

15.515 RECITATION AGENDA – SESSION 10

Shareholders' Equity & Business Combinations

Agenda

- Review of Shareholders' Equity
- Review of the three accounting methods for investing in the stock of other companies
- Overview Purchase Method
- Sample Problems

STOCKHOLDERS EQUITY

Common Stock - Basic residual ownership share in the corporation. Right to any residual value in the firm after the stated obligations are met.

Preferred Stock - General term for any special classes of stock. These stocks have different rights and/or preferences than Common Stock.

Treasury Stock - stock which has been repurchased by the company.

Stock options issued to employees - Options that give the holder the right to purchase the underlying stock at a specified price (exercise price) for a specified period of time. The company can choose whether or not to expense the options. If the exercise price = fair market value of underlying stock at grant date, no expense is recorded. If the exercise price < fair market value at grant date, some compensation expense may be recorded. Under SFAS 123, the company is required to disclose the potential expense and dilution impact in the footnotes to the financial statements.

Other Comprehensive Income - Some revenues/gains/expenses/losses are given accounting treatment that excludes them from the measurement of firm performance (net income) for that period, but instead are included as a separate component of equity. Examples include unrealized gains and losses on investment securities and foreign currency translation adjustments.

ACCOUNTING FOR INVESTMENTS IN OTHER COMPANIES

Three methods – appropriate method depends on extent of influence of investor over investee

- Market Method – passive influence, less than 20% ownership, use trading/AFS accounting learned in marketable securities lectures
- Equity Method – significant influence, ownership between 20-50%, investor records its proportional share of investee's income and dividend activity
- Consolidation Method – controlling influence, ownership greater than 50%, consolidated financial statements that treat parent (investor) and subsidiary (investee) as single economic entity

CONSOLIDATION METHOD – MINORITY INTEREST AND GOODWILL

Minority Interest

- Represents other investors share (interest) in subsidiary assets and earnings – similar in accounting to the equity method
- Classified as either a long-term liability (indeterminate life) or a separate component of shareholders' equity on the balance sheet

Goodwill

- Excess of purchase price over fair market value of net assets purchased
- In the past, goodwill was amortized over a period of up to 40 years for financial accounting purposes (U.S.)
- New accounting standards (SFAS 142) require (1) no amortization of goodwill and (2) review goodwill for impairment of value (i.e. is goodwill reasonably valued?)

PURCHASE METHOD

Purchase Method

- Assets purchased are recorded at fair market value
- Excess of purchase price over FMV of net assets is recorded as goodwill (described earlier)
- Additional expenses (compared to pooling) from depreciation of “stepped-up” PP&E
- Recorded as of date of purchase