

# Accounting Issues: An Essay Series

## Part VIII—Stockholders' Equity

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### ABSTRACT

*This eighth installment in the series on accounting theory pertains to stockholders' equity and its related conceptual, measurement and ethical issues. Coverage includes the associated theoretical, empirical, and popular literature.*

**Keywords:** stockholders' equity, hierarchy, theory

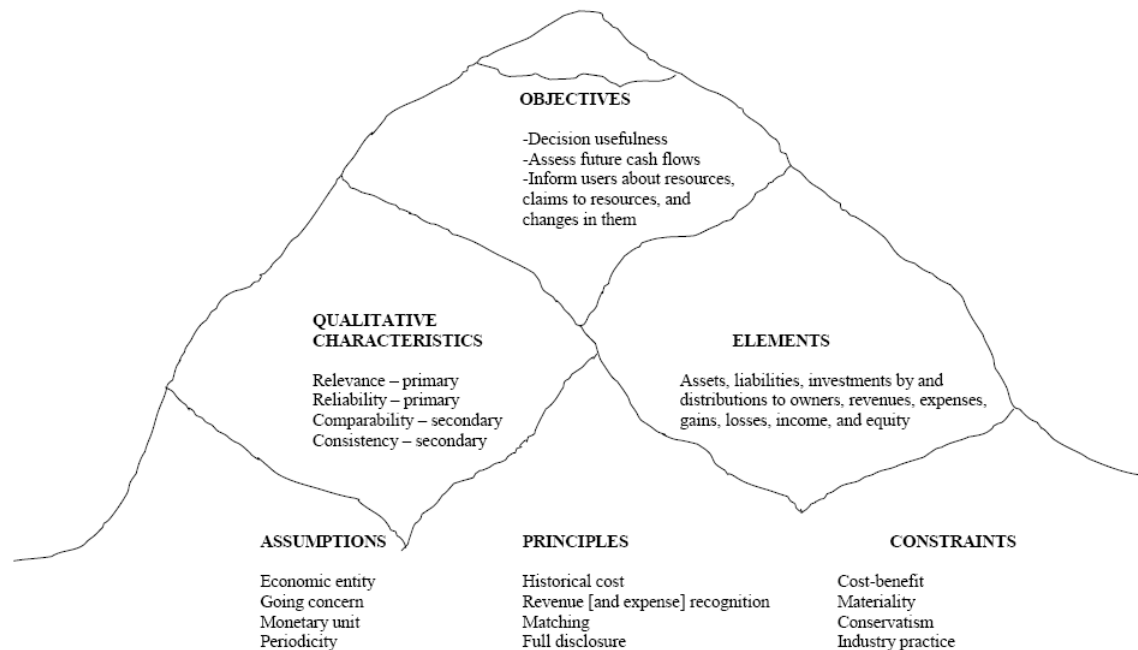
### INTRODUCTION

In an effort to attract even stronger students to the study of accounting, Laux 2007(a) defends the need for restoring to the introductory accounting course the theoretical coverage now absent from most textbooks. Parts I through VII of this series have covered the major accounting elements in both the asset and liability categories, and now we turn to the elements of the stockholders' equity section. Those who have followed the series are aware that the first article provides the knowledge required for tackling each subsequent essay and that the chosen theme is a mountain hiking analogy: The hierarchy of accounting characteristics (reproduced on the following page) is viewed as a mountain whose ascent represents the challenge to accountants. They must confront daily economic events at the base of the mountain and wrestle with measurement and classification issues as they climb the foothills with the express goal of reaching the mountaintop of decision usefulness (defined indirectly as reflecting economic reality). This paper first briefly reviews the general accounting rules for the major stockholders' equity elements then offers a segment connecting this treatment to the conceptual framework along with the most challenging measurement issues. The final section looks at some of the pertinent literature, both conceptual and empirical, along with a few events covered in the popular press.

### ACCOUNTING FOR STOCKHOLDERS' EQUITY

Of all the accounting categories, stockholders' equity offers some of the most confusing moments for students. While the concept of owners' equity as a residual amount (assets minus liabilities) seems straightforward, a number of accounting aspects conspire to make this one of the least understood classifications on the balance sheet. First, legal and accounting rules differ by state, so it matters whether a company is incorporated in Delaware or Colorado. Terminology differs from company to company, as well. Most principles-level texts avoid getting bogged down in the variety of resulting problems (a good thing) but fail to address the comparability issues that exist because of these differences (a bad thing). The general approach is to make students understand some basic fundamentals: The two sources of stockholders' equity (paid-in/invested capital and earned capital, in the form of Retained Earnings), the forms of stock typically issued (common and preferred), use of par value in the recording process, accounting for dividends, and handling reacquired shares (Treasury Stock). Admittedly, this constitutes plenty of fodder for an introductory course (and some lively discussions), but because financial statements would be found lacking in decision usefulness, if we were to stop there, the profession has added further dimensions—comprehensive income, stock-based compensation, and “mezzanine financing,” to name just a few. So most professors are content (even happy) if students emerge from the course comfortable with the following knowledge:

- Par value does not equal market value.
- Contributed (paid-in) capital is reported at historical value (the amount received by the corporation).
- Retained earnings represents historical earnings less losses and dividends, is a bookkeeping value not a market value, and has no relationship to the amount of cash on hand.



- Treasury Stock is a contra (negative) stockholders' equity account, represents shares reacquired by the firm but not cancelled, is carried on the books at cost, offers no ownership rights, and reduces the firm's assets upon purchase but increases them upon reissuance.<sup>1</sup>
- Paid-in capital can result from a variety of sources (common and preferred stock issuance, treasury stock transactions, donations, stock dividends and options, etc.), but it doesn't represent cash the company can spend.
- Cash dividends reduce assets, are paid on a pro-rata basis on outstanding shares only, reduce Retained Earnings when declared, represent a liability when declared, and reduce cash when paid.
- Stock dividends and stock splits carry no "market magic" (do not create excess value in the eyes of investors) but do require special accounting treatment.

Wow, is that all?! Can you really "get there from here" in a single course? If this brief reminder of that confusing time in your life leaves you stumbling around in search of the trailhead, perhaps the following section will help you find the path for the ascent to the mountaintop, as we connect the conceptual framework to accounting for stockholders' equity.

### CONNECTIONS TO THE CONCEPTUAL FRAMEWORK

Is stockholders' equity (the book value of assets minus liabilities) **relevant** to users? Financial statement readers commonly employ stockholders' equity in a measure called return on equity (net income divided by average stockholders' equity) to gauge management's ability to use shareholders' invested dollars to generate income.

<sup>1</sup> For a great refresher on treasury stock, see Kieso, Weygant, and Warfield [2003], pp. 584-88.

Because book value and market value quickly diverge after the initial sale of stock by a corporation, analysts devote much time and effort to supplementing this measure with other ratios, such as the price-earnings (PE) ratio (or, alternatively, the earnings to price ratio). One could infer then that, while the stockholders' equity value is widely perceived as **relevant**, it is not very **useful** in isolation because analysts must go elsewhere for a truer return measure, one based on dollars now invested—market price. Collins, Pincus, and Xie [1999] show the book value of stockholders' equity enhances pricing models, especially for firms experiencing losses. This suggests that, empirically, knowledge of equity book value matters in assessing changes in market value and, therefore, **expected future cash flows**.

How does stockholders' equity fare on the dimension of **reliability**? Certainly, auditors could verify how much a company receives upon stock issuance and could even weigh in on the appropriate accounting value for non-cash stock exchanges, so **reliability** is generally high for paid-in capital. **Comparability** problems arise, however, when analysts attempt to gauge return on equity for firms of different ages (dollars paid in thirty years ago are not really comparable to today's dollars), firms employing differing dividend policies (growth firms would tend to have higher returns on equity than their dividend-paying counterparts; that's why they are retaining earnings rather than paying dividends), or firms widely engaged in fruitful treasury stock transactions.<sup>2</sup> Thus analysts must be aware that return on equity measures cannot simply be taken at face value.

In recent decades, financial engineers have devoted much effort to designing financial instruments that generate the benefits of debt (interest deductibility for taxes, for example) while maintaining some appearance of equity (such as dividends) to keep the debt ratio down. This has resulted in a concept called "mezzanine financing," and accountants have struggled to find the most appropriate reporting and **disclosure** requirements for these ingenious "hybrid securities." SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity," addresses this dilemma. **Comparability** problems arise when some companies report such items as liabilities, others as equity, and still others between liabilities and owners' equity on the balance sheet. Frischman, Kimmel, and Warfield [1999] offer a good real-world example related to a special form of preferred stock. One can envision the compromised understandability and **decision usefulness**.

Since one major component of stockholders' equity, Retained Earnings, is a function of net income, any accounting shenanigans used to corrupt that measure by definition alters the **economic reality** of reported equity. Also some economic events affect owners' equity but lie outside the official income statement and are **disclosed** in a supplemental category called "other comprehensive income." These events include net holding gains (losses) on investments, net unrecognized loss on pensions, deferred gains (losses) from derivatives, and gains (losses) from foreign currency translation. The cumulative effect of these items is reflected in the stockholders' equity section as a separate component between Retained Earnings and Treasury Stock.<sup>3</sup> This represents the latest effort of the accounting profession to enhance **decision usefulness**, as this component is expected to help users better gauge **expected future cash flows** of the firm.

Finally, dimensions such as minimum legal capital and a firm's ability to pay out dividends differ from state to state, compromising **comparability** among firms. Thus, the distinction between paid-in capital and retained earnings becomes less **useful** to statement readers. This drawback is widely discussed in the literature covered in the next section, which reviews a number of conceptual and empirical studies, many of which attempt to ascertain the extent to which stockholders' equity, as currently reported, is truly helpful to financial statement users.

## **STOCKHOLDERS' EQUITY IN THE NEWS AND LITERATURE**

In the 1960s, accounting professionals began wrestling in earnest with how to make accounting reporting most useful to decision makers. Birnberg [1964] argues that, with regard to the stockholders' equity section, the

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<sup>2</sup> For example, consider two firms of equal size. One, Firm A, invests cash in income-producing assets; the other purchases treasury stock and then reissues it for an amount above cost equal to the income of Firm A. Both would have increased net assets by the same amount, but only Firm A would show income and a return on equity. The other would simply have more equity and no income.

<sup>3</sup> See Spiceland, Sepe, and Tomassini [2007], p. 895 for a good illustration.

only truly interested people—investors—are not well-served by the proscribed reporting format. Primary among their concerns are the value of their equity in the firm and the dividend prospects of the stock, because these two items are responsible for any future cash flow generation to the holder of the stock. Birnberg points out that the balance sheet presentation merely addresses the sources of equity (contributed capital and accumulated or earned capital) and, to a degree, the amount legally available for dividend payments, neither of which is particularly pertinent information. He advocates a “stewpot” approach—retained earnings would be broadened to include all the relevant changes in shareholders’ equity during the period, thus providing more useful data for statement readers. Today’s “comprehensive income” might constitute a start down that path, but it has taken us 40 years to come that far.

In their 1990 article “The Stockholders’ Equity Section: Form Without Substance?” Roberts, Samson, and Dugan “question the relevance of current stockholders’ equity disclosures” (p. 35), contending that changes in state laws have rendered the segregation into par value, additional paid-in capital, and retained earnings obsolete. A change in legal standards enables corporations to pay dividends “based on an equity definition of insolvency and on the excess fair value of assets over liabilities” (p. 45), and this makes reporting stockholders’ equity by source irrelevant and potentially misleading, as was the case for a company that suddenly announced an astronomical dividend:

*Consider the position in which the stockholders and creditors of Holiday Corporation found themselves at the end of 1987. Did they have any inkling that the Company had the capability of paying out a \$65 per share dividend? And, consider those who bought and sold the stock when rumors of a takeover were rife. Had those stockholders been informed of the possibility of a large payout, would these investors have sold their stock? (p. 44)*

This offers solid evidence that no predictive ability (a subset of **relevance**) resulted from GAAP-proscribed reporting.

A sizable body of literature addresses financial statement disclosures and the profession’s reactions to their efficacy.<sup>4</sup> Because stockholders’ equity requires much disclosure, especially in the area of stock-based compensation, the topic creates a fair amount of disgruntlement. It is among the top six subjects that accounted for 43 percent of all required disclosures [Barth and Murphy, 1994, p. 1], and SFAS No. 123 (accounting for stock-based compensation) ranks among the pronouncements rated “worst” by FASB constituents:

*Although the lack of economic reality (seven citations) is a significant factor in classifying SFAS No. 123...as one of the worst pronouncements, political compromise (seven citations) is an equal contributor to the pronouncement’s lack of popularity. Even though a prior exposure draft requires reporting the value of stock options given to employees as an expense, the FASB subsequently modified their position on this issue in response to intense pressure. The final standard requires only pro forma disclosure of the estimated stock compensation expense and the resulting pro forma net income. [Collins, Pasewark, and Strawser, 2002, pp. 147-48]*

It might restore your faith somewhat to learn that the FASB eventually listened, issuing a 2004 revision of the statement that required companies to expense stock options, the major critique concerning the lack of economic reality cited above. In a similar vein, accounting rule makers are currently discussing revision of an equally unpalatable statement concerning derivatives, SFAS No. 133 [Reilly, 2007, p. C2]. Despite the generally negative reaction to the FASB’s spawning ever more pronouncements and disclosure requirements, Hunton, Libby, and Mazza [2006, p. 135] make a good case for the value of disclosure in reducing earnings management: “...greater transparency in comprehensive income reporting...reduces the likelihood that managers will engage in earnings management...” An even more contemporary movement is afoot with respect to executive compensation, spurred by a number of scandalous events.

A major category of scandalous headlines in recent times has involved backdating stock options, a ploy wherein executive compensation is bolstered by setting the date of option “strike prices” (the price at which the

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<sup>4</sup> Barth and Murphy [1994], Collins, Pasewark, and Strawser [2002], and Reither [1996] represent a good sample of such works.

executive may contractually purchase the stock) at a low point in the stock's historical price range.<sup>5</sup> As the SEC threatened to change disclosure requirements to create more transparency with respect to executive compensation, Graziano [2006] posed the question, "Will Revealing More Be Enough?" She questions whether telling the public more about a firm's top five to eight highest-paid executives will really provide useful information or simply require more reporting effort and generate little useful information for statement readers. When executives and board members have been found guilty of stock options backdating, the courts have enforced "relatively modest payouts [along with] 'therapeutics,' or changes in governance" [Jones, 2007, p. A15] that lack any real bite. Stockholders of some companies are demanding a "say-on-pay" practice [Lublin, 2008, p. B1] in an effort to curtail "outsize executive rewards," including stock options.

One last newsworthy article relates to treasury stock. Many companies engage in treasury stock transactions for worthwhile reasons—to buoy up the stock price, provide shares for those employee stock option plans, and help flagging earnings per share—all of which CAN result in maximizing shareholder welfare. IBM was interested primarily in the latter when it spurred the headline "Hocus-Pocus: How IBM Grew 27% a Year" [McLean, 2000]. A telling excerpt follows:

*One way Big Blue has kept the fabulous EPS growth going has been by buying back shares of its own stock. Since 1995, IBM has spent a stunning \$34.1 billion to shrink shares outstanding. Indeed, \$34.1 billion is more than IBM reported in net income (\$31.3 billion) over the same period. [McLean, 2000, as cited in Spiceland et al., p. 984]*

If one believes in market efficiency, however, no one would be misled by the growing EPS, and market values would adjust accordingly. Cash used to reduce outstanding shares would shrink both the firm's assets and its stockholders' equity. Statement users could find this information in the disclosures related to treasury stock. Furthermore, if managers are able to maintain a high level of earnings with a shrinking asset base, isn't that cause for celebration (in the form of a higher stock price)?

One can see that the literature related to stockholders' equity covers a wide range—from empirical studies devoted to measuring the impact of required disclosures and innovative equity securities to conceptual discussions of the pros and cons of current reporting for the various elements to scandals related to treasury stock, stock options, and executive compensation. Most would agree that this balance sheet section requires improvement before decision makers truly will be well served.

## **THIS SERIES CONTINUES**

The current installment described accounting for stockholders' equity, connected the theoretical constructs to the conceptual framework, reviewed some related literature, and featured a few headline stories. The next installment in the series will address the Statement of Cash Flows and a concept that brings together all of the elements and the statements on which they appear—articulation.

## **AUTHOR INFORMATION**

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<sup>5</sup> For a plain-English explanation of the process—and why it's not ethical—see Lomax, 2008.

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