

# Stockholder's equity and balancesheet leverage case study examples

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- The stockholders' equity section of the balance sheet gives an analysis of the several classes of shares held by shareholders and the company as at the end of that financial period, December 31, 2007. It gives details of the number of the various types of stock that are held and further goes on to give an analysis of the shares that have been issued and those that are outstanding. The statement of stockholders' equity (exhibit 4) is almost similar to the stockholders' equity section of the balance sheet, the only difference being that it is more detailed. It gives the position of the stockholders' equity as at the end of the last three years. It similarly gives an analysis of the position of the various classes of shareholders. It however classifies each class of stock according to date acquired, stock based compensation, dividends declared and the total comprehensive income under each class.

- As of December 31, 2007, the preferred stock authorized was 10 million shares, with none issued. 1500 million shares of common stock have been authorized, with 604, 901, 407 shares issued. Class B stock as at that date were 10 million authorized with 2, 000, 000 issued and outstanding.

Companies issue different classes of stock to ensure that they meet all the needs of potential shareholders. Since different classes of shares have different privileges such as voting power for common stock and preferential treatment during liquidation for preferred stock, shareholders have their priorities assigned to different types of shares and they just have to make a choice from the available classes of shares on which present their interests more appropriately. Shares are also issued at different classes so that special minority interest groups can have their interests well protected.

Firms which were founded by families usually have a special class of shares with more powerful voting interests to ensure that they keep control of the voting power both in the general meetings and in the boardroom.

- The number of common shares issued as at December 31, 2007 was 604, 901, 479 going at a market price of \$92. 860 which translated to a value \$ 56, 171, 151, 340. This value is higher than the one reported in the balance sheet. These two values differ because the par value that is allocated to the shares by the company is different from the market price of the shares. This is because the valuation on the balance sheet is based on the value that the company issued the shares at while the market value is a result of forces of demand and supply.

- The change in the treasury stock held in 2007 was an increase in 23739255 which was sold at an average price of \$ 92. 860 which translates to a cash payment by the company of \$ 2, 204, 427, 219.

- The company declared a dividend of \$ 1. 15 per share and the earnings per share was \$ 7. 61 according to the financial statement. The dividend payout ratio is determined by dividing the dividend paid per share by earnings per share. According to this, the dividend payout ratio for Prudential was 15. 1117%.

The dividend yield shows how much the company paid out in dividends relative to the share price. It is obtained by a ratio of the annual dividend paid out per share of the price per share. Following this formula, the dividend yield for prudential is 0. 012384, obtained by a ratio of a dividend payout of \$ 1. 15 against a share price of \$ 92. 86.

- Accumulated other comprehensive income represents the positive change

in non owner equity for the period represented by the balance sheet. In the Prudential balance sheet, they most likely represent the change in the value of the aggregated retained earnings by the firm, which is a summation of the past and current retained earnings of the company up to the period ending December 31, 2007. This account is included in the stockholders' equity section of the balance sheet because it represents part of the funds that are attributable to the owners of the firm, who in this case are the stockholders' of the company. It is logical to include them in this section of the balance sheet because it is part of shareholders wealth.

- The balance sheet ratio is a measure of the financing by the debt holders and is measured by a ratio of total assets/equity, which in the case of Prudential in 2006 was  $\$ 485814/23457$  which translated into a leverage ratio of 20. 711, while in 2007, it was  $\$ 454266/22892$  which translated into a leverage of 19. 844 times. During the fall of 2008 at the advent of the economic crisis of 2008, this ratio was critical since it represented the capital adequacy of the company. It showed the level of exposure that the company had and the number of times the value of claims of equity stockholders were replicated in the value of assets of the company. A value of 19 as at the end of 2007 showed that the company was in a strong position and that the investments of shareholders were well represented in the assets of the company.

- The assets/equity ratio represents the value of the assets of a company that are financed by the equity capital. This is an inverted debt/equity ratio and it is a measure of how much assets that the company has compared to its equity. A high ratio would indicate that a company is utilising high

amounts of debt and other liabilities to finance its assets, and a lower assets/equity ratio would indicate that the level of leverage of the company is also low.

A company with an asset/equity ratio of 2 indicates that the company's debt leverage is relatively low, and it is therefore less risky to invest in such a company. This is because the amount of funds that the company will commit to the financing of the cost of debt will be low and therefore a large percentage of earnings will be attributable to the shareholders. On the other hand, an asset/equity ratio of 10 indicates that the company has been heavily financed through debt, and investing in such a company will be very risky because resources will be committed towards the financing of the debt of the company. The resultant effect is that a reduction in earnings attributable to stockholders will occur. There is also the risk of the company being unable to meet its obligations in financing, and result in the winding up of the company.

It would thus be less risky to invest in a company with an asset/equity ratio of 2 than in a company with a similar ratio of 10.

## **References**

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