 and to be distributed on December 31. The common stock had a par value of \$2 per share and the market price of Vargas stock on December 1 was \$50 per share. At that time Vargas had the following:

1. Common stock authorized: 100,000 shares
2. Common stock issued: 50,000 shares
3. Common stock in treasury: 5,000 shares

Date	Accounts	Debit	Credit
12/1	Stock Dividend	225,000	
	Stock Dividend Distributable		9,000
	Additional Paid-in Capital, S/D		216,000
12/31	Stock Dividend Distributable	9,000	
	Common Stock		9,000

Stock Options

- A common incentive to executives and others
- Accounting controversy
- Now required to be recorded as an expense when issued
- Valued using option pricing models

On January 31, 2008 the Board of Directors of Salazar Inc. established a stock option plan for all senior executives of the company. The plan granted a total of 100,000 stock options. The options gave the holder the right to purchase the shares of Salazar \$2 par value common stock for \$28 per share (which was the market price of Salazar stock on that day). The option could be exercised any time in the next 5 years. On the date of the grant the options were valued at \$7 each.

On December 1, 2008 50,000 of the options were exercised. The company issued treasury shares that had cost \$25 when repurchased.

On January 31, 2009, the remaining options were exercised and new shares were issued.

Date	Accounts	Debit	Credit
1/31/08	Stock Option Compensation Expense	700,000	
	Additional Paid-in Capital, S/O		700,000
12/1/08	Cash 50,000 X \$28	1,400,000	
	Additional Paid-in Capital, S/O	350,000	
	Treasury Stock 50,000 x \$25		1,250,000
	Additional Paid-in Capital, T/S		500,000
1/31/09	Cash	1,400,000	
	Additional Paid-in Capital, S/O	350,000	
	Common Stock		100,000
	Additional Paid-in Capital, C/S		1,650,000