

## **Libby Chapter 11 Adobe Connect Live Owners' Equity**

### **STOCKHOLDERS' EQUITY**

In GAAP-based financial statements, Stockholders' Equity normally consists of the following

- **Contributed Capital** (sometimes, Paid-In-Capital)
  - Common stock at par
  - Preferred stock at par
  - Paid in capital in excess of par
  - Other paid-in-capital accounts (e.g., from treasury stock transactions)
- **Retained Earnings**
- **Accumulated Other Comprehensive Income (Loss)**

## STATEMENT OF COMPREHENSIVE INCOME

A **Statement of Comprehensive Income (Loss)** has two components

- **Net Income (Loss)**

- Detail provided in a separate Income Statement (or Statement of Earnings, Statement of Operations, or Statement of Income)

- **Other Comprehensive Income (Loss)**

- One example discussed in Appendix E
  - Closed at the end of the period directly to Accumulated Other Comprehensive Income (Loss)

We will cover one item related to other comprehensive income in Appendix E.

**DIRECT TRANSACTIONS WITH OWNERS (Do Not Affect Net Income)**

- **Issue common and preferred stock**
- **Repurchase common stock temporarily:** Treasury Stock
- **Reissue Treasury Stock**
- **Repurchase and retire common stock:** Stock Buyback
- **Dividends**
  - Cash
  - Stock
    - Small (valued at fair value)
    - Large (valued at par value)
- **Stock Split**

**Dividends (affect retained earnings)**

**A DIVIDEND IS NOT AN EXPENSE.** A dividend declaration decreases retained earnings rather than contributed capital.

**TRANSACTIONS WITH EMPLOYEES (Affect Net Income)**

- **Stock Options**

## ACCOUNTING MODEL

**Net assets** is defined as total assets – total liabilities.

$$\Delta (A-L) = \Delta OE$$

We describe two different situations:

1. **Direct transactions with owners** (the focus of most of Chapter 11)
  - **Do Not Affect Comprehensive Income (Loss)**
2. **Transactions that are not direct transactions with owners** (the focus of most of the other Libby et al. chapters)
  - **Affect Comprehensive Income (Loss)**
    - **Net Income**
    - **Other Comprehensive Income (Loss)**

*Direct transactions with stockholders either increase or decrease net assets.*

- The associated effects are usually reflected in contributed capital (paid-in-capital).
- No gains/or losses on direct transactions with owners are shown on the income statement.
  - Any economic gains/losses are reflected in contributed capital.

## EXAMPLES

### Issue Common Stock

Issue 1,000,000 shares of \$0.05par value common stock for \$12 per share.

| Assets               | = | Liabilities | + | Equity   |
|----------------------|---|-------------|---|--|
| Cash<br>↑ 12,000,000 |   |             |   | Common stock<br>↑ 50,000<br>PIC in excess of par<br>↑ 11,950,000 |

$$1,000,000 \times 0.05 = 50,000$$

$$1,000,000 \times 12.00 \text{ par} = 1,200,000$$

$$100,000 \times (12 - 0.05)() = 11,950,000$$

|                                      |            |            |
|--------------------------------------|------------|------------|
| Cash                                 | 12,000,000 |            |
| Common stock                         |            | 50,000     |
| Paid-in capital in excess of par (1) |            | 11,950,000 |

(1) Alternative account titles: Additional paid in capital in excess of par;  
Contributed capital in excess of par (used in text); Additional contributed  
capital in excess of par; Etc.

## Issue Preferred Stock

Issue 750,000 shares of \$0.01 par value preferred stock for \$13 per share.

| Assets              | = | Liabilities | + | Equity  |
|---------------------|---|-------------|---|---|
| Cash<br>↑ 9,750,000 |   |             |   | Preferred stock<br>↑ 7,500<br>PIC in excess of par<br>↑ 9,742,500 |

$$750,000 \times 13 = 9,750,000$$

$$750,000 \times 0.01 = 7,500$$

$$750,000 \times (13.00 - 0.01) = 9,742,500$$

|                                  |           |           |
|----------------------------------|-----------|-----------|
| Cash                             | 9,750,000 |           |
| Preferred stock                  |           | 7,500     |
| Paid-in capital in excess of par |           | 9,742,500 |

**Preferred shareholders' receive a preference as to dividends.**

Preferred shares are either **cumulative** (the **normal feature**) or **noncumulative**

- Presume cumulative unless told otherwise
- *Dividends in arrears are not recognized as a liability, but they are disclosed in footnotes.*

## Declare Cash Dividend

**Declare** a \$0.50 per share dividend on 1,000,000 shares of outstanding common stock.

| <b>Assets</b> | = | <b>Liabilities</b>             | + | <b>Equity</b>                  |
|---------------|---|--------------------------------|---|--------------------------------|
|               |   | Dividends payable<br>↑ 500,000 |   | Retained earnings<br>↓ 500,000 |

|                   |         |         |
|-------------------|---------|---------|
| Retained earnings | 500,000 |         |
| Dividends payable |         | 500,000 |

**NOTE: the declaration of dividends affects retained earnings.**

## Pay Dividend

Pay a \$4,000,000 dividend previously declared.

| Assets              | = | Liabilities                      | + | Equity |
|---------------------|---|----------------------------------|---|--------|
| Cash<br>↓ 4,000,000 |   | Dividends payable<br>↓ 4,000,000 |   |        |

|                   |           |           |
|-------------------|-----------|-----------|
| Dividends payable | 4,000,000 |           |
| Cash              |           | 4,000,000 |



## Repurchase and Retire Common Stock (Stock Buyback)

Assume that a company repurchased and retired 100,000 shares of \$1 par common stock at a cost of 6 per share. The stock had originally been issued for \$7.50 per share.

|   |  |         |
|---|--|---------|
|   | Cash paid to retire stock  | 600,000 |
| - | Original basis when stock issued   | 750,000 |
| = | Economic Gain (Loss)<br><i>Does not affect net income because it is a direct transaction with owners</i> | 150,000 |

| Assets            | = | Liabilities | + | Equity   |
|-------------------|---|-------------|---|--|
| Cash<br>↓ 600,000 |   |             |   | Common stock<br>↓ 100,000 (1)<br>PIC in excess of par<br>↓ 650,000 (1)<br>PIC retirement of stock<br>↑ 150,000 |

(1) Must write off the original basis of the stock

|   |         |         |
|---|---------|---------|
| Common stock                                    | 100,000 |         |
| Paid in capital in excess of par                | 650,000 |         |
| <b>Paid in capital from retirement of stock</b> |         | 150,000 |
| Cash  |         | 600,000 |

Note: the accounting is a bit more complicated if the repurchase and retirement is an economic loss.

## Purchase Treasury Stock

*Note: the difference between the number of shares issued and the number of shares outstanding is the number of treasury shares.*

Note: *treasury stock is a contra equity account; it is not an asset account.*

Assume that a company repurchased 200,000 shares of \$1 par common stock at \$7 per share as treasury stock.

| Assets              | = | Liabilities | + | Equity                        |
|---------------------|---|-------------|---|-------------------------------|
| Cash<br>↓ 1,400,000 |   |             |   | Treasury stock<br>↓ 1,400,000 |

|                |           |           |
|----------------|-----------|-----------|
| Treasury Stock | 1,400,000 |           |
| Cash           |           | 1,400,000 |

## Reissue Treasury Stock

Assume that a company reissued 100,000 treasury shares of \$0.01 par common stock at \$5.00 per share as treasury stock. The treasury stock had been purchased at \$4.80 per share.

| Assets            | = | Liabilities | + | Equity   |
|-------------------|---|-------------|---|--|
| Cash<br>↑ 500,000 |   |             |   | Treasury stock (1)<br>↑ 480,000<br>PIC treasury stock transactions<br>↑ 20,000 |

|   |         |         |
|---|---------|---------|
| Cash  | 500,000 |         |
| Treasury Stock                                      |         | 480,000 |
| Paid in capital, <i>treasury stock transactions</i> |         | 20,000  |

Economic loss situations are more complicated and are not discussed.

## Declare and Issue a Stock Dividend

The accounting for the stock dividend depends upon the size of the dividend: small (< 20-25%), and large (> 20-25%).

- **Small stock dividends are accounted for at market value.**
- **Large stock dividends are accounted for at par value.**

Assume a company had 10,000,000 shares of \$8 par value common stock outstanding on a date when the market value = \$15 per share.

### *Small Stock Dividend*

The company issues 5% stock dividend.

| Assets | = | Liabilities | + | Equity   |
|--------|---|-------------|---|--|
|        |   |             |   | ↓ 7,500,000, Retained earnings<br>↑ 4,000,000, Common stock<br>↑ 3,500,000, PIC in excess of par |

$$10,000,000 \times 5\% \times \$15 = 7,500,000$$

$$10,000,000 \times 5\% \times \$8 = 4,000,000$$

$$10,000,000 \times 5\% \times (\$15 - 8) = 3,500,000$$

|                                  |           |           |
|----------------------------------|-----------|-----------|
| Retained earnings                | 7,500,000 |           |
| Common Stock                     |           | 4,000,000 |
| Paid in capital in excess of par |           | 3,500,000 |

### ***Large Stock Dividend***

The company issues a 40% stock dividend

$$10,000,000 \times 40\% \times \$8 \text{ par value} = 32,000,000$$

| <b>Assets</b> | <b>=</b> | <b>Liabilities</b> | <b>+</b> | <b>Equity</b>   |
|---------------|----------|--------------------|----------|---|
|               |          |                    |          | Retained earnings<br>↓ 32,000,000<br>Common stock<br>↑ 32,000,000 |

|                   |            |            |
|-------------------|------------|------------|
| Retained earnings | 32,000,000 |            |
| Common Stock      |            | 32,000,000 |

### **Stock Split**

In a stock split, the company increases the number of shares outstanding and proportionately decreases the par value such that the total par value of the stock pre and post split is the same.

## Issue Stock Options as Compensation

GAAP treats stock options as compensation expenses to employees, not as a direct transaction with owners. **Therefore, net income is affected.**

- The value of the stock option is computed on the day of the grant
- The value is allocated over the period benefitted, usually the date of grant until the options vest
- The accounting is an historical cost allocation process
  - Compensation expense is recognized each period benefitted

**Stock Options Example.** On January 1, 2015, the Dahms Co. issued 10,000,000 options to its president, Mr. Dahms as an incentive for the 2015-2018 period, *a four year period*. Mr. Dahms can exercise the options on January 1, 2019, only if he remains at the company. The strike (option price) on January 1, 2015 is \$20 per share, the same as the closing market price. An options pricing model indicates that on January 1, 2015 the option value was \$0.80 per option.

### January 1, 2015 (No Journal Entry is Made)

Total Compensation Computed:  $10,000,000 \times \$0.80 = \$8,000,000$

*Compensation expense will be accrued as earned.* For convenience, assume annual AJEs.  $8,000,000 / 4 = 2,000,000$  per year.

**December 31, 2015**

| <b>Assets</b> | <b>=</b> | <b>Liabilities</b> | <b>+</b> | <b>Equity</b>   |
|---------------|----------|--------------------|----------|---|
|               |          |                    |          | Compensation expense<br>↓ 2,000,000<br>PIC stock options<br>↑ 2,000,000 |

**December 31, 2015**

|  |           |           |
|--|-----------|-----------|
| Compensation expense                       | 2,000,000 |           |
| Paid in capital, stock options outstanding |           | 2,000,000 |

The same entry would be made on December 31, 2016, 2017, and 2018.

Note: if Mr Dahms leaves before the options vest, the compensation expense is reversed.

## **RATIOS**

### **Dividend Yield**

$$\text{Dividend Yield Ratio} = \frac{(\text{Annual}) \text{ Dividends Per Share}}{(\text{Current}) \text{ Market Price Per Share}}$$

## Earnings Per Share (EPS)

The text considers the intricacies of computing Basic EPS and Diluted EPS beyond the scope of the text. However, the text does introduce the simplest version of the EPS computation.

$$\text{Earnings Per Share} = \frac{\text{Net Income}}{\text{Average Number of Common Shares Outstanding}}$$

In the instructor's notes, I show that a better definition than the simply definition is:

$$\text{Earnings Per Share} = \frac{\text{Net Income} - \text{Preferred Dividends Declared}}{\text{Average Number of Common Shares Outstanding}}$$

Thus, **earnings per share is the net income available to an average common share after meeting preferred dividend requirements**

Recall that EPS is a required disclosure on an income statement, just after net income.



## Statement of Cash Flows

The transactions in Chapter 11 affect cash flow from financing activities.

|   |              |
|---|--------------|
| <b>Cash Flow From Operating Activities</b>                            |              |
| Net Income  | \$48,000,000 |
| Adjustments to reconcile from net income to cash flow from operations |              |
| ...Compensation expense, stock options                                | 1,400,000    |
|   |              |
| Net Cash Flow From Operating Activities                               |              |
|   |              |
| <b>Cash Flow From Financing Activities</b>                            |              |
| Issue stock   | 14,000,000   |
| Retire common stock   | (11,000,000) |
| Purchase treasury stock   | (1,000,000)  |
| Reissue treasury stock  | 2,000,000    |
| Pay dividends   | (500,000)    |
| ...   |              |
| Net Cash Flow From Financing Activities                               |              |

**Item 8. Financial Statements and Supplementary Data**

**Southwest Airlines Co.**  
**Consolidated Balance Sheet**  
(in millions, except share data)

|  | December 31, 2014 | December 31, 2013 |
|--|-------------------|-------------------|
| <b>ASSETS</b>  |                   |                   |
| Current assets:  |                   |                   |
| Cash and cash equivalents  | \$ 1,282          | \$ 1,355          |
| Short-term investments   | 1,706             | 1,797             |
| Accounts and other receivables   | 365               | 419               |
| Inventories of parts and supplies, at cost   | 342               | 467               |
| Deferred income taxes  | 477               | 168               |
| Prepaid expenses and other current assets  | 232               | 250               |
| Total current assets   | 4,404             | 4,456             |
| Property and equipment, at cost:   |                   |                   |
| Flight equipment   | 18,473            | 16,937            |
| Ground property and equipment  | 2,853             | 2,666             |
| Deposits on flight equipment purchase contracts  | 566               | 764               |
| Assets constructed for others  | 621               | 453               |
|  | 22,513            | 20,820            |
| Less allowance for depreciation and amortization   | 8,221             | 7,431             |
|  | 14,292            | 13,389            |
| Goodwill   | 970               | 970               |
| Other assets   | 534               | 530               |
|  | \$ 20,200         | \$ 19,345         |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                   |                   |
| Current liabilities:   |                   |                   |
| Accounts payable   | \$ 1,203          | \$ 1,247          |
| Accrued liabilities  | 1,565             | 1,229             |
| Air traffic liability  | 2,897             | 2,571             |
| Current maturities of long-term debt   | 258               | 629               |
| Total current liabilities  | 5,923             | 5,676             |
| Long-term debt less current maturities   | 2,434             | 2,191             |
| Deferred income taxes  | 3,259             | 2,934             |
| Construction obligation  | 554               | 437               |
| Other noncurrent liabilities   | 1,255             | 771               |
| Stockholders' equity:  |                   |                   |
| Common stock, \$1.00 par value: 2,000,000,000 shares authorized;<br>807,611,634 shares issued in 2014 and 2013 | 808               | 808               |
| Capital in excess of par value   | 1,315             | 1,231             |
| Retained earnings  | 7,416             | 6,431             |
| Accumulated other comprehensive loss   | (738)             | (3)               |
| Treasury stock, at cost: 132,017,550 and 107,136,946 shares<br>in 2014 and 2013 respectively                   | (2,026)           | (1,131)           |
| Total stockholders' equity   | 6,775             | 7,336             |
|  | \$ 20,200         | \$ 19,345         |

See accompanying notes.

**GENERAL MOTORS COMPANY AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
(In millions)

|  | Years Ended December 31, |                  |                 |
|--|--------------------------|------------------|-----------------|
|  | 2014                     | 2013             | 2012            |
| <b>Net income</b>  | \$ 4,018                 | \$ 5,331         | \$ 6,136        |
| <b>Other comprehensive income (loss), net of tax (Note 21)</b>       |                          |                  |                 |
| Foreign currency translation adjustments                             | (473)                    | (733)            | (103)           |
| Cash flow hedging losses, net  | —                        | —                | (2)             |
| Unrealized gains (losses) on securities, net                         | (5)                      | (39)             | 45              |
| Defined benefit plans, net   | (4,505)                  | 5,693            | (2,120)         |
| Other comprehensive income (loss), net of tax                        | (4,983)                  | 4,921            | (2,180)         |
| <b>Comprehensive income (loss)</b>                                   | (965)                    | 10,252           | 3,956           |
| Comprehensive (income) loss attributable to noncontrolling interests | (46)                     | 33               | 41              |
| <b>Comprehensive income (loss) attributable to stockholders</b>      | <u>\$ (1,011)</u>        | <u>\$ 10,285</u> | <u>\$ 3,997</u> |

Reference should be made to the notes to consolidated financial statements.

**Southwest Airlines Co.**  
**Consolidated Statement of Cash Flows**  
(in millions)

|   | Year ended December 31, |                 |                 |
|---|-------------------------|-----------------|-----------------|
|   | 2014                    | 2013            | 2012            |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                  |                         |                 |                 |
| Net income  | \$ 1,136                | \$ 754          | \$ 421          |
| Adjustments to reconcile net income to cash provided by operating activities: |                         |                 |                 |
| Depreciation and amortization   | 938                     | 867             | 844             |
| Unrealized (gain) loss on fuel derivative instruments                         | 279                     | (5)             | (189)           |
| Deferred income taxes   | 501                     | 50              | 251             |
| Changes in certain assets and liabilities:                                    |                         |                 |                 |
| Accounts and other receivables  | 54                      | (17)            | (33)            |
| Other assets  | 142                     | (46)            | (104)           |
| Accounts payable and accrued liabilities                                      | 36                      | 343             | 186             |
| Air traffic liability   | 326                     | 400             | 334             |
| Cash collateral received from (provided to) derivative counterparties         | (233)                   | 57              | 233             |
| Other, net  | (277)                   | 74              | 121             |
| Net cash provided by operating activities                                     | 2,902                   | 2,477           | 2,064           |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                  |                         |                 |                 |
| Capital expenditures  | (1,748)                 | (1,433)         | (1,348)         |
| Assets constructed for others   | (80)                    | (14)            | —               |
| Purchases of short-term investments   | (3,080)                 | (3,135)         | (2,481)         |
| Proceeds from sales of short-term and other investments                       | 3,185                   | 3,198           | 2,996           |
| Other, net  | (4)                     | —               | —               |
| Net cash used in investing activities   | (1,727)                 | (1,384)         | (833)           |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                  |                         |                 |                 |
| Proceeds from issuance of long-term debt                                      | 300                     | —               | —               |
| Proceeds from Employee stock plans  | 110                     | 96              | 27              |
| Reimbursement for assets constructed for others                               | 27                      | —               | —               |
| Proceeds from termination of interest rate derivative instrument              | —                       | —               | 38              |
| Payments of long-term debt and capital lease obligations                      | (561)                   | (313)           | (578)           |
| Payments of cash dividends  | (139)                   | (71)            | (22)            |
| Repayment of construction obligation  | (11)                    | (5)             | —               |
| Repurchase of common stock  | (955)                   | (540)           | (400)           |
| Other, net  | (19)                    | (18)            | (12)            |
| Net cash used in financing activities   | (1,248)                 | (851)           | (947)           |
| <b>NET CHANGE IN CASH AND CASH EQUIVALENTS</b>                                | <b>(73)</b>             | <b>242</b>      | <b>284</b>      |
| <b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>                       | <b>1,355</b>            | <b>1,113</b>    | <b>829</b>      |
| <b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>                             | <b>\$ 1,282</b>         | <b>\$ 1,355</b> | <b>\$ 1,113</b> |
| <b>CASH PAYMENTS FOR:</b>   |                         |                 |                 |
| Interest  | \$ 128                  | \$ 133          | \$ 153          |
| Income taxes  | \$ 155                  | \$ 346          | \$ 100          |
| <b>SUPPLEMENTAL DISCLOSURE OF NONCASH TRANSACTIONS:</b>                       |                         |                 |                 |
| Assets constructed for others   | \$ 88                   | \$ 105          | \$ 129          |

See accompanying notes.