Chapter 11

Stockholders' Equity

Key Concepts

- What is included in stockholders' equity?
- What is the result of a sale of stock?
- What are the differences between the classes of capital stock?
- How does treasury stock affect stockholders' equity?
- How is a cash dividend different from a stock dividend?
- What is the difference between a stock dividend and a stock split?
- How do stockholders' equity transactions affect cash?

An Overview of Stockholders Equity

Financing is available in two forms:

- **Debt** is borrowed capital from banks or other creditors
- **Equity** is capital invested by the company's owners through issuing stock

Advantages of issuing stock (Exhibit 11-1):

- Flexibility
- Stock is easily traded on open markets
- Stock usually provides a higher return to investors than debt

Disadvantages of issuing stock (Exhibit 11-1):

- Control of the company is more widely distributed
- Dividends are not tax deductible, whereas interest on debt can be deducted
- Additional capital stock decreases certain key ratios, such as Earnings Per Share

How Income and Dividends Affect Retained Earnings

LO 1

Components of the Stockholders' Equity Section of the Balance Sheet

For a corporation: Assets = Liabilities + *Stockholders' Equity*

- *Stockholders' Equity* = Contributed Capital + Retained Earnings
    - or, stock sold to stockholders + income earned and not paid as dividends

Two general categories of **contributed capital (stock):**

- *Common* stock
    - votes to elect officers, establish governing rules
    - often more than one class
- *Preferred* stock

Number of shares of stock:

- *Authorized*: maximum shares corporation will be allowed to issue
- *Issued*: shares which have been sold or transferred to stockholders, however this does not necessarily mean the number of shares currently outstanding
- *Outstanding*: shares actually in the hands of stockholders
    - sometimes a company repurchases shares and holds them as *treasury stock*
        - not counted as outstanding shares
- *Treasury:* shares which have been repurchased by the corporation, it is not part of the number of shares outstanding

Par value is an arbitrary amount stated on the face of the stock certificate and represents the legal capital of the corporation.

- Generally very low, fulfills legal requirements.
- Not the value of the stock, or the issue price
- Legal requirements depend on state of incorporation
- Some states do not require corporations to indicate a par value
- Some states require *stated value* instead of par value

  - accounted for and disclosed similarly to par value
- Recorded in Capital Stock account as the number of shares issued multiplied by par value per share

Additional paid-in capital is the amount received for stock in addition to par value; may also be called:

- Paid-in capital in excess of par
- Premium on stock
- Often recorded on the balance sheet on a single line, for all classes of stock

Retained earnings is the amount of net income over the life of the company not paid out as dividends.

- Not the amount available to the stockholders
- Does not represent a pool of liquid assets

Characteristics of Common and Preferred Stock

LO 2

Preferred stock is flexible, with provisions tailored to company's needs.

- Dividends distributed to preferred stockholders *before common stockholders*
- Dividend rate can be stated in two ways
  - percent of stock's par value
  - per share amount
- The greater the obligation to preferred stock, the less attractive the common stock
- *Cumulative* feature: if no dividend is declared in one year, dividend on preferred stock is considered to be in arrears
  - before any subsequent common dividends can be paid, dividends in arrears on preferred stock must be paid
  - does NOT guarantee a preferred dividend, only says that IF ANY dividend *is paid*, preferred dividend must be satisfied first, including amounts in arrears if any
- *Participating* feature: in a year of an unusually large dividend
  - preferred stock gets its usual dividend
  - common stock receives dividend proportionate to preferred
  - excess above these amounts is shared by common and preferred in proportion to total par values
- *Convertible* feature: allows preferred shareholders to convert their shares to common stock
  - Offers stockholder advantage of low risk with preferred stock and possibility of higher return with common stock
- *Callable* feature: issuing firm can retire stock at a specified price (call premium)
- Preferred stock may have features that cause it to resemble debt, and management must decide whether to classify the item as debt or equity

Issuance of Stock

LO 3

Stock may be **issued** for *cash*, for *noncash assets*, or on *subscription* basis.

- **Stock issued for cash:**
  - When stock is issued for cash, the amount of its par value should be reported in the stock account and the amount in excess of par should be reported in the paid-in capital account**.**

Cash (asset) increases and Common Stock and Additional-Paid-in-Capital (both shareholders' equity accounts) increase.

- for no-par stock there is no additional paid-in capital account

- **Stock exchanged for noncash items** must be recorded at the fair market value of the stock or the property, whichever is most readily determined

LO 4

Treasury Stock

Treasury stock is created when a company buys back (repurchases) its own stock sometime after issuing it.

- Corporation's own stock, previously issued to shareholders
- Must be repurchased from stockholders
- Stock is not retired, but held for some purpose
  - bonuses or benefits
  - maintain favorable market price
  - improve ratios
  - maintain control and ownership, ward off hostile takeover

Treasury stock is *not outstanding*, and has *no voting* rights.

Purchase of treasury stock:

- No direct effect on common stock account
- Increase **Treasury Stock**, a *contra account* in equity (<u>not</u> an asset)
- Treasury stock is subtracted from subtotal of contributed capital and retained earnings accounts

Resale of treasury stock:

- At greater than cost
  - create Additional Paid-In Capital (APIC)—Treasury Stock account
- At less than cost
  - deduct from APIC—Treasury Stock
  - if account does not exist, deduct from retained earnings
  - APIC can never have a negative balance
- No income statement accounts affected in treasury stock transactions, only stockholders' equity accounts

Retirement of stock: bought back with no intention of reissuing

- Company may wish to eliminate a particular class of stock or group of stockholders
- Remove from capital stock account at original issue price
- Remove any paid-in capital that resulted from the original issue
- If retired at less than its issue price, reflect the difference in Paid-In Capital from Stock Retirement account
- If retired at more than its issue price, the difference reduces retained earnings

Cash dividends reduce retained earnings when declared.

- Create a liability, Dividend Payable, on the date they are declared
- Payment reduces liability, does not affect retained earnings

- Requires sufficient cash, and adequate balance of retained earnings
- A dividend is not an expense on the income statement

Cash Dividends for Preferred and Common Stock

LO 5

When more than one class of stock is outstanding, cash dividends must be *allocated* between them.

- Calculate amount due **preferred** shareholders first, per the terms of the stock
  - *noncumulative preferred* stock receives only this year's dividend
  - *cumulative* preferred shareholders must also receive all dividends in *arrears*, that is, dividends from any previous year in which the company did not pay or distribute dividends
    - calculate dividends in arrears on preferred stock
    - add the current year's preferred dividend
    - subtract this subtotal from the total dividend to be paid to find the amount available for distribution to common stockholders
  - for *cumulative and participating* preferred stock
    - calculate dividends in arrears and current preferred dividend as above
    - distribute an equal percentage to common at agreed-on rate
    - divide remainder of dividend monies between preferred and common stockholders, based on agreed algorithm, for example, the proportion of each type of stock to total par value
- Subtract preferred stockholders' share from total dividends available to find total amount due common shareholders
- Calculate per share amount for common and preferred shares
- Cumulative and participating features make preferred stock more attractive to investors, but company must avoid diminishing the attractiveness of their common stock when investors see less dividend money available to common shareholders after preferred stockholders receive their allocation

Stock Dividends

LO 6

Company may issue **shares of its own stock** in lieu of paying cash dividends to stockholders.

- Not enough cash for a cash dividend
- Does not require the use of corporate resources and allows cash to be retained for other purposes
- Increase the number of shares of stock outstanding and decreases market price of the stock if the dividend is large
  - lower stock price is more attractive to investors
- Not taxable for recipient, so wealthier investor may find it attractive
- Declared and paid in manner similar to cash dividend
- **Small stock dividend** (less than 20–25%) is usually recorded at market value of stock on date of declaration, since it is considered unlikely to have a material effect on stock price
  - *common stock dividend distributable* is not a liability (no assets will be required to satisfy it), but is merely part of equity on company's balance sheet
  - reclassifies dollars from retained earnings to paid-in capital, with no effect on total stockholders' equity
  - **large stock dividend** (greater than 20–25%) considered likely to affect stock price, but exact amount is not known

- recorded at par value rather than market price
- still no effect on total equity, only on components

LO 7

Stock Splits

Similar to a stock dividend, a **stock split** increases the number of shares outstanding.

- May be used for same reasons
  - increase the number of shares
  - reduce market price per share
  - make stock accessible to more investors

Differences:

- *Legal* difference: a stock split affects par value per share of stock, stock dividend does not
- A*ccounting* difference: stock dividend requires a journal entry, a stock split requires no entry, no equity accounts are affected
  - footnote required to disclose additional shares and new par value
- Does not affect total par value of the stock

LO 8

Statement of Stockholder's Equity and Comprehensive Income

- The purpose of this statement is to explain all the reasons for the difference between the beginning and the ending balances of each of the accounts in the stockholders' equity category of the balance sheet.
- *Comprehensive income* is the term to describe all "income-type" items that affect the shareholders' equity but may not be included on the income statement. See Exhibit 11-7.

LO 9

What Analyzing Owners' Equity Reveals About a Firm's Value

Book value per share: rights of each share of stock to net assets (assets - liabilities).

- *If only common stock is present,*

$$\textbf{book value per share} = \frac{\textbf{total stockholders' equity}}{\textbf{number of shares of stock outstanding}}$$

- Book value per share indicates the recorded value per share, not the market value of common stock
- Considered to be the minimum value of the stock
  - assets recorded at historical, not current, value
- *If preferred stock is present*
  - deduct liquidation value of preferred stock from total stockholders' equity
  - deduct any preferred dividends in arrears
  - remainder belongs to common stockholders, and denominator is common shares only, no preferred included

Market value per share is the price at which stock is currently selling.

How Changes in Stockholders' Equity Affect the Statement of Cash Flows

LO 10

Issue and repurchase of stock and payment of dividends are *financing* items.

- Issue of stock results in cash inflow
- Repurchase or retirement represents cash outflow
- Cash dividends are outflows of cash
  - outflow occurs not on declaration date, but on payment date

Lecture Suggestions

LO 1

Ask students to review the assignment for **LO 2**, **Chapter 1**, on forming a corporation. What were the State's requirements related to the issue of stock?

LO 3

Students will enjoy a discussion at this time of the stock market, including the difference between an issue of stock by the company, and the purchase of stock from another existing stockholder. Many students are unaware that an exchange between existing stockholders has no effect at all on the *company's* balance sheet, but only increases cash for one *stockholder* and stock holdings for another. Show students a section of the Wall Street Journal's New York Stock Exchange's Composite Transactions. If you show the section with Berkshire Hathaway, you can use it to illustrate the effect of not paying either cash or stock dividends, or having stock splits.

LO 4

Discuss why income is not affected by either "gains" or "losses" on the reselling of treasury stock. If the company invests in the stock of another company and sells that stock, a gain or loss is recorded. Explain why the company does not have the same result when it sells its own stock, which many students view as a logical result. Emphasize that the company is dealing in its *own equity*, not a revenue-generating commodity or investment. When stock is originally sold at greater than par value, additional paid-in capital is created. When stock is repurchased, it is on "hold" in the treasury stock account. If that treasury stock is resold for precisely the purchase price, the net effect is zero. If treasury stock is resold for more than the purchase price, more additional paid-in capital has been created. If the resale is for less than the purchase price, then either the paid-in capital account must be reduced, or lacking an APIC account, in effect a bonus, or dividend, is being given to the stockholders who purchase the stock, so retained earnings is reduced.

LO 6

The idea that total equity remains the same is not always understood by students. Do a "before" and "after" example in class to illustrate. For example, the three stockholders' equity sections for Shah company in LO 6 in the textbook can be compared on an overhead transparency.

LO 7

Add a stock split to the comparison from the previous suggestion. Prepare another stockholders' equity section showing the effect of a 2:1 stock split instead of a 100% stock dividend.

Projects and Activities

Components of the Stockholders' Equity Section of the Balance Sheet

LO 1

In-class discussion: Delta Airlines Shareowners' Equity

Study the shareowners' equity section of the balance sheet of Delta Airlines in your textbook.

- How many classes of stock does the company have? What are they? Do they have a par value?
- How many shares of each class are issued as of June 30, 1999
- What does the $3,208 million in additional paid-in capital represent?

Solution

- Delta Airlines has Employee Stock Ownership Plan Preferred Stock with a par value of $1 per share, and Common Stock with a par value of $1.50 per share.
- As of June 30, 1999, 6,547,495 shares were issued and outstanding, up from the previous year.
- Additional paid-in capital is another name for capital in excess of par value, and is the total amount received by the company for all common and preferred shares they have sold, less the par value of those shares, which is carried above on a separate line.

Outside assignment: Comparison of Delta Airlines and AMR Corporation

Compare the stockholders' equity sections of Delta Airlines and AMR Corporation, both of which are found in your textbook.

- Do the two companies have similar types of capital stock?
- Each company has a significant amount of Retained Earnings. What is the "debit side" of this amount? Is it cash that should be invested?
- Are Delta and AMR good companies to compare? Explain why or why not.

Solution

This can be used alone, or as a follow-up assignment to the previous class discussion.

- The two are very similar. However, Delta has Employee Stock Ownership Plan Preferred Stock. But both companies have common stock and both companies have treasury stock.
- This question is meant to emphasize the fact that retained earnings are NOT cash. Earnings are invested in a wide variety of assets, including cash, and their retention is not an indicator of unproductive cash or cash being held back from stockholders that ought to have been paid in dividends. A growing company retains a portion of their earnings to fund growth. Note as a contrast the comment in the text concerning partners' withdrawals of earnings limiting the growth of partnerships.
- Comparisons between Delta and AMR are meaningful because both are in the same industry, and are among the leading companies in that industry. Industry averages are also available to enhance comparison and analysis.

Preferred Stock

LO 2

In-class discussion: "MIPS"

In 1995, Ford Motor Co. Capital Trust issued 9% Preferred Securities, and Ford Motor Co. (the parent) purchased the Trust's common securities and issued to the Trust 9% subordinated debentures whose interest and other payment dates correspond to distribution and payment dates on the preferred shares. The debentures are the Trust's only asset. If the company redeems the debentures, or at their maturity, the Trust must redeem the Preferred Securities, with any accrued dividends.

- Should Ford's common shareholders have any concerns about this transaction?
- Is the fact that the Preferred Securities issued by the Trust are cumulative important?

Solution

- Common stockholders are always interested in any outstanding preferred stock, since preferred dividends reduce the cash available for common dividends. The fact that these dividends are converted to debt by the time they reach the parent company does not change the fact that they are still an obligation that reduces the cash available for distribution to common shareholders. Of course the company would maintain that they are enabled by these transactions to increase profitability, and that this outweighs the above disadvantage. Common stockholders need to keep an eye on the bottom line and future dividend declarations to determine what real effect if any takes place.
- The fact that the shares are cumulative reinforces these points.

Food for thought: Mandatory redeemable preferred stock

Your textbook describes callable preferred stock as preferred stock which the *company* has the right to buy back (retire) at a specified price. An article in *Business Week* described another type of preferred stock known as "mandatory redeemable preferred stock," (MRPS) which the *investor* can, under specified conditions, *require* the *company* to buy back.[1]

- Are MRPS equity, or are they really debt?
- Where would you classify MRPS on the balance sheet?
- What disadvantages does MRPS have for the issuing company? What are the advantages?
- Stock is freely traded and investors could sell the shares on the open market even without the redemption option. Why then would an investor find the mandatory redemption feature attractive?

Solution

- It is called preferred stock, so technically it is equity. However, the article points out, it costs like debt, and has features of both. Students can discuss the differences between equity and debt, and consider the form versus the substance of this financing instrument.
- According to the article, the Securities and Exchange Commission believes MRPS belongs on the balance sheet in between equity and debt, so many companies literally leave it hanging there alone in limbo with no label. This is a good question for students to consider because it has no "right" answer.
- Begin with the big advantage. Since it is, technically, equity, it allows the company to borrow money without adding debt to the balance sheet. Also, dividends, unlike interest, are not mandatory. The disadvantage is the redemption feature, which could leave the company at the mercy of the investors who have the ability to call back their money at a time that may not be convenient for the company.
- For the investor, the ability to sell the stock on the open market may not be as useful as it seems if the stock has declined considerably in value. The redemption price will have been set by the terms of the stock certificate and may give investors a better choice than the market, a valuable option.

This type of security is another example for students of why it is so necessary to look carefully at balance sheet items. In this case, the reader may have to study the footnotes to realize that this preferred stock is very close to debt—in fact it could under certain circumstances become a current liability—and might change the opinion of a potential investor or lender. This last point can be used to

[1]Business Week, November 7, 1988, James Norman, "How To Juggle Numbers So the Debt Doesn't Show."

begin a brief class discussion about off balance sheet financing and how companies can disguise the real nature of balance sheet items if the reader of the statements is not thorough.

Stock Issued for Cash

LO 3

Food for thought: Vermont Teddy Bear Co.

In November 1993, Vermont Teddy Bear Co., a privately held company, "went public" by offering 1 million shares of their stock (about 20% of the company) to the public at $7.50 per share.[2] This is known as an IPO, or Initial Public Offering.

- How do you suppose Vermont Teddy Bear, or any company, determines the price at which they will initially offer their stock for public sale? Is this an arbitrary number?
- Does the offering of shares guarantee that the company will receive $7.5 million? What happens if no one buys at $7.50?
- What advantage is there for the current owners of the company to dilute their share of the company by offering a 20% stake to outsiders?
- Based on what you have studied about companies thus far, what are the two most likely uses to which Vermont Teddy Bear might put the proceeds of the offering?
- As a potential investor, what information would you want from Vermont Teddy Bear to enable you to make a decision about whether you want to own their stock, how many shares you want, and what price you are willing to pay? Is the product important? (For your information, they sell huggable hand-sewn teddy bears, in a variety of sizes, priced from around $60 at the bottom end, to over $650 at the top end.)

Solution

- The initial offering price is based on a company's balance sheet position, and its operating results, in comparison with similar companies already publicly traded. The price is usually developed with the help of an investment banker. The offering price is in no way arbitrary. The company wants to ask a price that will be acceptable to the public, without undervaluing the company.
- There is no guarantee that a company will receive exactly the offering price. In the happy event that demand exceeds expectations the company receives more than they expected. For example, Boston Chicken's IPO, priced at $20, soared to $48.50 by the end of the first day[3]. In other cases, the price a company receives may actually be lower than what had been hoped. If it becomes clear that the price is going to be unacceptably low, the company may even withdraw the offering, as Dr Pepper/Seven-Up Cos. did in 1992.[4] Vermont Teddy Bear was a highly successful offering. Trading opened at $10, and went as high as $19, closing at $16.75[5].
- The owners of the company need cash to expand the company, do not have sufficient personal means to supply it, and do not wish to, or cannot, borrow.

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[2]The Boston Globe, November 21, 1993, Ronald Rosenberg, "Vermont Teddy Bear Has High Hopes Stock Offering Won't Hibernate."
[3] The Wall Street Journal, November 10, 1993, William Power, "Boston Chicken Soars By 143% On Its IPO Day."
[4]The Wall Street Journal, July 2, 1992, Bob Ortega, "Dr Pepper Withdraws Stock Offering, Citing Weakness in the Market for IPO's."
[5]The New York Times, November 24, 1993, Michael Janofsky, "Vermont Teddy Bears Get a Big Hug From Investors."

- Most companies either want to retire debt or expand the company. As stated in the article, Vermont Teddy Bear wished to enlarge the factory, offices and computer systems, as well as add catalog and retail store sales of their products. Most sales to this point had been via mail-order "Bear-Gram[6]" sales.
- You would want to know the company's financial position: assets; current and long-term debt. You would also want to evaluate their performance to date, by reviewing operating figures for the current as well as previous years for comparison. In the case of Vermont Teddy Bear, in the first six months of the year of the offering, sales were $9 million, or nearly equal to the previous whole year's sales of $10.56 million. Earnings were 14¢ a share.[7] Certainly the product is important, since investors generally have seen which areas of the economy are showing growth and which are not. Product information would also let investors look at comparable companies to assess the performance of Vermont Teddy Bear and the value of the stock in light of what their competitors are doing. There are those who buy stock strictly because they like the product. This is not necessarily a bad strategy, but it has its limitations.

Outside assignment: What does stock cost?

How much can a company expect to receive if it issues additional stock? What would it cost you to buy a share of McDonald's, PepsiCo or J.C. Penny? How do these prices change over time? Let's put together a comparison. For some of the companies mentioned in your textbook (listed is shown below), find the following information. Most of it will be available in *The Wall Street Journal*, or on the Internet.

- What is the highest price their common stock has reached during the past 52 weeks? What was the lowest price? Point out to students that stock prices are now expressed in decimals rather than fractions.
- What is the current market price of each company's common stock?
- Compare the high and the low, for the last 52 weeks for each company, given to you by your instructor. What do you think is the reason for the changes in price? Were the changes large or small? Were they up or down? Are they closer today to the high or low? Think about the economy, the respective industries, and events you may have heard about through the media that happened to a particular company.
- What general characteristics of companies seem to influence stock price? You are not expected to be an expert. Be an informed, careful observer. Try to develop a list of factors that appear to influence stock price.

Look up the following: K2, Delta Airlines, McDonald's, The Gap, Circuit City, Pepsico, Time-Warner, J. C. Penney, Coca Cola, Whirlpool, IBM, and Wrigley.

Solution

Students can work on this together in teams, or even as a class. Divide them into "work groups" to gather, collate, and analyze the information. Expand the assignment if time permits by asking students, in explaining the change in price, to produce a key article from a business publication that helps to explain the increase or decrease in a particular company's price. The stock prices follow. Obviously your students' "current" price will not be for March 24, 2000. These are included to establish only a point of reference. These figures could be used after the students have done the assignment for comparison purposes.

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[6] "Bear-Gram" is a trade mark of Vermont Teddy Bear Co.
[7]The Boston Globe, November 21, 1993, Ronald Rosenberg, "Vermont Teddy Bear Has High Hopes Stock Offering Won't Hibernate."

Company	March 24, 2000	52 week high	52 week low
K2	7 ¾	11 5/8	6 3/16
Gateway	58	84	28 3/8
McDonald's	35 3/16	49 9/16	29 13/16
The Gap	47 13/16	53 ¾	29 5/16
Circuit City	47 7/8	53 7/8	29 5/16
PepsiCo	33 ½	41 ½	29 11/16
Time-Warner	101 1/16	104 11/16	57 3/16
J. C. Penney	15 7/16	54 7/16	13 5/8
Coca Cola	47	70 7/8	42 7/8
Whirlpool	58	78 ¼	48 5/8
IBM	115 ¼	139 3/16	81 1/2
Wrigley	73 7/16	98	59 7/8

Stock prices change for a wide variety of reasons. Stock splits, changes in the economy, world affairs, consumer habits, acquisitions or dispositions of business segments, weather, can all cause a company's stock to rise or fall. Students' attention should also be directed to factors like the relative prices of stock. Some are very high-priced, some very low.

If students are interested in understanding stock quotes and the various symbols and information in *The Wall Street Journal*, the *Journal* publishes a booklet, offered free to educators, that explains stock quotes in easy-to-read language. They will send a number of copies on request. (See bibliography.)

Ethical discussion: Insider trading

There have been many "insider trading" scandals in the news. Do you really understand what the term means, and what was wrong with the actions taken by these individuals?

- What do you personally believe "insider trading" is? Define it as completely as possible in your own words, without going to reference materials just now.
- Next look up "insider trading" in a business dictionary. What is the definition given? How does it differ from your original understanding?
- Why is insider trading considered to be a criminal act? Who is harmed?
- Look through the periodical index and find two articles that describe cases of insider trading. Summarize what happened in each. What did the people involved do? Why was it considered wrong? Were there mitigating circumstances? Did the parties involved argue that they were not wrong? If so, what justification did they offer?
- In light of your limited research into the question, comment on your observations on insider trading investigations and prosecutions in terms of the:
    - size of the trades involved
    - position (occupation) of the person involved
    - number of people in the same company involved, and the communication between them.
- Suppose you are an employee of a company who is negotiating with another, larger company. Your company is going to sell one of its subsidiaries, based upon the discovery of a new technology, to the larger company, which is in a better position to manufacture and market the product. These negotiations have not as yet been made public. Everyone in your office is talking about buying as many shares in the subsidiary as they can because, when the sale takes place, the stockholders in the subsidiary will be bought out by the larger company at a very advantageous price. Is this insider trading? Why or why not?

Solution

- Students' own definitions will vary. Many have little idea what the term means. Ask this question in class before students research the remainder of the exercise, and note down their responses.

- The Dictionary of Investing[8] defines insider trading as "the practice of participating in transactions based on privileged information, gained by one's position and not available to the public. When such transactions affect the price, giving an unfair advantage to the trader, it is illegal."[9]
- The wrong is vested in the assumption that the stock market is an even playing field, with any investor having the same opportunity to gain or lose based on their own research into publicly available information and their actions based on this research. If we assume this is true, then anyone who has access to information that others cannot obtain will gain an unfair advantage over all other investors, and the investors without inside information cannot do as well. This harms the investors without privileged information and the market in general if these trades influence the stock's price.
- There are a number of cases that have gained notoriety. Students may be interested in reading the details.
- Insider trading is common, and generally goes unnoticed. Some writers have commented that the very fact that it *is* so common makes it difficult for regulators to detect and prosecute offenders. Too many sources of information have limited distribution. The cases that are found out and prosecuted are those that involve substantial amounts of money, or many participants, making them obvious. Also certain individuals, such as those involved in the securities industry, are watched more closely than those more removed from the regular buying and selling of stocks. If too many shares change hands and the trades all seem to center around a related group of people, such as people who all work for the same company, they draw attention to themselves. However, the legal actions focus on the effect the trading has on the market price, so that it is only the larger operations that stand out. The smaller cases profit individually (this does not justify the practice) but have little measurable effect on the market, even for the individual stock in question.
- It is insider trading because you have advance notice of the negotiations. You have information that has not been made available to all investors. The only way to get out of this is if every one of the shares not held by your company is held by an employee of your company who knows about these negotiations. This is unlikely. However, if the employee trades are relatively minor in number of shares and do not have any significant effect on the market, then the actions would not be considered illegal, by the definition.

LO 4

Treasury Stock

Food for thought: IBM on Black Monday, October, 1987

Late in October of 1987, it was revealed that IBM planned to buy up to $1 billion of its own stock. This news came just a few days after the now-legendary "Black Monday" stock market crash. IBM said that the buy-back had been planned previously, and was not related to the market fall.

They considered their own stock to be a good long-term investment. However, the article noted that many firms were buying large quantities of their own stock in the wake of the market decline.[10]

- What could a company hope to accomplish by buying large quantities of its own stock during a serious decline in market values?
- What conditions must be present in the company to make a large buy-back possible?
- What would IBM do with all this stock? What future benefit might it have?

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[8]Jerry M. Rosenberg, Dictionary of Investing, New York: John Wiley & Sons Inc., 1993.
[9]Ibid.
[10]The Wall Street Journal, October 28, 1987.

Solution

- The company can halt the decline of its own stock by removing shares from trading, thus breaking the selling cycle. They can stabilize the price, even if at a lower level than they might prefer. At the same time, they obtain treasury stock at a favorable price.
- Cash must be available or obtainable to do so. Thus, we assume that any company making a large stock purchase is fundamentally healthy, as many companies at the time were. In fact many companies complained that their stock was plunging despite no signs of decline in the company.
- Treasury stock can be used in the future for employee programs, bonuses, or options. The company might want to temporarily decrease the number of shares in circulation. They could release the shares to the market slowly, to minimize the effect on market price. As the market price rose, they would be able to resell the stock at a gain, a benefit for the company.

Cash Dividends for Preferred and Common Stock

LO 5

In-class exercise: Ford preferred Stock and Dividends

Ford Motor Co. says in Note 10 to their 1998 Annual Report that their Series A Preferred Stock is "Cumulative Convertible Preferred Stock[11]."

- What does this mean? Does it create a liability for the company? Explain why or why not.
- On January 9, 1998, the Series A Depositary Shares, representing 1/1,000 of a share of Series A Cumulative Convertible Preferred Stock, were redeemed at a price of $51.68 per Depositary Share plus an amount equal to accrued and unpaid dividends. Did this create a liability for Ford? Explain why or why not. Explain what this means for the owner of shares of this Preferred Stock.
- Ford's Series B Cumulative Preferred Stock is "Mandatorily Redeemable." Does this create a liability for Ford? Explain why or why not.

Solution

- The stock's cumulative feature means that in a year in which no dividend is paid, the preferred dividend accumulates, and these accrued dividends must be paid before any future common stock dividends are paid. The preferred shares may also be exchanged, under the convertible feature, at the option of the shareholder, for shares of Ford's Common Stock. No liability is created for Ford by either of these features until a dividend is declared, or a shareholder elects to convert his Preferred Stock and turns the shares in for that purpose.
- This particular redeemable feature is an option for Ford, not an obligation. No liability is recorded. The shareholders knew they might be required to return their shares. However, shareholders were paid a redemption price specified on the shares, plus any dividends in arrears.
- See the exercise in this chapter, "In-class discussion: MIPS," in LO 2. The mandatorily redeemable preferred stock does not create a liability, but it could be thought of as a potential off-balance-sheet liability, since if the debt to which it is tied is redeemed, it must be redeemed. It is a contingent liability, in that sense.

Stock Dividends

LO 6

Food for thought: Stock dividends and taxes

You have learned that stock dividends are not taxable for the recipient (the shareholder). Why do you think this is true? Is it because they have no value?

- If a stock dividend is not taxable, and a cash dividend is, could you avoid taxes by asking the company you own shares in to pay you your dividend in stock instead of cash, even though

[11] Ford Motor Co., 1995 Annual Report, page 49.

they intended to send you cash? Why or why not? What is the difference between this situation and a declared stock dividend?

Solution

- Stock dividends certainly have value. The stockholder who receives a small stock dividend hopes (probably correctly) that the stock will recover its market price before the dividend, or close to it, and their shares will be worth more in total. For a large stock dividend, the market price often also increases enough after the dividend to give the shareholder more total market value than they had before the dividend. However, the increase in market value in both cases is merely "paper gain," not an increase in cash, until the shareholder actually elects to sell some of the stock. The company has not paid out retained earnings, but has reinvested them permanently in the company, in the shareholders' names, by distributing a stock dividend. This unrealized gain cannot be determined, or thus taxed, until shares are sold and an actual dollar amount realized.
- In the second case, an actual dollar amount of gain to the shareholder has been set. The company declared a cash dividend, a distribution of earnings, in a set amount. The fact that the shareholder in effect asks the company to take his or her gain and buy some stock for it and send that to the shareholder does not alter this. Thus it is taxable like a cash dividend. The difference is in the intent of the company, and the way the dividend is expressed (cash or stock).

LO 7

Stock Splits

Food for thought: Reverse split

You have learned about stock splits, their purposes, and their results. Now consider a "reverse split." What do you think this might be? Why do you think a company might consider one? Look for a recent example of a company activating a reverse split. Explain what happened, and why.

Solution

A reverse split occurs when a company reduces, rather than increases, the number of shares outstanding. This would of course increase the par value and the market value of each share. The company may be concerned about an erosion in the price of its stock, especially in relation to the stock of companies they consider to be comparable. The decrease in the number of shares available should correct this although it is not guaranteed to accomplish this any more than a regular stock split will always necessarily lower the price to a desired level.

LO 1

Components of Stockholders Equity

In-class exercise: Components of Stockholders Equity

Review the stockholders' equity section of Whirlpool's 1998 balance sheet.

Stockholders' Equity	
Common stock, $1 par value: 250 million shares authorized,	$ 85
Paid-in capital	321
Retained earnings	2,024
Unearned restricted stock	(3)
Cumulative translation adjustments	(241)
Treasury stock – 6 million shares at cost	(241)
	$2,001

- What *types* of stock does Whirlpool have?
- Whirlpool does not show an "additional paid-in capital" account. What do they show instead? Does it mean the same thing?

Solution

- In 1998, Whirlpool had only one class of stock, their $1.00 par value common stock.
- Whirlpool calls it simply "Paid-in capital." The meaning is the same.