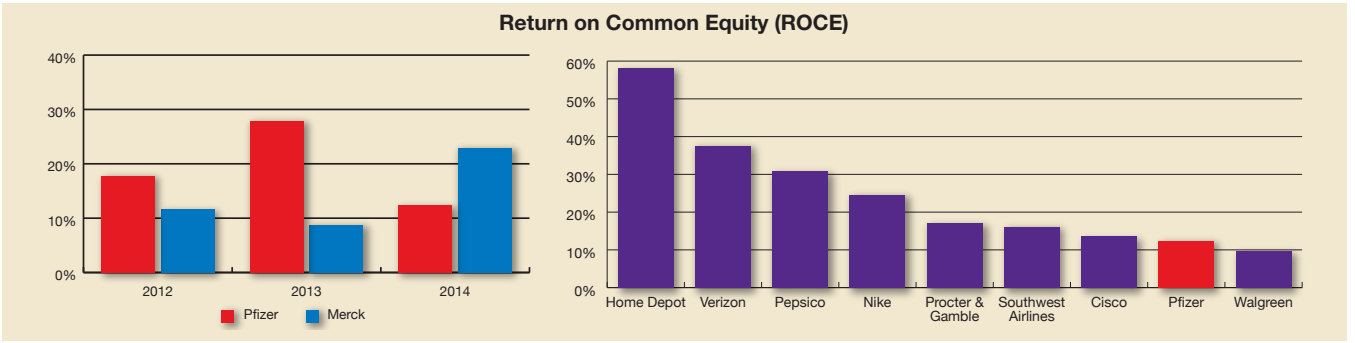
Applying the Ratio to Pfizer

$$\text{2013 ROCE} = \frac{\$22{,}072 - \$69 - \$2}{[(\$76{,}620 - \$313 - \$33) + (\$81{,}678 - \$418 - \$39)]/2} = 0.279, \text{ or } 27.9\%$$

$$\text{2014 ROCE} = \frac{\$9{,}168 - \$32 - \$2}{[(\$71{,}622 - \$321 - \$29) + (\$76{,}620 - \$313 - \$33)]/2} = 0.124, \text{ or } 12.4\%$$

Guidance ROCE is similar to ROE except that when we compute ROCE, we remove the effect of noncontrolling interests and preferred stock from both the numerator and denominator.

Pfizer in Context



Takeaways Neither Pfizer's nor Merck's ROCE has been stable for the past few years. The large values in 2013 for Pfizer and in 2014 for Merck reflect unusual gains from the sale of discontinued businesses. Such items are not likely to recur on a regular basis. Relative to other focus companies in this text, Pfizer's ROCE is low. It is about the same as that of Cisco and higher than Walgreens.

Many companies have little or no preferred stock or noncontrolling interests. So the difference between return on common equity (ROCE) and return on equity (ROE) will be immaterial for these firms. When preferred stock is present, ROCE is a more accurate measure of return to common shareholders.

Other Considerations In Chapter 5, we learned that ROE can be decomposed into two components: return on assets and return on financial leverage. Differences between firms may reflect a difference in performance, or a difference in the reliance on debt financing. A similar division can be done with ROCE with the caveat that ROCE essentially treats preferred stock as debt rather than equity.

One final point: the financial press sometimes refers to a measure called **book value per share**. This amount is the net book value of the company that is available to common shareholders, defined as: stockholders' equity less preferred stock less equity attributable to noncontrolling interest divided by the number of common shares outstanding (issued common shares less treasury shares). Pfizer's 2014 book value per share is computed as: ($71,622 million − $29 million − $321 million)/(9,110 million shares − 2,819 million shares) = $11.33 book value per common share.

MID-CHAPTER REVIEW 4

The stockholders' equity of Sloan Corporation at December 31, 2014, follows.

Common stock, $5 par value, 400,000 shares authorized; 160,000 shares issued and outstanding	$800,000
Paid-in capital in excess of par value	920,000
Retained earnings	513,000

During 2015, the following transactions occurred:

June 28	Declared and issued a 10% common stock dividend when the market value is $11 per share.
Dec. 5	Declared and paid a cash dividend of $1.25 per share.
Dec. 31	Updated retained earnings for net income of $412,000.

Compute the year-ending balance of retained earnings for 2015.

The solution to this review problem can be found on page 560.

CHAPTER ORGANIZATION

Reporting and Analyzing Financial Investments

Passive Investments	Investments with Significant Influence	Investments with Control	Further Considerations
• Trading Securities • Available-for-Sale Securities • Held-to-Maturity Securities	• Accounting and Reporting • Equity Method and Effects on Ratios	• Accounting and Reporting • Acquired Assets and Liabilities • Accounting for Goodwill • Noncontrolling Interest	• Equity Method Mechanics (Appendix 12A) • Consolidation Accounting Mechanics (Appendix 12B) • Reporting Derivative Securities (Appendix 12C)

LO1 Explain and interpret the three levels of investor influence over an investee—passive, significant, and controlling.

1

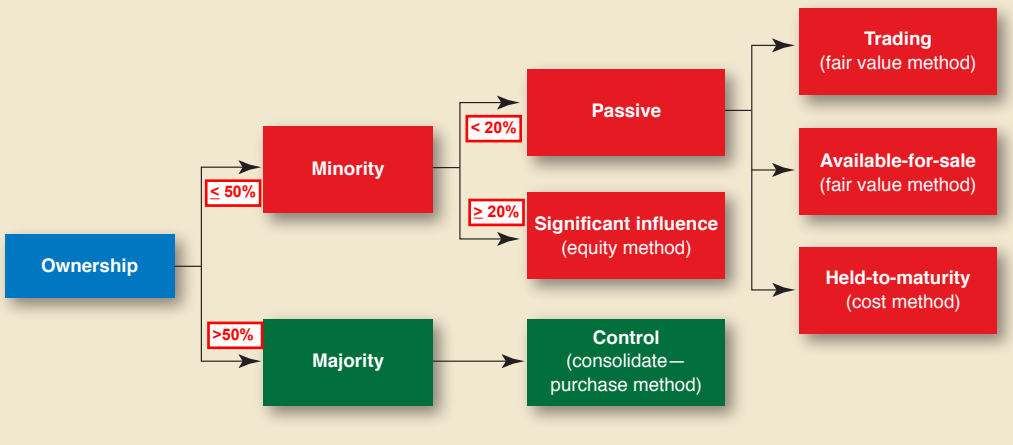
INTRODUCTION

Most companies invest in government securities or the securities of other companies. These investments often have the following strategic goals:

- **Short-term investment of excess cash.** Companies often generate excess cash for investment either during slow times of the year (after receivables are collected and before seasonal production begins) or for liquidity needs (such as to counter strategic moves by competitors or to quickly respond to acquisition opportunities).[1]
- **Alliances for strategic purposes.** Companies often acquire an equity interest in other companies for strategic purposes, such as gaining access to their research and development activities, to supply or distribution markets, or to their production and marketing expertise.
- **Market penetration or expansion.** Acquisitions of controlling interests in other companies can achieve vertical or horizontal integration in existing markets or can be avenues to penetrate new and growing markets.

Investments in government securities and in the securities of other companies are usually referred to as **financial investments**. Firms make these investments for different purposes, so accounting for the investments can follow one of five different methods, each of which affects the balance sheet and the income statement differently. To help assimilate the materials in this chapter, **Exhibit 12.1** provides a graphical depiction of accounting for financial investments as we will explore it.

EXHIBIT 12.1 Financial Investment Diagram



[1] Many U.S. firms operate subsidiaries in foreign countries with lower tax rates. The income earned by those subsidiaries is subject to U.S. income tax only when the income is repatriated in the form of dividends. The desire to delay those tax payments results in a cash build-up in the subsidiaries.