MBA in Food & Agribusiness

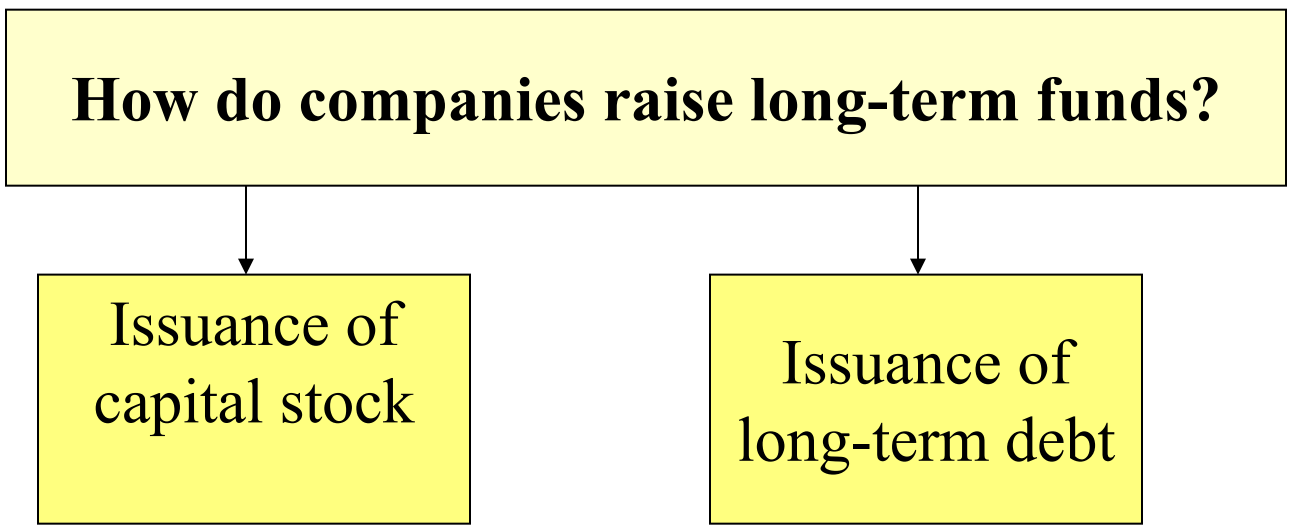
Financial Management

Contributed Capital

Agenda

- Management issues related to Contributed Capital
- Components of Stockholders Equity
- Preferred stock
- Issuance of Common stock
- Accounting for Treasury stock

Deciding to issue capital stock



Using Equity Financing

Stock Certificate
Shows units of ownership in a corporation

- ✓ A stock certificate is issued to the owner
- ✓ Stockholder can transfer ownership at will
- ✓ Independent registrars and transfer agents are often used to keep track of stockholders' records

Authorized, Issued, and Outstanding Shares

Authorized shares: Maximum number that the corporation's charter allows it to issue

Issued shares: Sold or transferred to stockholders

Outstanding shares: Shares issued and still in circulation

Stockholders' Equity		
Contributed capital		
Preferred stock, $50 par value, 1,000 shares authorized, issued, and outstanding		$50,000
Common stock, $5 par value, 30,000 shares authorized, 20,000 shares issued, 18,000 shares outstanding	$100,000	
Additional paid-in capital	50,000	150,000
Total contributed capital		$200,000

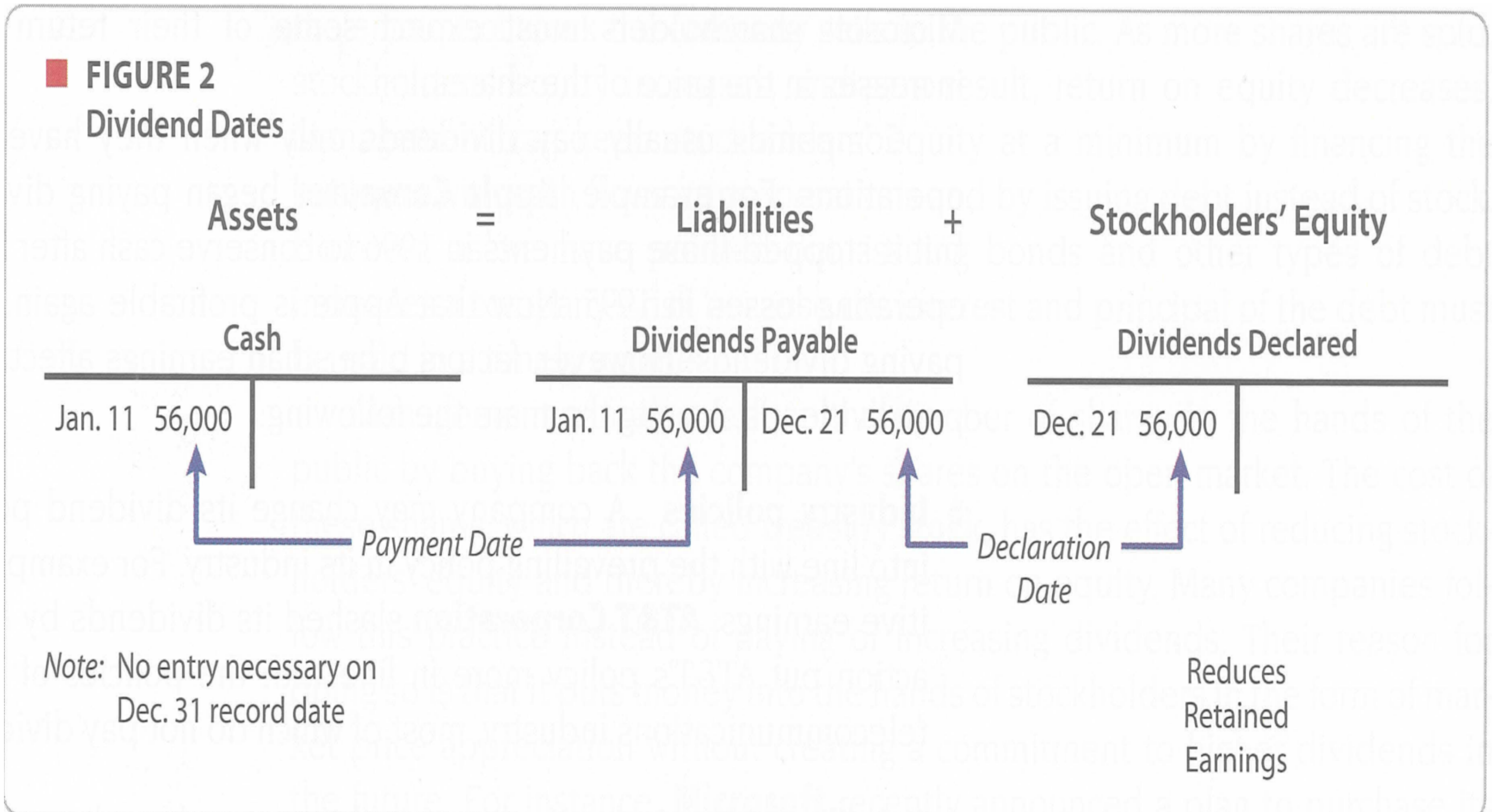
Dividends

Distribution among stockholders of the assets that a corporation's earnings have generated

Stockholders receive these assets, usually cash, in proportion to the number of shares they own

- ✓ Board of directors has sole authority to declare dividends
- ✓ Decision to declare dividends affected by cash flows, pending lawsuits, economic situation, or debt levels.

Dividend journals



Par Value

An arbitrary amount assigned to each share of stock

Usually bears little or no relationship to the market value or book value of shares

Constitutes the legal capital of the corporation

Legal capital

- The number of shares issued times the par value
- The minimum amount that can be reported as contributed capital

Par Value Stock- Issue above Par

Xon Corporation is authorized to issue 20,000 shares of **$10 par** value common stock. The company issues 10,000 shares at **$12 per** share on January 1, 20xx.

Jan. 1	Cash	120,000	
	Common Stock		100,000
	Additional Paid-in Capital		20,000
	Issued 10,000 shares of $10 par value common stock for $12 per share		

Always at PAR value

Par Value Stock

Balance Sheet Presentation

Stockholders' Equity Section

Contributed capital	
Common stock, $10 par value, 20,000 shares authorized, 10,000 shares issued and outstanding	$100,000
Additional paid-in capital	20,000
Total contributed capital	$120,000
Retained earnings	—
Total stockholders' equity	$120,000

No-Par Stock

Xon Corporation is authorized to issue 20,000 shares of no-par common stock. Suppose the company issues 10,000 shares at $15 per share on January 1, 20xx.

Jan. 1	**Cash**	**150,000**	
	Common Stock		**150,000**
	Issued 10,000 shares of no-par common stock for $15 per share		

No-Par Stock – stated value

Assume Xon's board puts a $10 **stated value** on its no-par stock. It issues 10,000 shares at *$15 per share* on January 1, 20xx.

Jan. 1	**Cash**	**150,000**	
	Common Stock		**100,000**
	Additional Paid-in Capital		**50,000**
	Issued 10,000 shares of no-par value common stock with $10 stated value for $15 per share		

Treasury Stock

Why do more than 67 percent of large companies repurchase their own stock?

- ✓ Use the stock for employee stock option plans
- ✓ Want to maintain a favorable market for their stock
- ✓ Want to increase earnings per share or stock price per share
- ✓ Want to have additional shares of stock available for purchasing other companies
- ✓ Attempt to prevent hostile takeovers

Purchase of Treasury Stock Illustrated

On Sept. 15, Caprock Corporation purchases 1,000 shares of its common stock on the market **for $50 per share.**

When treasury stock is purchased, it is usually recorded at cost:

Sept. 15	Treasury Stock, Common	50,000	
	Cash		50,000
	Acquired 1,000 shares of the company's common stock for $50 per share		

Purchase of Treasury Stock illustrated

Stockholders' Equity Section

Contributed capital	
Common stock, $5 par value, 100,000 shares authorized, 30,000 shares issued, 29,000 shares outstanding	$150,000
Additional paid-in capital	30,000
Total contributed capital	$180,000
Retained earnings	900,000
Total contributed capital and retained earnings	$1,080,000
Less treasury stock, common (1,000 shares at cost)	50,000
Total stockholders' equity	$1,030,000

Notice that the number of shares issued, and therefore legal capital, has not changed even though the number of shares outstanding has decreased.

Sale of Treasury Stock

At cost	Above cost
Debit Cash Credit Treasury Stock, Common	Debit Cash for proceeds Credit Treasury Stock, Common for cost Credit Paid-in Capital, Treasury Stock for amount over cost

Sale of Treasury Stock Below Cost

Dec. 15: Caprock Corporation sells 600 shares of its treasury stock for $42 per share. (Cost was $50 per share.)

Dec. 15	Cash	25,200	
	Paid-in Capital, Treasury Stock	4,000	
	Retained Earnings	800	
	Treasury Stock, Common		30,000
	Sold 600 shares of the treasury stock for $42 per share; cost was $50 per share		

$42 x 600

$50 x 600

When treasury shares are sold below cost, the difference is deducted from Paid-in Capital, Treasury Stock

If the Paid-in Capital, Treasury Stock account cannot absorb the full amount of the difference, or doesn't exist, Retained Earnings absorbs the remainder.

Retirement of Treasury Stock

Treasury stock is retired when the company determines that it will not reissue stock it has purchased

- Shares will be cancelled
- Shareholders approval needed

✓ If buy back price < original contributed capital

Credit Paid-In Capital, Retirement of Stock

✓ If buy back price > original contributed capital

Debit Retained Earnings

Retirement of Treasury Stock

Nov 15	**Common stock**	**5.000**	
	Additional Paid-In-Capital	**1.000**	
	Retained earnings	**44.000**	
	Treasury stock, common		**50,000**
	Retired 1000 shares that cost $50 per share and were issued originally at $6 per share		

Dividends Yield Ratio

Tells investors how much they can expect to receive in dividends expressed as a percentage of the market price per share

$$\text{Dividends Yield} = \frac{\text{Dividends per Share}}{\text{Market Price per Share}}$$

$$\text{Microsoft} = \frac{\$0.32}{\$24.20} = 1.3\%$$

Return on Equity

How well equity funding of the company is used to generate income

$$\text{Return on Equity} = \frac{\text{Net Income}}{\text{Average Stockholders' Equity}}$$

$$\text{Microsoft} = \frac{\$105{,}548}{(\$588{,}770 + \$173{,}953)\ /\ 2}$$

$$= 27.7\%$$

Decomposing ROE – Traditional approach (DuPont Decomposition)

$$\text{ROE} = \overbrace{\text{Return on sales (ROS)} \times \text{Asset turnover (AT)}}^{\text{Return on assets (ROA)}} \times \text{Equity multiplier}$$

- ROE = $\dfrac{\text{Net Income}}{\text{Sales}} \times \dfrac{\text{Sales}}{\text{Total Assets}} \times \dfrac{\text{Total Assets}}{\text{Equity}}$

Reformulation of BS and IS to improve analysis

- **Net interest expense after tax**
  (Interest expense - Interest income) x (1 - Tax rate)

- **Net operating profit after taxes** (NOPAT)
  Net income + Net interest expense after tax

- **Operating working capital** (OWC)
  (CA – Cash) – (CL – STD)

- **Net long term assets** (NLTA)
  Total long term assets – non-interest bearing long term liabilities (e.g. deferred taxation)

- **Net debt**
  Total interest bearing liabilities - cash and marketable securities

- **Net (operating) assets** (OWC + NLTA)

- **Net capital**
  Net debt + shareholders' equity

Price/Earnings (P/E) Ratio

A measure of investors' confidence in a company's future

$$\text{Price Earnings (P/E) Ratio} = \frac{\text{Market Price per Share}}{\text{Earnings per Share}}$$

$$\text{Microsoft} = \frac{\$24.20}{\$0.968} = 25 \text{ times}$$

Because the market price is 25 times earnings, investors are paying a high price in relation to earnings. They do so in the expectation that this software company will continue to be successful

Price/Earnings (P/E) Ratio

Corporatefocus Premium By **in** financials

Company,ISIN,*Ticker Guess go

Home | My Lists | Help Center | Logout

Company Screener | Document Search

Vodafone Group Country: United Kingdom ISIN: GB00B16GWD56 Ticker: VOD Sector ICB: Mobile Telecommunications **Print**

Snapshot | Fundamentals | Markets | Credit Ratings | Documents | Estimates | Revisions | Peer Tracker | Multiples | Ratios | Stock Performance | Comp Charts

Forecast Multiples | Historical Multiples

Current peergroup: Infinancials PG (Est) Refine peergroup: Peer Tracker Model

Full | Page1 | Page2 — USD | EUR

	Enterprise Value	EV/Net Sales				EV/EBITDA			
	Current (USDm)	Last	2007(e)	2008(e)	2009(e)	Last	2007(e)	2008(e)	2009(e)
Vodafone Group	220 808	3.47	3.17	2.99	2.85	7.09	8.56	8.11	7.82
Peer Median	**42 152**	**2.48**	**2.45**	**2.41**	**2.34**	**6.38**	**6.71**	**6.36**	**6.11**
France Telecom	148 130	2.01	1.97	1.96	1.93	5.51	5.59	5.54	5.46
Ntt Do Co Mo Inc	64 363	1.54	1.57	1.59	1.60	4.87	4.68	4.76	4.77
MTN Group	32 449	4.29	3.00	2.57	2.34	9.87	6.92	5.86	5.33
Telefonica	211 041	2.71	2.61	2.54	2.47	7.68	6.48	6.63	6.42
Deutsche Telekom AG	148 039	1.69	1.66	1.64	1.62	6.35	5.44	5.35	5.24
Sprint Nextel Corp.	74 179	1.81	1.81	1.77	1.72	6.13	6.71	6.12	5.54
Telenor ASA	41 939	2.48	2.40	2.23	2.14	6.38	7.59	7.00	6.64
Turkcell	18 878	3.37	3.21	3.06	2.80	7.75	7.91	7.53	7.21
Cosmote Mobile Telecommunications SA	15 303	4.50	3.44	3.12	2.92	12.24	10.35	9.02	8.15
BT Group Plc	66 227	1.60	1.56	1.53	1.51	5.91	5.59	5.48	5.35
AT&T Inc	316 035	5.01	2.65	2.55	2.46	14.20	7.22	6.53	6.11
KDDI CORPORATION	36 376	1.25	1.20	1.18	1.15	6.20	5.26	4.70	4.58
Teliasonera Ab	42 152	2.98	2.85	2.75	2.67	7.41	8.71	8.24	8.01
Alltel	25 954	3.29	2.98	2.80	2.64	9.99	8.63	7.97	7.47
Telekom Austria Ag	16 758	2.47	2.45	2.41	2.37	6.16	6.38	6.36	6.19

	EV/EBIT				Market Cap	PE			Price to Cash Flow(P/CF)		
	Last	2007(e)	2008(e)	2009(e)	Current (USDm)	2007(e)	2008(e)	2009(e)	2007(e)	2008(e)	2009(e)
Vodafone Group	N/M	14.82	14.13	13.14	191 492	15.96	14.74	1[illegible].93	9.68	9.32	7.59
Peer Median	**14.34**	**11.65**	**11.14**	**10.79**	**39 950**	**15.69**	**13.95**	**1[illegible].29**	**5.95**	**5.63**	**5.45**
France Telecom	14.34	9.98	9.84	9.53	86 924	12.94	12.89	1[illegible].77	4.68	4.63	4.73
Ntt Do Co Mo Inc	9.56	9.67	9.23	8.88	63 410	15.74	15.36	1[illegible].28	5.71	5.93	6.33
MTN Group	13.73	9.58	7.97	6.79	29 074	0.17	0.13	[illegible].11	0.09	0.08	0.06
Telefonica	15.47	12.10	11.67	10.93	132 167	14.50	13.06	1[illegible].99	5.49	5.46	5.27
Deutsche Telekom AG	19.53	12.91	12.33	11.73	85 646	20.11	16.80	1[illegible].57	4.31	4.15	4.15
Sprint Nextel Corp.	27.32	41.74	20.96	13.46	54 085	21.59	18.10	1[illegible].83	5.95	5.17	4.85
Telenor ASA	10.86	14.47	12.53	11.52	33 813	15.69	13.95	1[illegible].29	7.45	7.01	6.74
Turkcell	14.15	11.65	10.34	9.66	19 768	16.24	13.79	1[illegible].85	8.92	8.56	8.23
Cosmote Mobile Telecommunications SA	19.37	15.58	13.06	11.53	11 905	19.44	15.72	1[illegible].66	10.67	9.08	8.22
BT Group Plc	12.69	11.52	11.14	10.79	50 844	13.12	12.54	1[illegible].97	5.34	4.86	4.86
AT&T Inc	25.60	11.10	10.13	9.35	258 657	15.37	13.51	1[illegible].19	8.02	7.15	7.13
KDDI CORPORATION	13.78	10.14	8.49	8.47	32 649	15.59	12.98	1[illegible].55	7.49	5.63	5.45
Teliasonera Ab	10.63	11.11	10.17	9.76	39 950	15.29	14.40	1[illegible].55	10.72	10.26	9.84
Alltel	16.56	14.74	13.14	12.60	24 154	24.73	21.81	2[illegible].20	10.65	9.64	8.78
Telekom Austria Ag	15.19	15.39	14.55	13.29	12 147	16.07	14.47	1[illegible].77	5.29	5.23	4.92

The Corporate Income Statement and the Statement of Stockholder's Equity

Agenda

- Income taxes
- Non operating items
- Earnings per share
- Comprehensive Income and statement of Stockholders equity
- Stock dividends and Stocksplits.
- Book value

Taxable Income Versus GAAP Income

Taxable Income

- ✓ Determined by deducting allowable expenses from income
- ✓ Tax laws dictate which expenses corporations may deduct

Accounting Income

- ✓ Determined in accordance with GAAP
- ✓ Income taxes expense is recognized on an accrual basis

Deferred Income Taxes (IAS 12)

Represents the amount by which income taxes expense differs from income taxes payable

Envest Corporation has income taxes expense of $144,500 on its income statement, but has actual income taxes payable of $92,000.

Dec. 31	Income Taxes Expense	144,500	
	Income Taxes Payable		92,000
	Deferred Income Taxes		52,500
	To record estimated current and deferred income taxes		

Deferred Income Taxes

Deferred income taxes are recognized for the estimated future tax effects resulting from temporary differences in the valuation of assets, liabilities, equity, revenues, expenses, gains, and losses for tax and financial reporting purposes.

What are temporary differences?

Revenues and expenses or gains and losses that are included in taxable income before or after they are included in accounting income

Deferred Income Taxes illustrated

ABC Inc buys a machine for $ 50.000 with an economic life of 2 years. Due to the environmentally friendly nature of the machine, the tax regime allows the company to use as an allowable expense $ 50.000 in the first year.

	Financial accountant	Taxman
Machine	$ 50.000	$ 50.000
Depr'n	($ 25.000)	($50.000)
NBV	$ 25.000	$ 0

Earnings Per Share (EPS) – IAS 33

Used to evaluate a company's performance and compare it with other companies

- ✓ Should be presented on the face of the income statement
- ✓ Usually disclosed just below net income
- ✓ Show earnings per share for income from continuing operations and other major components of net income

Basic EPS

$$\text{Basic EPS} = \frac{\text{Net Income}}{\text{Weighted – Average Common Shares Outstanding}}$$

Envest Corporation had net income of $334,500 and 100,000 shares of common stock outstanding.

$$\text{Basic EPS} = \frac{\$334{,}500}{100{,}000 \text{ shares}} = \$3.35 \text{ per share}$$

Calculating Weighted-Average

Suppose that from Jan. 1 to March 31, Envest had 100,000 shares outstanding; from April 1 to Sept. 30, it had 120,000 shares outstanding; and from Oct. 31 to Dec. 31, 130,000 shares were outstanding. Envest had net income of $334,500.

100,000 shares × **3/12 year**	25,000
120,000 shares × **6/12 year**	60,000
130,000 shares × **3/12 year**	32,500
Weighted-average common shares outstanding	<u>117,500</u>

$$\text{Basic EPS} = \frac{\$334{,}500}{117{,}500 \text{ shares}} = \$2.85 \text{ per share}$$

Diluted EPS

Complex Capital Structure	Issued securities or stock options that can be converted to common stock

Diluted earnings per share are calculated by adding all potentially dilutive securities to the denominator of the basic earnings per share calculation.

Diluted EPS Illustrated

Possible Corporation had net income of $759,500 and 500,000 shares of common stock outstanding. It also issued preferred stock that could be converted into 100,000 shares of common stock. Compute diluted earnings per share.

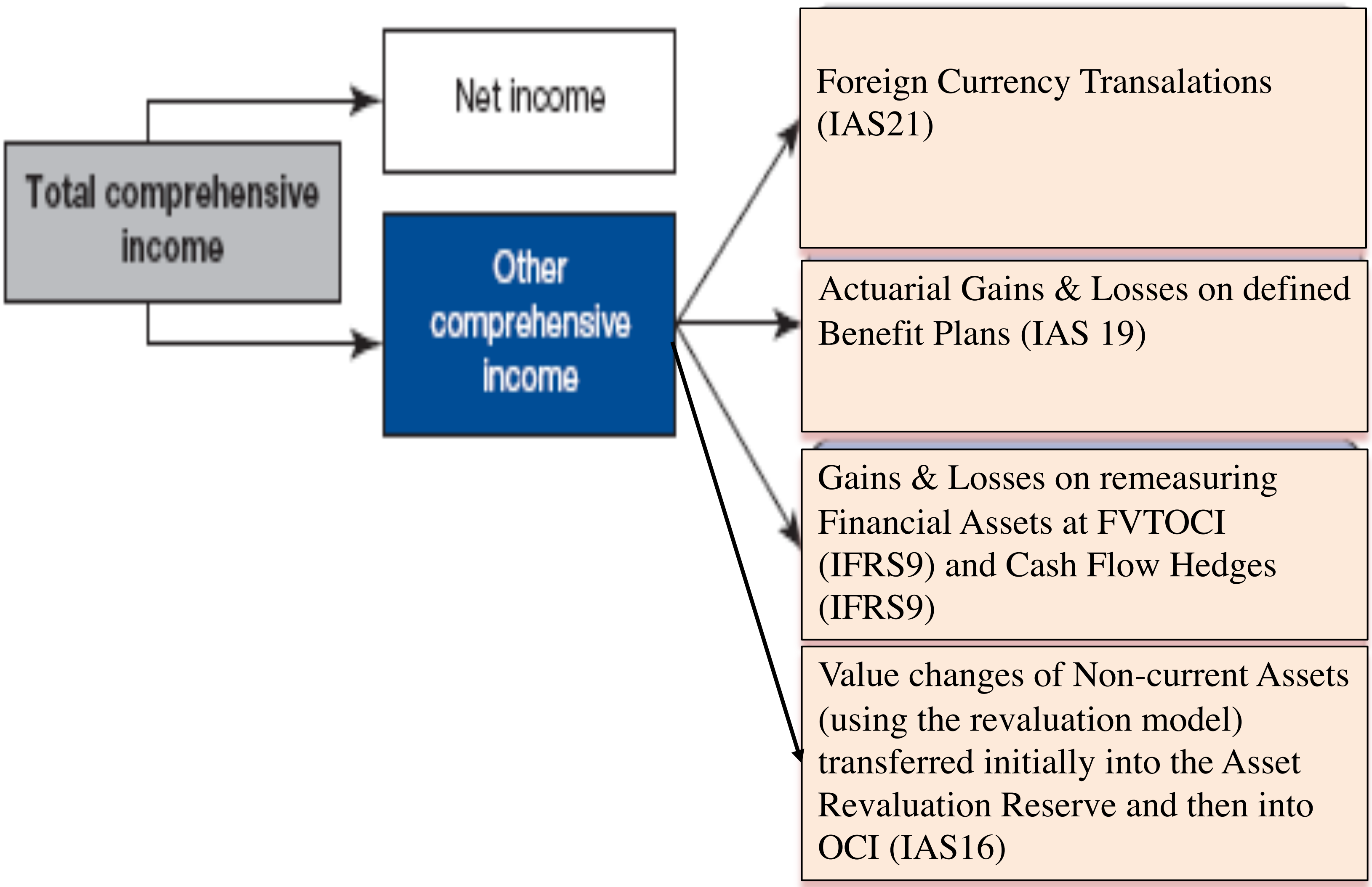
$$\text{Diluted EPS} = \frac{\$759{,}500}{600{,}000\text{ shares}} = \$1.27^{*}\text{ per share}$$

* Rounded

Comprehensive income

- ‘Total comprehensive income’: ‘change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners’
- ‘Other comprehensive income’: ‘Items of income and expense (including reclassification adjustments) that are not recognized in profit or loss as required or permitted by other IFRSs)’ (IAS 1, 2007: § 7)

Components of the total comprehensive income



Stock Dividend

Proportional distribution of shares of a corporation's stock to its shareholders

- ✓ Modifies the content of stockholders' equity
- ✓ Involves no distribution of assets
- ✓ No effect on a firm's assets or liabilities

Stock Dividends Illustrated

Geminix Corporation has the following stockholders' equity structure before stock dividends are declared:

Contributed Capital	
Common stock, $5 par value, 100,000 shares authorized, 30,000 shares issued and outstanding	$ 150,000
Additional paid-in capital	30,000
Total contributed capital	$ 180,000
Retained earnings	900,000
Total stockholders' equity	$1,080,000

Stock Dividends Illustrated

Geminix Corporation declares a 10 percent stock dividend on February 24, distributable on March 31 to stockholders of record on March 15. The market price of the stock on February 24 is $20 per share.

Date of Declaration:

10% of 30,000 shares @ $20 per share

Feb. 24	Stock Dividend Declared	60,000	
	Common Stock Distributable		15,000
	Additional Paid-in Capital		45,000
	Declared a 10 percent stock dividend on common stock, distributable on March 31 to stockholders of record on March 15		
	30,000 shares x .10 = 3,000 shares		
	3,000 shares x $20/share = $60,000		
	3,000 shares x $5/share = $15,000		

10% of 30,000 shares @ $5 per share

Stock Dividends Illustrated

Date of Record:

- No entry is required
- Recall that this date is used to determine the owners of stock who will receive dividends

Date of Distribution:

Mar. 31	Common Stock Distributable	15,000	
	Common Stock		15,000
	Distributed a stock dividend of 3,000 shares		

Effects of Stock Dividends on Contributed Capital

Stockholders' Equity	Before Dividend	After Dividend
Common stock	$ 150,000	$ 165,000
Additional paid-in capital	30,000	75,000
Total contributed capital	$ 180,000	$ 240,000
Retained earnings	900,000	840,000
Total stockholders' equity	$1,080,000	$1,080,000

Stock Split

A corporation **increases the number** of shares of stock issued and outstanding and **reduces the par or stated value** proportionally

Stock Split Illustrated

July 15: Calderon Corporation's 30,000 shares of $5 par value common stock issued and outstanding were split 2 for 1.

Common Stock	Before Stock Split	After Stock Split
Shares issued and outstanding	30,000	60,000
Par value per share	$5.00	$2.50
Amount of common stock equity	$150,000	$150,000

A stock split does not increase the number of shares authorized, nor does it change the balances in the accounts in the stockholders' equity section of the balance sheet.

No journal entry required, memorandum entry is appropriate.

Book Value

$$\text{Book Value per Share} = \frac{\text{Total Stockholders' Equity}}{\text{Total Common Shares Outstanding}}$$

When a company has both common and preferred stock, subtract the call value of the preferred stock plus any dividends in arrears from total stockholders' equity. (Use par value if call value is not specified.)

Book Value per Share Illustrated

Kavra Corporation has total stockholders' equity of $2,014,400 that includes: 3,000 shares of $100 par 8 percent convertible preferred stock outstanding; 41,800 shares issued and 41,300 shares outstanding of $10 par value common stock; and 500 shares of treasury stock. ***No dividends are in arrears*** and the preferred stock is callable at $105. What is the book value per share for both preferred and common stock?

Book Value per Share Illustrated

Total stockholders' equity	$2,014,400
Less equity allocated to preferred shareholders	
(3,000 shares x $105)	315,000
Equity pertaining to common shareholders	$1,699,400

$$\text{Preferred Stock}: \$315{,}000 \div 3{,}000 \text{ shares} = \$105.00 \text{ per share}$$

$$\text{Common Stock}: \$1{,}699{,}400 \div 41{,}300 \text{ shares} = \$41.15^{*} \text{ per share}$$

* Rounded