SOUTH-WESTERN
CENGAGE Learning

CHAPTER 11

DISCUSSION QUESTIONS

1. Debt financing is borrowing money and almost always involves the payment of interest on the amount borrowed. Debt holders do not receive any ownership in the company from loaning the money. Equity financing is raising money by selling stock or ownership interests in the company. While equity (stock) holders aren't guaranteed periodic interest payments as are debt holders, they often receive dividends on their equity investments. With equity, you are buying ownership in the organization; with debt, you are loaning money.

2. Partnerships are unincorporated businesses that are easy to start and easy to terminate; they are not legally separate from their owners nor are they separately taxed. Corporations are legal entities authorized by states; they are separately taxed and offer limited liability to their creditors.

3. When a person decides to establish a proprietorship, he or she merely acquires the necessary cash, inventory, equipment, business license, and other assets and begins providing goods or services to customers. The same is true for a partnership, except that two or more persons are involved and so together must decide which assets will be acquired and how business will be conducted.

4. Anything that terminates or changes the contract between partners (including the death of a partner) legally dissolves the partnership. The legal dissolution does not mean that the business must cease operations, however. Usually, partnership agreements specify how modifications in ownership should be handled, so there is often no outward indication that any change has taken place.

5. As long as the partners' actions are within the scope of the normal business activity of the partnership, all partners are legally responsible for each other's actions. In fact, creditors can even seek payment for claims authorized by a departed partner from the personal assets of the remaining partners.

6. The only type of business entity in which all owners have limited liability is the corporation.

7. Corporate profits are subject to double taxation in that most corporations pay taxes on their profits, and then stockholders pay taxes on dividends distributed to them by corporations.

8. The major difference between common and preferred stock is in the rights granted to holders. Common stockholders have voting rights, while preferred stockholders usually do not. Common stockholders also have a residual type of equity in that each stockholder shares dividends and assets upon liquidation, after the rights and privileges of creditors and preferred stockholders are satisfied. Preferred stockholders usually have dividend and liquidation privileges that are superior to those of the common stockholders. Two dividend privileges associated with preferred stock are the current-dividend preference and the cumulative-dividend preference.

9. Historically, all stock was par-value stock. When sold at a price above par, it was said to have sold at a "premium." When sold at a price below par, it was said to have sold at a "discount." Now, however, most states have passed laws that forbid the initial sale of stock by corporations to investors below par, so par value has become less meaningful. Originally, the concept of par value was thought to protect creditors and investors because it provided a minimum level of assets that could not be impaired. Par value does not establish value in the market, and the idea that it provided a realistic minimum level of protection for creditors was ill conceived. Accountants use par value to identify the approximate legal capital of a corporation, although some states view all paid-in capital as the corporation's legal capital.

10. There are many reasons why a firm would buy back shares of its own stock. Five of the most common are that management may (1) want the stock for a profit-sharing, bonus, or

stock-option plan for the employees; (2) feel that the stock is selling for an unusually low price and is a good buy; (3) want to stimulate trading in the company's stock; (4) want to remove some shares from the market in order to avoid a hostile takeover; and (5) want to increase reported earnings per share by reducing the number of shares of stock outstanding.

11. Treasury stock is not an asset, because in many ways it is not different from the unissued stock of a corporation. Some people argue that the debit balance in the treasury stock account should be reported on the balance sheet as an asset rather than as a reduction in equity. Their argument is that treasury stock can be sold for cash just as readily as can the shares of other corporations. However, because treasury stock does not provide voting or dividend rights, as do investments in stocks of other corporations, it is not considered an asset. Also, most states impose certain restrictions on the amount of treasury stock a corporation can hold at any one time. Finally, it is generally agreed that a company cannot own part of itself.

12. Treasury stock is usually accounted for on the cost basis. That is, when repurchased, it is recorded at cost regardless of whether or not it has a par value. When sold, it is taken off the books at cost. And, while being held, treasury stock is shown on the balance sheet as a contra-equity account.

13. The equity section identifies sources of assets by showing the ways money comes into a firm. There are only three major sources of funds: borrowing money, earning money, and issuing stock. The latter two sources are reported in the equity section. Thus, by studying the equity section, a financial statement reader can identity how much of a firm's assets were financed by earnings and how much by issuing stock. (*Note:* There is one other way to obtain funds: by selling productive assets such as plant or equipment. However, this source cannot be viewed as a long-term solution to a business's funding problems.)

14. The Retained Earnings balance of a corporation is increased by net income and can also be increased by prior-period adjustments that would have increased prior years' earnings. Retained Earnings is decreased by the declaration of dividends and can also be decreased by prior-period adjustments that would have reduced prior years' earnings. Retained Earnings is also decreased by net losses and by certain treasury stock transactions.

15. A firm can have a large Retained Earnings balance and no cash because cash coming into a firm through earnings may be used to purchase other assets such as plant or equipment. If a firm did not spend any of its earnings, it would be difficult to have a large Retained Earnings balance and no cash. A cash-poor, high-earnings firm is like an individual who makes $1 million a year but, because he or she spends $2 million, is always in financial difficulty. Retained Earnings merely shows that a firm has had earnings; it does not guarantee that the cash from those earnings is still on hand.

16. Companies are usually barred from paying cash dividends if their Retained Earnings balance (or sometimes their total equity) is less than the amount of the dividend. Sometimes, a company's board of directors will also place formal restrictions on retained earnings, which become legally binding.

17. A person buying common stock should examine the dividend preferences of the preferred stock because those preferences can significantly affect the amount of dividends common stockholders receive. For example, if preferred stock is cumulative, common stockholders will usually receive substantially less in dividends than if the preferred stock is noncumulative.

18. The dividend payout ratio is computed by dividing the dividends declared by the net income for the year. The result can be interpreted as the percentage of income for the year that was paid out to stockholders in the form of cash dividends. The dividend payout ratio for Deedle Company indicates that the company paid out 40% of its net income for the year as cash dividends.

19. Accumulated other comprehensive income is a separate category of equity that summarizes the effect on equity that results from market-related increases and decreases in the reported values of assets and liabilities.

This concept was adopted to allow the reporting of market values on the balance sheet while keeping the income statement uncluttered with gains and losses from market value changes. This approach allows the balance sheet to report more relevant numbers and yet keep the income statement focused on reporting profits from the activities of the business.

20. There are a few equity items that bypass the income statement and are referred to as "other equity items." Two of the most common are:

a. Foreign currency translation adjustments
b. Unrealized gains and losses on certain investments

PRACTICE EXERCISES

PE 11–1 (LO1) Characteristics of Proprietorships and Partnerships

The correct answer is A. Proprietorships and partnerships are not limited in size. However, most proprietorships and partnerships are smaller than corporations because of the nature of their businesses.

PE 11–2 (LO2) Characteristics of Corporations

The correct answer is B. Corporations do not have a limited life. For example, DuPont, one of the oldest corporations in the world, began operations in 1802.

PE 11–3 (LO2) Characteristics of Common Stock and Preferred Stock

The correct answer is B.

a. False. Preferred stockholders usually do not have any voting power in corporate matters.
b. True. Once all loans have been repaid and the claims of the preferred stockholders have been met, all the excess assets belong to the common stockholders.
c. False. Preferred stock is not better than common stock. It is just different.
d. False. Preferred stockholders receive dividends before common stockholders.
e. False. Companies may issue convertible preferred stock, which may be converted into common stock at a specified conversion rate.

PE 11–4 (LO3) Issuance of No-Par Common Stock

Cash	1,125,000	
Common Stock		1,125,000
Issued 25,000 shares of no-par common stock at $45 per share.		

PE 11–5 (LO3) Issuance of Common Stock for Cash

Cash (3,000 shares × $40)	120,000	
Common Stock (3,000 shares × $1 par value)		3,000
Paid-In Capital in Excess of Par, Common Stock (3,000 shares × $39)		117,000
Issued 3,000 shares of $1 par-value common stock at $40 per share.		

PE 11–6 (LO3) Issuance of Common Stock for Other Assets

Building (10,000 shares × $40)	400,000	
Common Stock (10,000 shares × $0.01 par value)		100
Paid-In Capital in Excess of Par, Common Stock (10,000 shares × $39.99)		399,900
Issued 10,000 shares of $0.01 par-value common stock for building (10,000 shares × $40 per share = $400,000).		

PE 11–7 (LO3) Accounting for Stock Repurchases

Treasury Stock, Common (1,500 shares × $64)	96,000	
Cash		96,000
Purchased 1,500 shares of treasury stock at $64 per share.		

PE 11–8 (LO3) Accounting for Sale of Treasury Stock at Price Higher than Cost

Cash (400 shares × $80)	32,000	
Treasury Stock, Common (400 shares × $64 cost)		25.600
Paid-In Capital, Treasury Stock [400 × ($80 – $64)]		6,400
Reissued 400 shares of treasury stock at $80 per share.		

PE 11–9 (LO3) Accounting for Sale of Treasury Stock at Price Lower than Cost

Cash (300 shares × $56)	16,800	
Paid-In Capital, Treasury Stock*	2,400	
Treasury Stock, Common (300 shares × $64 cost)		19,200
Reissued 300 shares of treasury stock at $56 per share.		

*Assuming a credit balance in this account of at least $2,400. Otherwise, the debit would be to Retained Earnings.

PE 11–10 (LO3) Accounting for Sale of Treasury Stock at Price Lower than Cost

Cash (800 shares × $60)	48,000	
Paid-In Capital, Treasury Stock	2,000	
Retained Earnings	1,200	
Treasury Stock, Common (800 shares × $64 cost)		51,200
Reissued 800 shares of treasury stock at $60 per share; original cost was $64 per share.		

PE 11–11 (LO4) Dividend Declaration Accounting

Dividends, Preferred Stock	45,000*	
Dividends, Common Stock	30,000	
Dividends Payable		75,000
Declared dividends on preferred and common stock.		

*Preferred stock dividend = $30 × 0.10 × 15,000 shares = $45,000.

PE 11–12 (LO4) Dividend Payment Accounting

Dividends Payable	75,000	
Cash		75,000
Paid dividends on preferred and common stock.		

PE 11–13 (LO4) Dividend Closing Entry (or Entries)

Retained Earnings	75,000	
Dividends, Preferred Stock		45,000
Dividends, Common Stock		30,000
To close dividends to Retained Earnings.		

PE 11–14 (LO4) Dividend Payout Ratio

$$\text{Dividend payout ratio} = \frac{\text{Cash dividends}}{\text{Net income}} = \frac{\$19{,}000}{\$76{,}000} = 25.0\%$$

PE 11–15 (LO4) Stock Dividends and Stock Split

Items	Stock dividend	Stock split
(a) Number of shares outstanding	Increase	Increase
(b) Total equity	No change	No change
(c) Retained earnings	Decrease	No change
(d) Common stock	Increase	No change

PE 11–16 (LO4) Stock Split

There's no entries necessary to record on the book, just to memo it.

PE 11–17 (LO5) Balance Sheet Preparation

Contributed capital:	
Preferred stock ($20 par value, 2,500 shares issued and out standing)	$ 50,000
Common stock ($1 par value, 8,400 shares issued, 8,000 outstanding)	8,000
Paid-in capital in excess of par, common stock	492,000
Total contributed capital	$550,000
Retained earnings	200,000
Total contributed capital and retained earnings	$750,000
Less treasury stock (400 shares of $1 common at cost of $45)	(18,000)
Total equity	$732,000

PE 11–18 (LO5) Statement of Comprehensive Income

Net income	$104,000
Foreign currency translation adjustment	8,000
Unrealized loss on investments	(22,000)
Comprehensive income	$90,000

EXERCISES

E11-1(LO2) Characteristics of a Corporation

1. True.
2. True.
3. False. Most of the largest U.S. corporations are publicly held corporations.
4. True.
5. False. The net income of a corporation is taxed as a separate entity.
6. False. Creditors have no legal claim on the personal assets of the owners of a corporation if the corporation does not pay its debts.
7. False. The transfer of shares from one owner to another does not require the approval of either the corporation or other shareholders; it is entirely at the discretion of the shareholder.
8. False. The board of directors of a corporation manages the corporation for the shareholders, who legally own the corporation.
9. True.
10. False. Corporations are subject to more government regulations than partnerships or proprietorships.

E 11–2 (LO3) No-Par Stock Transactions

1. a. Cash	744,000	
Common Stock		744,000
Issued 31,000 shares of no-par common stock at $24 per share.		
b. Cash	109,200	
Common Stock		109,200
Issued 3,900 shares of no-par common stock at $28 per share.		
c. Building	90,000	
Common Stock		90,000
Issued 3,000 shares of no-par common stock for a building.		
d. Dividends	56,850	
Dividends Payable		56,850

Declared a $1.50-per-share dividend on common stock.

e.	Revenues	405,000	
	Retained Earnings		187,000
	Expenses		218,000
	Closed revenues and expenses for the year to Retained Earnings.		
f.	Retained Earnings	56,850	
	Dividends		56,850
	Closed dividends to Retained Earnings.		

2.	Common stock (no par)	$ 943,200
	Retained earnings	130,150*
	Total equity	$1,073,350

*$187,000 – $56,850

E 11–3 (LO3) **Treasury Stock Transactions**

a. No journal entry is required, but a memo note would be recorded in the company's board of directors' minutes.

b.	Cash	750,000	
	Common Stock		500,000
	Paid-In Capital in Excess of Par Value, Common Stock		250,000
	Issued 50,000 shares of $10 common stock at $15 per share.		
c.	Treasury Stock	57,000	
	Cash		57,000
	Purchased 3,000 shares of treasury stock at $19 per share.		
d.	Treasury Stock	31,500	
	Cash		31,500
	Purchased 1,500 shares of treasury stock at $21 per share.		
e.	Cash	28,800	
	Treasury Stock		22,800
	Paid-In Capital, Treasury Stock		6,000
	Reissued 1,200 shares of treasury stock that cost $19 per share for $24 per share.		
f.	Cash	24,000	
	Paid-In Capital, Treasury Stock	6,000	
	Retained Earnings	1,500	
	Treasury Stock		31,500
	Reissued 1,500 shares of treasury stock that cost $21per share for $16 per share.		

g.

$	57,000	(c)
+	31,500	(d)
–	22,800	(e)
–	31,500	(f)
$	34,200	balance

E 11–4 (LO4) Dividend Calculations

Case	Preferred Stock	Common Stock
A	$1,600,000 × 6% = $ 96,000	$304,000 (remaining portion)
B	$1,600,000 × 6% = $ 96,000 (current year) 288,000 (arrears—3 years) $384,000	$ 16,000 (remaining portion)

E 11–5 (LO4) Dividend Payout Ratio

	Iris	Orchid	Columbine
Cash dividends	$ 30	$ 200	$ 340
Net income	÷ $310	÷ $420	÷ $460
Dividend payout ratio	0.10	0.48	0.74

E 11–6 (LO4) Stock Dividends

July 1	Stock Dividends *(NT$33× 37,500)*	1,237,500	
	Stock Dividends Distributable *(NT$10× 37,500)*		375,000
	Paid-in Capital in Excess of Par *(NT$23× 37,500)*		862,500
	Declaration of 15% stock dividends		
July 31	Stock Dividends Distributable	375,000	
	Common Stock		375,000
	Issuing 37,500 dividend shares		

E 11–7 (LO4) Stock Dividends

July 1	Stock Dividends *(NT$10× 62,500)*	625,000	
	Stock Dividends Distributable		625,000
	Declaration of 25% stock dividends		

E 11-8(LO4) Comparing Effects of Share Dividends and Share Split

	Before Action	After Share Dividend	After Share Split
Equity			
Common stock	$ 600,000	$ 642,000	$ 600,000
Capital Surplus	0	49,000[(1)]	0
Retained earnings	1,720,000	[(2)]	
Total equity	$2,320,000	1,629,000	1,720,000

		$2,320,000	$2,320,000
Outstanding shares	50,000	57,000	100,000
Par value per share	$ 6	$ 6	$ 3

(1)7,000 X ($13 – $6) (2) $1,720,000 – (7,000 X $13)

E 11–9 (LO3, LO4) Stock Issuance and Cash Dividends

a.	Cash	1,000,000	
	Common Stock		1,000,000
	Issued 25,000 shares of no-par common stock at $40 per share.		
b.	Building	100,000	
	Preferred Stock		75,000
	Paid-In Capital in Excess of Par, Preferred Stock		25,000
	Issued 3,000 shares of preferred stock in exchange for a building (building fair market value = $100,000; 3,000 × $25 = $75,000).		
c.	Dividends, Preferred Stock	9,000	
	Dividends, Common Stock	100,000	
	Dividends Payable		109,000
	Declared dividends on preferred and common stock (preferred: 3,000 × $25 × 0.12 = $9,000; common: 25,000 × $4.00 = $100,000).		

E 11–10 (LO3, LO4) Stock Issuance, Treasury Stock, and Dividends

a.	Cash	2,090,000	
	Common Stock		475,000
	Paid-In Capital in Excess of Par, Common Stock		1,615,000
	Issued 95,000 shares of common stock at $22 per share (95,000 × $22 = $2,090,000; 95,000 × $5 = $475,000).		
b.	Cash	234,000	
	Preferred Stock		180,000
	Paid-In Capital in Excess of Par, Preferred Stock		54,000
	Issued 18,000 shares of preferred stock at $13 per share (18,000 × $13 = $234,000; 18,000 × $10 = $180,000).		
c.	Treasury Stock	300,000	
	Cash		300,000
	Purchased 10,000 shares of outstanding common stock at $30 per share (10,000 × $30 = $300,000).		

E 11–10 (LO3, LO4) (Continued)

d.	Cash	27,000	
	Retained Earnings	3,000	
	Treasury Stock		30,000
	Reissued 1,000 shares of treasury stock at \$27 per share (1,000 × \$27 = \$27,000).		
e.	Dividends, Preferred Stock	12,600	
	Dividends, Common Stock	14,800	
	Dividends Payable		27,400
	Declared dividends on preferred and common stock.		

Dividend calculations:
Preferred dividend:
18,000 × \$10 × 7% = \$12,600
Common dividend:

Total dividend	\$27,400
Less preferred dividend	12,600
Common stock dividend	\$14,800

f.	Dividends Payable	27,400	
	Cash		27,400
	Paid dividends to preferred and common stock-holders.		

E 11–11 (LO3, LO4) Stock Transactions and Dividends

a.	Cash	896,000	
	Common Stock		896,000
	Issued 28,000 shares of common stock at \$32 per share (28,000 × \$32).		
b.	Land	200,000	
	Preferred Stock		120,000
	Paid-In Capital in Excess of Par, Preferred Stock		80,000
	Issued 15,000 shares of preferred stock at \$13.33 per share for land (15,000 shares × \$8 par value = \$120,000; remainder is paid-in capital).		
c.	Dividends, Preferred Stock	14,400	
	Dividends, Common Stock	56,000	
	Dividends Payable		70,400
	Declared dividends on preferred and common stock (preferred: 15,000 × \$8 × 12%; common: 28,000 × \$2).		

d. The entire amount of the dividend would be paid to preferred stockholders.

E 11–12 (LO3, LO4) Stock Issuance, Treasury Stock, and Dividends

1\.

2018			
Jan. 15	Cash	104,000	
	Common Stock		104,000
	Issued 6,500 shares of common stock at par value.		
Feb. 6	Dividends, Common Stock	60,650	
	Dividends Payable		60,650
	Declared a 50¢-per-share dividend to common stockholders of record on March 6, 2018.		
Mar. 6	No entry		
8	Cash	346,000	
	Common Stock		320,000
	Paid-In Capital in Excess of Par, Common Stock		26,000
	Issued 20,000 shares of stock for $346,000 or $17.30 per share (20,000 × $16 = $320,000; 20,000 × $1.30 = $26,000).		
Apr. 6	Dividends Payable	60,650	
	Cash		60,650
	Paid 50¢-per-share dividend on common stock.		
June 19	Treasury Stock	9,350	
	Cash		9,350
	Purchased 800 shares of treasury stock.		
Sept. 6	Dividends, Common Stock	77,275	
	Dividends Payable		77,275
	Declared a 55¢-per-share dividend to common stockholders of record on October 15 (141,300 – 800 = 140,500; 140,500 × $0.55 = $77,275).		

E 11–12 (LO3, LO4) (Continued)

2018			
Oct. 6	No entry		
15	No entry		
Nov. 16	Dividends Payable	77,275	
	Cash		77,275
	Paid 55¢-per-share dividend on common stock.		
Dec. 15	Dividends, Preferred Stock	34,560	
	Cash		34,560
	Paid 6% cash dividend on preferred stock (18,000 shares × $32 × 6%).		

2. The following dividends were paid during 2018.

To common stockholders ($60,650 + $77,275)	$137,925
To preferred stockholders	34,560
Total dividends paid	$172,485

E 11–13 (LO3, LO4) Analysis of Equity

1. 6,000 shares at $40 = $240,000

2. $\dfrac{\$318{,}000 + \$129{,}000}{53{,}000 \text{ shares}} = \$8.43$ per share

3. $3 ($43 – $40) × 6,000 shares = $18,000

4. $2,000/350 shares = $5.71 per share

5. $240,000 + $318,000 + $18,000 + $129,000 + $86,000 – $2,000 = $789,000

6. $67,000 – (6% × $240,000) = $52,600

E 11–14 (LO3, LO4) Preparing the Equity Section

Spring Company
Partial Balance Sheet
December 31, 2018

Equity	
Contributed capital:	
Preferred stock (8%, $50 par value, 50,000 shares authorized, 5,000 shares issued and outstanding)	$ 250,000
Common stock ($1 par value, 100,000 shares authorized, 70,000 shares issued and outstanding)	70,000
Paid-in capital in excess of par, preferred stock	5,000
Paid-in capital in excess of par, common stock	1,330,000
Total contributed capital	$1,655,000
Retained earnings	400,000*
Total equity	$2,055,000

*$350,000 (beginning balance) + $125,000 (net income) – $75,000 (dividends) = $400,000

E 11–15 (LO5) Comprehensive Income

Larkin Company
Statement of Comprehensive Income

Net income	$100,000
Unrealized loss on long-term investment portfolio	(10,000)
Foreign currency translation adjustment	20,000
Comprehensive income	$110,000

E 11–16 (LO5) Other Equity Items

1. $46.4 ($70.9 – $24.5)
2. $24.5—the total amount of retained earnings
3. $30.8 ($25.6 + $5.2)
4. Most of the increase in equity came from the market value increase in certain debt and equity securities. None of the increase came from earnings that were retained.

PROBLEMS

P11-1(LO3) Accounting for Treasury Stock

(a)

Apr.	1	Treasury Stock (10,000 X £7)	70,000	
		Cash		70,000
July	1	Cash (1,600 X £10)	16,000	
		Treasury Stock (1,600 X £7)		11,200
		Paid-in Capital—Treasury Stock (1,600 X £3)		4,800
Oct.	1	Cash (3,400 X £9)	30,600	
		Treasury Stock (3,400 X £7)		23,800
		Paid-in Capital—Treasury Stock (3,400 X £2)		6,800
Dec.	1	Cash (2,000 X £5)	10,000	
		Paid-in Capital— Treasury stock (2,000 X £2)	4,000	
		Treasury Stock (2,000 X £7)		14,000
	31	Income Summary	80,000	
		Retained Earnings		80,000

(b)

Paid-In Capital – Treasury stock

12/1	4,000	7/1	4,800
		10/1	6,800
		End. Bal.	7,600

Retained Earnings

		Beg. Bal.	200,000
		12/31	80,000
		End. Bal.	280,000

Treasury Stock

4/1	70,000	7/1	11,200
		10/1	23,800
		12/1	14,000
		End. Bal.	21,000

(c)

Lilbourg Company
Balance Sheet (Partial)
December 31, 2018

Equity	
Common Stock	
£1 par, 800,000 shares issued and 797,000 outstanding	£ 800,000
Paid-in Capital in excess of par	1,000,000
Paid-in Capital—Treasury stock	7,600
Retained Earnings	280,000
Less: Treasury Stock (3,000 shares)	21,000
Total Equity	£2,,066,600

P 11–2 (LO4) Dividend Calculations

1. In this case, preferred stockholders should receive $15,000 for each year (10,000 shares × 0.10 × $15) and common stockholders will receive the rest. Thus, the allocations for 2017 and 2018 are as follows:

Year	Total Dividends	Preferred	Common
2017	$ 8,000	$ 8,000	$ 0
2018	92,000	15,000	77,000
	$100,000	$23,000	$77,000

2. In this case, preferred stockholders should receive $15,000 each year plus dividends in arrears. In 2018, dividends of $7,000 are in arrears from 2017. Common stockholders receive the remainder.

Year	Total Dividends	Preferred	Common
2017	$ 8,000	$ 8,000	$ 0
2018	92,000	22,000	70,000
	$100,000	$30,000	$70,000

3. In this case, preferred stockholders would receive $8,000 in 2017, and common stockholders would get nothing. In 2018, preferred stockholders would get $52,000 ($15,000 for 2018, $7,000 for 2017, $15,000 for 2016, and $15,000 for 2015). Common stockholders would get the remaining $40,000.

Year	Total Dividends	Preferred	Common
2017	$ 8,000	$ 8,000	$ 0
2018	92,000	52,000	40,000

$100,000	$60,000	$40,000

P 11–3 (LO4) Dividend Calculations

1. In this case, preferred stockholders should receive $128,000 (80,000 shares × $20 par value × 0.08), and common stockholders should get the rest. Thus, in the years 2016–2018, the allocation would be as follows:

Year	Total Dividends	Preferred Stock	Common Stock
2016	$ 50,000	$ 50,000	$ 0
2017	280,000	128,000	152,000
2018	340,000	128,000	212,000

2. In this case, preferred stockholders should receive $128,000 each year plus dividends in arrears. In 2017, dividends of $78,000 are in arrears from 2016. Common stockholders then receive all other dividends, as shown below.

Year	Total Dividends	Preferred Stock	Common Stock
2016	$ 50,000	$ 50,000	$ 0
2017	280,000	206,000	74,000
2018	340,000	128,000	212,000

3. A common stockholder should know about the dividend privileges of preferred stockholders because, as the above shows, those privileges can significantly affect the amount of dividends common stockholders receive.

P 11–4 (LO4) Dividend Payout Ratio

1.

	A	B	C
Cash dividends	$ 0	$ 200	$1,200
Net income	÷ $800	÷ $1,400	÷ $1,800
Dividend payout ratio	0	0.143	0.667

2. The company most likely to be a high-growth Internet company is A, which has a 0% dividend payout ratio. Young or rapidly growing companies tend to have low dividend payout ratios, preferring to retain the profits in the business in order to help fund their expansion. The company most likely to be an old, stable company is C with the highest dividend payout ratio.

P11-5(LO4) Dividends, Stock Split, and Equity Section

(a)	Feb. 1	Cash Dividends (96,000 X €1)	96,000	
		Dividends Payable		96,000

Mar.	15	Dividends Payable	96,000	
		Cash		96,000
Apr.	30	Memo—five-for-one share split increases number of shares to 480,000 = (96,000 X 5) and reduces par value to €5 per share.		
July	1	Share Dividends (48,000 X €7)	336,000	
		Stock Dividends Distributable (48,000 X €5)		240,000
		Paid-in capital in excess of par (48,000 X €2)		96,000
	31	Stock Dividends Distributable	240,000	
		Common Stock		240,000
Dec.	1	Cash Dividends (528,000 X €.40)	211,200	
		Dividends Payable		211,200
	31	Income Summary	700,000	
		Retained Earnings		700,000
		Retained Earnings	336,000	
		Share Dividends		336,000
		Retained Earnings	307,200	
		Cash Dividends		307,200

P 11-5 (Continued)

(b)

Common Stock

		Beg. Bal.	2,400,000
		7/31	240,000
		End. Bal.	2,640,000

Stock Dividends distributable

7/31	240,000	Beg. Bal.	240,000
		End. Bal.	0

Paid-In Capital in Excess of Par

		Beg. Bal.	400,000
		7/1	96,000
		End. Bal.	496,000

Retained Earnings

7/31	1,564,000	Beg. Bal.	1,200,000
7/31	307,200	7/31	700,000
		End. Bal.	1,256,800

Dividends

2/1	96,000		
12/1	211,200	12/31	307,200
		End. Bal.	0

Share dividends

7/1	336,000	12/31	336,000
		End. Bal.	0

SOUTH-WESTERN
CENGAGE Learning

P 11-5 (Continued)

(c)

Allergo Company
Balance sheet (Partial)
December 31, 2018

Equity	
Common stock, €5 par value, 528,000 shares issued and outstanding	€2,640,000
Paid-in Capital in excess of par	496,000
Retained earnings	1,256,800
Total equity	€4,392,800

P11-6 (LO 3, 4) Stock Transactions and Analysis

1.	a. Cash	4,000	
	Common Stock		2,000
	Paid-In Capital in Excess of Par, Common Stock		2,000
	Issued 200 shares of common stock.		

b. $125,000 + $2,000 = $127,000

2.	a. Cash	20,400	
	Preferred Stock		20,000
	Paid-In Capital in Excess of Par, Preferred Stock		400
	Issued 200 shares of preferred stock.		

b. $1,000 + $400 = $1,400

3.	a. Building	11,000	
	Common Stock		5,000
	Paid-In Capital in Excess of Par, Common Stock		6,000
	Issued 500 shares of common stock for a building.		

b. $850,000 + $11,000 = $861,000

4.	a. Treasury Stock	23,000	
	Cash		23,000
	Purchased 1,000 shares of treasury stock.		
	Cash	21,500	
	Paid-In Capital, Treasury Stock	1,000	
	Retained Earnings	500	
	Treasury Stock		23,000
	Reissued 1,000 shares of treasury stock.		

b. $1,000 – $1,000 = $0

5.	a. Dividends, Preferred Stock	35,000	
	Dividends, Common Stock	40,000	
	Dividends Payable		75,000
	Declared dividends on preferred and common stock (5,000 shares × $100 par × 7% = $35,000; $75,000 – $35,000 = $40,000).		

b. $310,000 – $75,000 = $235,000

P 11–7 (LO3, LO4) Stock Transactions and the Equity Section

1\.

a.	Cash	186,000	
	Preferred Stock		150,000
	Paid-In Capital in Excess of Par, Preferred Stock		36,000
	Issued 3,000 shares of preferred stock at $62 per share.		
b.	Treasury Stock	42,500	
	Cash		42,500
	Purchased 2,500 shares of treasury stock at $17 per share.		
c.	Retained Earnings	179,250	
	Cash		179,250
	Paid dividends to common and preferred stockholders (preferred: 12,000 shares × $50 par × 7% = $42,000; common: 91,500 shares × $1.50 = $137,250).		
d.	Cash	18,000	
	Treasury Stock		15,300
	Paid-In Capital, Treasury Stock		2,700
	Reissued 900 shares of treasury stock at $20 per share.		
e.	Cash	25,600	
	Paid-In Capital, Treasury Stock	1,600	
	Treasury Stock		27,200
	Reissued 1,600 shares of treasury stock at $16 per share.		
f.	Revenues	350,000	
	Retained Earnings		83,000
	Expenses		267,000
	Closed net income for the year to Retained Earnings.		

2\. The equity section can be easily prepared if T-accounts are used to update the account balances, as follows:

P 11–7 (LO3, LO4) (Continued)

Preferred Stock

	Beg. Bal.	450,000
	(a)	150,000
	End. Bal.	600,000

Common Stock

	Beg. Bal.	752,000
	End. Bal.	752,000

Paid-In Capital in Excess of Par, Preferred Stock

	Beg. Bal.	125,000
	(a)	36,000
	End. Bal.	161,000

Paid-In Capital in Excess of Par, Common Stock

	Beg. Bal.	326,000
	End. Bal.	326,000

Treasury Stock

(b)	42,500	(d)	15,300
		(e)	27,200
End. Bal.	0		

Paid-In Capital, Treasury Stock

(e)	1,600	(d)	2,700
		End. Bal.	1,100

Retained Earnings

(c)	179,250	Beg. Bal.	540,000
		(f)	83,000
		End. Bal.	443,750

Saratoga Springs Company
Partial Balance Sheet
December 31, 2018

Equity	
Contributed Capital:	
Preferred stock (7%, $50 par value, noncumulative, 22,000 shares authorized, 12,000 shares issued and outstanding)	$ 600,000
Common stock (110,000 shares authorized, $8 par value, 94,000 shares issued and outstanding)	752,000
Paid-in capital in excess of par, preferred stock	161,000
Paid-in capital in excess of par, common stock	326,000
Paid-in capital, treasury stock	1,100
Total contributed capital	$1,840,100
Retained earnings	443,750
Total equity	$2,283,850

P 11–8 (LO3, LO4) Equity, Dividends, and Treasury Stock

1\. 2018

Jan. 20	Dividends Payable	10,000	
	Cash		10,000
	Paid the $2-per-share cash dividend on common stock that was declared on December 15, 2017.		
Aug. 15	Treasury Stock	20,000	
	Cash		20,000
	Reacquired 1,000 shares of common stock at $20 per share.		
Sept. 30	Cash	10,500	
	Treasury Stock		10,000
	Paid-In Capital, Treasury Stock		500
	Reissued 500 shares of treasury stock at $21 per share (purchase price = $20).		
Oct. 15	Dividends, Common Stock	13,500	
	Cash		13,500
	Declared and paid cash dividends of $3 per share on common stock.		

Number of shares is calculated as follows:

5,000	Beginning balance
(1,000)	August 15
500	September 30
4,500	Ending balance

Nov. 1	Cash	3,600	
	Paid-In Capital, Treasury Stock	400	
	Treasury Stock		4,000
	Issued 200 shares of treasury stock at $18 per share (purchase price = $20).		
Dec. 15	Dividends, Preferred Stock	5,000	
	Cash		5,000
	Declared and paid the 10% cash dividend on preferred stock ($50,000 × 0.10).		

P 11–8 (LO3, LO4) (Continued)

31	Revenues	260,000	
	Retained Earnings		40,000
	Expenses		220,000
	*Closed net income to Retained Earnings.*2018		
Dec. 31	Retained Earnings	18,500	
	Dividends, Preferred Stock		5,000
	Dividends, Common Stock		13,500
	Closed dividends to Retained Earnings.		

2. The equity section is easily prepared by using the following T-accounts to accumulate the end-of-period balances.

Preferred Stock

		Beg. Bal.	50,000

Common Stock

		Beg. Bal.	75,000

Paid-In Capital in Excess of Par, Preferred Stock

		Beg. Bal.	2,000

Paid-In Capital in Excess of Par, Common Stock

		Beg. Bal.	25,000

Retained Earnings

		Beg. Bal.	102,000
12/31	18,500	12/31	40,000
		End. Bal.	123,500

Treasury Stock

8/15	20,000	9/30	10,000
		11/1	4,000
End. Bal.	6,000		

Paid-In Capital, Treasury Stock

11/1	400	9/30	500
		End. Bal.	100

Dividends, Common Stock

10/15	13,500	12/31	13,500
End. Bal.	0		

Dividends, Preferred Stock

12/15	5,000	12/31	5,000
End. Bal.	0		

P 11–8 (LO3, LO4) (Continued)

Nielsen Corporation
Partial Balance Sheet
December 31, 2018

Equity	
Contributed Capital:	
Preferred stock ($50 par value, 10%, 10,000 shares authorized, 1,000 shares issued and outstanding)	$ 50,000
Common stock ($15 par value, 100,000 shares authorized, 5,000 shares issued, 4,700 shares outstanding)	75,000
Paid-in capital in excess of par, preferred stock	2,000
Paid-in capital in excess of par, common stock	25,000
Paid-in capital, treasury stock	100
Total contributed capital	$152,100
Retained earnings	123,500
Total contributed capital plus retained earnings	$275,600
Less treasury stock (300 shares of common stock at $20 cost)	(6,000)
Total equity	$269,600

3. Earnings per share is computed by dividing net income by the number of shares of common stock outstanding. When a company purchases treasury stock, fewer shares are outstanding. However, purchasing treasury stock also uses corporate assets (cash), so the amount of assets available to generate earnings also decreases. Accordingly, the net effect on earnings per share from a treasury stock purchase is not certain.

P 11–9 (LO3, LO4) Dividend Transactions and Calculations

1. 2018

Jan.	1	Memo entry: Received authorization for 150,000 shares of 5% cumulative preferred stock, par value $15.		
	2	Cash	280,000	
		Preferred Stock		210,000
		Paid-In Capital in Excess of Par, Preferred Stock		70,000
		Issued 14,000 shares of preferred stock at $20 per share.		

P 11–9 (LO3, LO4) (Continued)

June	1	Treasury Stock	900,000	
		Cash		900,000
		Repurchased 36,000 shares of common stock at $25 per share.		
	2	Dividends, Preferred Stock	10,500	
		Dividends, Common Stock	9,500	
		Dividends Payable		20,000
		Declared a $20,000 cash dividend.		

Calculation of Dividend Distribution:

	Preferred Stock	Common Stock
Current preference	$10,500	
Remaining portion		$9,500
	$10,500	$9,500

	30	Dividends Payable	20,000	
		Cash		20,000
		Paid the cash dividend.		

2.

	Total Dividends	Preferred Stock	Common Stock
June 2	$ 20,000	$10,500	$ 9,500
December 31	150,000	0	150,000
	$170,000	$10,500	$159,500

3. The preferred stockholders did not receive the current-dividend preference of $10,500 in part (2) because they had already received the full annual dividend for 2018 on June 30 (declared June 2).

P 11–10 (LO3, LO4) Preparing the Equity Section and Recording Dividends

1.

The Candy Jar
Partial Balance Sheet
December 31, 2018

Equity	
Contributed Capital:	
Preferred stock (10%, $20 par value, cumulative 50,000 shares authorized, issued, and outstanding)	$1,000,000
Common stock ($15 par value, 300,000 shares authorized, 150,000 shares issued and outstanding)	2,250,000
Paid-in capital in excess of par, preferred stock	100,000
Paid-in capital in excess of par, common stock	750,000
Total contributed capital	$4,100,000
Retained earnings	700,000*
Total equity	$4,800,000

*Retained earnings calculation:

Beginning balance	$ 0
Net income (2015–2018)	1,250,000
Less dividends (2015–2018)	(550,000)
Ending balance	$ 700,000

P 11–10 (LO3, LO4) (Continued)

2. To determine how much of the 2016 dividends go to the preferred and common stockholders, dividends paid in the years 2015–2018 must be examined for dividends in arrears as follows:

Year	Total Dividend	Preferred	Common	Dividends in Arrears at the End of Year
2015	$100,000	$100,000	$ 0	$ 0
2016	300,000	100,000	200,000	0
2017	0	0	0	100,000
2018	150,000	150,000	0	50,000

Dividends, Preferred Stock	150,000	
Cash		150,000
Paid cash dividends of $150,000.		

P 11–11 (LO3, LO4) Equity Calculations

1. Answers to parts (a)–(d) are based on the following journal entries:

Cash (7,000 shares × $12)	84,000	
Common Stock (7,000 shares × $1)		7,000
Paid-In Capital in Excess of Par, Common Stock		77,000
Dividends, Preferred Stock	25,000	
Dividends Payable		25,000
Dividends Payable	25,000	
Cash		25,000
Treasury Stock (3,000 shares × $14)	42,000	
Cash		42,000
Cash (2,500 shares × $16)	40,000	
Treasury Stock (2,500 shares × $14)		35,000
Paid-In Capital, Treasury Stock		5,000

a. $8,000 + $7,000 = $15,000
b. $12,000 + $77,000 = $89,000
c. $5,000
d. $3,000 + $15,000 + $1,500 + $89,000 + $5,000 + $7,400 – $7,000 = $113,900

2. Beginning retained earnings + Net income – Dividends = Ending retained earnings
$18,200 + Net income – $25,000 = $7,400
Net income = $14,200

P 11–12 (LO3, LO4) Unifying Concepts: Stock Transactions and the Equity Section

1. a. No journal entry is required, but a memo entry will be made in the board of directors' minutes.

b.	Cash	600,000	
	Common Stock		500,000
	Paid-In Capital in Excess of Par, Common Stock		100,000
	Issued 25,000 shares of $20 par-value common stock at $24 per share.		
c.	Cash	80,000	
	Preferred Stock		50,000
	Paid-In Capital in Excess of Par, Preferred Stock		30,000
	Issued 10,000 shares of $5 par-value preferred stock at $8 per share.		
d.	Cash	110,000	
	Common Stock, No-Par		110,000
	Issued 5,000 shares of no-par common stock at $22 per share.		
e.	Treasury Stock, Common	25,000	
	Cash		25,000
	Repurchased 1,000 shares of $20 par-value common stock at $25 per share.		
f.	Treasury Stock, Common, No-Par	10,000	
	Cash		10,000
	Repurchased 500 shares of no-par common stock for $20 per share.		
g.	Cash	5,750	
	Retained Earnings	500	
	Treasury Stock, Common		6,250
	Resold, for $23 per share, 250 shares of $20 par-value common stock that was previously purchased at $25 per share.		
h.	Cash	11,500	
	Treasury Stock, Common, No-Par		10,000
	Paid-In Capital, Treasury Stock		1,500
	Reissued no-par treasury stock for $23 per share; the stock was previously purchased for $20 per share.		

P 11–12 (LO3, LO4)   (Continued)

i.	Revenues	90,000	
	Retained Earnings		14,000
	Expenses		76,000
	Closed net income to Retained Earnings.		

2. The equity section can be easily prepared if T-accounts are used to update the account balances, as follows:

Common Stock

		(b)	500,000

Paid-In Capital in Excess of Par, Common Stock

		(b)	100,000

Preferred Stock

		(c)	50,000

Paid-In Capital in Excess of Par, Preferred Stock

		(c)	30,000

Common Stock, No-Par

		(d)	110,000

Treasury Stock, Common

(e)	25,000	(g)	6,250
End. Bal.	18,750		

Treasury Stock, Common, No-Par

(f)	10,000	(h)	10,000
End. Bal.	0		

Retained Earnings

(g)	500	(i)	14,000
		End. Bal.	13,500

Paid-In Capital, Treasury Stock

		(h)	1,500

P 11–12 (LO3, LO4) (Continued)

Richard Corporation
Partial Balance Sheet
December 31, 2018

Equity	
Contributed Capital:	
Preferred stock ($5 par value, 6%, 50,000 shares authorized, 10,000 shares issued and outstanding)	$ 50,000
Common stock ($20 par value, 100,000 shares authorized, 25,000 shares issued, 24,250 shares outstanding)	500,000
Common stock (no par, 50,000 shares authorized, 5,000 shares issued and outstanding)	110,000
Paid-in capital in excess of par, preferred stock	30,000
Paid-in capital in excess of par, common stock	100,000
Paid-in capital, treasury stock	1,500
Total contributed capital	$791,500
Retained earnings	13,500
Total contributed capital plus retained earnings	$805,000
Less treasury stock (750 shares at cost)	(18,750)
Total equity	$786,250

P 11–13 (LO5) Comprehensive Income

1. First, net income must be computed, as follows:

Sales	$60,000
Cost of goods sold	36,000
Gross profit	$24,000
Other operating expenses	8,000
Operating income	$16,000
Interest expense	500
Income before income taxes	$15,500
Income tax expense	5,400
Net income	$10,100

Loveland Company
Statement of Comprehensive Income

Net income	$ 10,100
Unrealized loss on long-term investment portfolio	(9,000)
Foreign currency translation adjustment	(3,700)
Comprehensive income	$ (2,600)

2. Comprehensive income is not necessarily a good measure of the change in a company's value for a given year. Although comprehensive income does include more information about value changes than does net income, this Loveland example illustrates that comprehensive income is not really "comprehensive" after all. For example, increases in the value of long-term operating assets, such as land, are not included in either net income or comprehensive income.

P 11–14 (LO5) **Equity Section with Selected "Other Information"**

1. Glory Company did make a profit in 2018. Since retained earnings was affected by only net income and dividends and since the balance in retained earnings increased by $10.6 million ($51.8 – $41.2), net income exceeded dividends by $10.6 million.

2. Two contributed capital accounts increased during 2018. Common Stock increased by $5.2 million ($48.4 – $43.2) and Paid-In Capital increased by $7.3 million ($22.6 – $15.3) during 2018. Thus, the total amount of money raised by selling stock was $12.5 million.

3. The market value of Glory Company's securities that affect the equity section decreased substantially during the year. The amount of the decrease was $37.6 million ($46.4 accumulated loss at end of year – $8.8 accumulated loss at beginning of year).

4. Even though total equity decreased substantially, it wasn't necessarily management's fault. In fact, it appears that the company was quite profitable in the year 2018 as shown by part (1). The substantial decrease was caused by factors beyond management's control. In particular, the negative foreign currency translation adjustment and the reduction in market value of debt and equity securities were to blame. Unless the board of directors believes management can control such things as the stock market and exchange rates, they probably should not punish management for the decrease in equity.

P 11–15 (LO3, LO5) Unifying Concepts: Stock Transactions, the Equity Section, and the Statement of Changes in Equity

1.

2018				
Feb.	15	Treasury Stock	108,000	
		Cash		108,000
		Purchased 6,000 shares of treasury stock at $18 per share.		
May	21	Cash	73,500	
		Treasury Stock		63,000
		Paid-In Capital, Treasury Stock		10,500
		Reissued 3,500 of the treasury shares purchased on February 15; selling price was $21 per share.		
Sept.	15	Cash	264,000	
		Common Stock		120,000
		Paid-In Capital in Excess of Par, Common Stock		144,000
		Issued 12,000 shares of common stock at $22 per share.		
Dec.	21	Cash	57,500	
		Treasury Stock		45,000
		Paid-In Capital, Treasury Stock		12,500
		Reissued the remaining 2,500 treasury shares purchased on February 15; selling price was $23 per share.		
	31	Revenues	291,600	
		Retained Earnings		91,600
		Expenses		200,000
		Closed net income to Retained Earnings.		

2. Probably the easiest way to prepare the equity section of the balance sheet is to first prepare T-accounts with the beginning equity balances, then post the equity part of the journal entries, and finally compute the ending balances to be reported in the equity section.

P 11–15 (LO3, LO5) (Continued)

Common Stock

		Beg. Bal.	700,000
		9/15	120,000
		End. Bal.	820,000

Paid-In Capital in Excess of Par, Common Stock

		Beg. Bal.	140,000
		9/15	144,000
		End. Bal.	284,000

Treasury Stock

2/15	108,000	5/21	63,000
		12/21	45,000
End. Bal.	0		

Paid-In Capital, Treasury Stock

		5/21	10,500
		12/21	12,500
		End. Bal.	23,000

Retained Earnings

		Beg. Bal.	173,000
		12/31	91,600
		End. Bal.	264,600

JCB Corporation
Partial Balance Sheet
December 31, 2018

Equity	
Contributed Capital:	
Common stock, $10 par value, 150,000 shares authorized, 82,000 shares issued and outstanding	$ 820,000
Paid-in capital in excess of par, common stock	284,000
Paid-in capital, treasury stock	23,000
Total contributed capital	$1,127,000
Retained earnings	264,600
Total equity	$1,391,600

P 11–15 (LO3, LO5) (Continued)

3.

JCB Corporation
Statement of Changes in Equity
For the Year Ended December 31, 2018

	Common Stock Shares	Common Stock Amount	Paid-In Capital in Excess of Par, Common Stock	Retained Earnings	Treasury Stock	Paid-In Capital, Treasury Stock	Total Stockholders' Equity
Balance, December 31, 2017	70,000	$700,000	$140,000	$173,000	$ 0	$ 0	$1,013,000
Net income	....	....	....	91,600	....	....	91,600
Purchase of treasury stock (6,000 shares at $18)...............	....	....	....	....	(108,000)	....	(108,000)
Sale of treasury stock (3,500 shares at $21)...............	....	....	....	....	63,000	10,500	73,500
Issuance of 12,000 previously unissued shares at $22	12,000	120,000	144,000	....	....	....	264,000
Sale of treasury stock (2,500 shares at $23)...............	....	....	....	....	45,000	12,500	57,500
Balance, December 31, 2018	82,000	$820,000	$284,000	$264,600	$ 0	$23,000	$1,391,600

ANALYTICAL ASSIGNMENTS

AA 11–1 To Pay or Not To Pay Dividends

Discussion

Some companies, often known as growth companies, prefer to plow their earnings back into the company rather than to pay dividends. They rationalize that by investing earnings in the company, the company will grow and investors will benefit, because the stock price of the company will increase to recognize the increased value of the company. This is especially true in the high-tech, computer area, where business changes so quickly that earnings must often be invested to keep up. Although investors of Lenny Company are not getting cash dividends, the stock price has gone up 400% so they should be happy. Many investors have doubled, tripled, and even quadrupled their money, depending on when they bought the stock. Paying dividends and investing only part of the earnings back in the company is a more conservative approach, and the stock price of these companies usually doesn't increase as fast as that of growth companies.

AA 11–2 *You Decide:* Should partners of a business be held personally liable for the debts of the business, or should their business activities and debts be kept separate from their personal activities?

Judgment Call

Issues to be discussed with this question are:

1. When one becomes a partner, he or she is liable for the debts of the other partners. Any partner can sign the partnership's name, so there must be a level of trust among the partners.
2. Because of partnership obligations, partners often create a written partnership agreement when they form the partnership that specifies how much money each partner will contribute, how profits and losses will be shared, and so forth. However, all partners are liable for the debts of the partnership.
3. If partners don't want to be personally liable for the actions of the other partners, they should incorporate as a corporation.

AA 11–3 *You Decide:* Should companies be required to pay cash dividends on their stock to shareholders, or should it be left up to the companies' discretion whether they pay dividends or reinvest those funds back in the company?

Judgment Call

Issues to be discussed with this question are:

1. The return an investor gets comes from two sources: (1) from dividends and (2) from increases in the stock price (you can sell the stock at a higher price than you bought it and make a profit).
2. Companies argue that if they don't pay dividends, they can put the money back into the company, make it grow faster, and thus the stock price will increase faster.
3. Companies that pay dividends regularly are referred to as dividend companies, and companies that don't are often referred to as growth companies. Having some companies that pay regular dividends and some that don't provides investors with options.

AA 11–4 Philips

Real Company Analysis

1. Common stockholders received €298 million in dividends.
2. Looking at the statement of changes in equity would indicate that Philips repurchased more shares than it issued during the 2015 fiscal year. Looking at the statement indicates that the company issued 17.7 million shares relating to the dividends distributed and 5.3 million shares relating to the re-issuance of treasury shares during the 2013 fiscal year and repurchased 20.3 million shares.

AA 11–5 Buying Your Own Shares Back

Ethics

Buying back the company's own stock could result in the per-share stock price increasing because it sends a signal that management believes the stock is a good buy. Although the value of the company actually decreases (because cash is used to buy back the stock), there are fewer shares outstanding over which to allocate the smaller value. Theoretically, the stock price should stay the same because the total assets of the company per share are the same. If the stock price goes up, this plan may seem like a win-win situation. If the stock buyback is motivated by management's sincere belief that the stock is under-valued, or if management is using unneeded cash to finance the buyback, then the action seems to be a responsible one. However, if the buyback is merely a ploy to temporarily boost the price per share in order to benefit management bonuses, then clearly the action is not in the best interest of the share-holders.

SOLUTIONS TO "STOP & THINK"

Stop & Think (p. 472): If you were a Microsoft shareholder, would you want to receive a high level of cash dividends, or would you prefer that Microsoft use your share of the profits for business expansion?

If Microsoft were to pay you a cash dividend, what would you do with the money? You might use it for living expenses, for travel, for a new car, or to reinvest somewhere. If you want to use it to reinvest, do you have an investment in mind that you think will be superior to Microsoft? If you don't have any hot stock tips, you might be better off to leave your investment money in the hands of Bill Gates.

Stop & Think (p. 480): Which will have a greater impact on a company's stock price: net income of $100 million or a $100 million unrealized gain from a change in exchange rates or securities prices?

A $100 million unrealized gain from a change in exchange rates or securities prices is a one-time event that reflects an increase of $100 million in the value of the company. There is no reason to believe that a favorable movement in prices or exchange rates this year will be followed by similar changes in future years. In contrast, net income of $100 million represents not only an increase in wealth in the current year, but also suggests that there will be a similar increase next year, the year after, and so on. This continuing stream of income arises because the same business processes that produced the $100 million this year are likely to be in place in future years. Thus, a one-time gain really reflects a single stroke of good fortune for a company, whereas the existence of net income indicates that the company has profitable business processes in place. So, net income of $100 million should have a greater impact on a company's stock price.