

Chapter 11 - REPORTING AND ANALYZING STOCKHOLDERS' EQUITY

LO 1: Describe the major characteristics of a corporation.

WHAT IS A CORPORATION

- **Corporation:** legal entity, *separate* and *distinct* from the individuals who create and operate it (owners). The owners of the corporation are called **STOCKHOLDERS** and they can buy and sell shares without affecting the corporation's operations or continued existence. Classified by..
 1. **Purpose**
 - **Not-for-Profit** (Ex: Charity, Medical, or Educational Corporation)
 - **For Profit**
 2. **Ownership**
 - **Publicly Held:** May have thousands of stockholders, and its stock is traded on national securities market such as the New York Stock Exchange. (Ex: Facebook, IBM, and General Electric)
 - **Privately Held:** Have a few stockholders and do not offer stock for sale to the general public.

ADVANTAGES AND DISADVANTAGES OF A CORPORATION

Advantages

1. *Separate legal existence:* Corporation acts under its own name rather than in the name of its stockholders.
2. *Limited Liability of Stockholders:* Limited to their investment into a corporation.
3. *Transferable Ownership Rights:* Shareholders may sell their stock.
4. *Ability to Acquire Capital:* Corporation can obtain capital through the issuance of stock.
5. *Continuous Life:* Continuance as a going concern is not affected by the withdrawal, death, or incapacity of a stockholder, employee, or officer.

Disadvantages

1. *Corporation Management:* Separation of ownership and management prevents owners from having an active role in managing the company.
2. *Government Regulations:* A corporation is subject to numerous state and federal regulations including state laws about the requirements for issuing stock, federal securities laws if the sale of stock is to the general public, and publicly held corporations have to provide quarterly and annual reports to the SEC (Securities and Exchange Commission) about their financial affairs.
3. *Additional Taxes:* Corporations pay income taxes as a separate legal entity and in addition, stockholders pay taxes on cash dividends.

OTHER FORMS OF A CORPORATION

- **Limited partnerships.**
- **Limited liability partnerships (LLPs)**
- **Limited liability companies (LLCs)**
- **S Corporation** which allows for legal treatment as a corporation, but tax treatment as a partnership.
 - No double taxation and cannot have more than 100 shareholders.

FORMING A CORPORATION

1. *File application with the Secretary of State.*
2. *State grants **charter** (“a document that describes the name and purpose of the corporation, the types and number of shares of stock that are authorized to be issued, the names of the individuals that formed the company, and the number of shares that these individuals agreed to purchase.”)*
3. *Corporation develops **by-laws** (establish the internal rules and procedures for conducting the affairs of the corporation.)*
4. *Corporations engaged in interstate commerce must obtain a license from each state in which they do business.*

*** Companies generally incorporate in a state whose laws are favorable to the corporate form of business (Delaware, New Jersey).

STOCKHOLDER RIGHTS

- When a corporation has only one class of stock, it is identified as **common stock**.
- The rights of common stockholders are.....
 1. **Vote** in election of board of directors and on actions that require stockholder approval.
 2. **Share** the corporate **earnings** through receipt of dividends.
 3. Keep the same percentage ownership when new shares of stock are issued (**preemptive right**).
 4. Share in assets upon liquidation in proportion to their holdings. This is called a **residual claim**.

OTHER STOCK ISSUE CONSIDERATIONS

- **Authorized Stock:** the number of shares that a corporation’s charter allows it to sell.
- **Treasury Stock:** When a corporation buys back their own stock.
- **Issued Stock:** Shares issued to stockholders.
- **Outstanding Stock: Issued Stock – Treasury Stock**
 - ***Stock remaining in hands of stockholders.
- **Par value stock:** capital stock that has been assigned a value per share.
 - Years ago, par value determined the **legal capital** per share that a company must retain in the business for the protection of corporate creditors.

- Many states do not require a par value.
- **No-par value stock:** is capital stock that has not been assigned a value in the corporate charter.
 - In many states the board of directors assigns a **stated value** to no-par shares.
- **Owners' Equity:** Also referred to as **stockholders' equity, shareholders' equity, or corporate capital.** This section of a balance sheet has two parts:
 1. **Paid-in Capital:** Total amount of cash and other assets paid into the corporation by stockholders in exchange for capital stock.
 - **Common Stock**
 - **Preferred Stock**
 - **Paid-In Capital in Excess of Par**
 2. **Retained Earnings:** net income that a corporation retains for future use in the business.

LO 2: Explain how to account for the issuance of common and preferred stock, and the purchase of treasury stock.

1. Common Shareholders: owners of a corporation that **1)** have the right to vote, **2)** have preemptive rights to protect their proportionate interest in the corporation (if a shareholder owns 30% of the company and the company issues new stock, the shareholder has the right to buy 30% of any of the new stock issued), **3)** Share in any assets remaining after creditors and preferred stockholders are paid when, and if, the corporation is liquidated, and **4)** Share the corporate earnings through receipt of dividends.

2. Preferred Shareholders: have priority over common stock in certain areas such as the right to receive dividends and the distribution of assets if the corporation is liquidated BEFORE common shareholders. However, preferred shareholders usually **HAVE NO RIGHT TO VOTE.**

Summary of Issuance of Common and Preferred Stock Journal Entries

| | | DEBIT | CREDIT | For |
|--|---|-------|--------|-----|
| 1. To record issuance of common stock with a par value. | Cash | xxx | | |
| | Common Stock | | xxx | |
| | Paid-in Capital in Excess of Par Value- Common | | xxx | |
| 2. To record issuance of no-par common stock. | Cash | xxx | | |
| | Common Stock | | xxx | |
| 3. To record issuance of preferred stock with a par value. | Cash | xxx | | |
| | Preferred Stock | | xxx | |
| | Paid-in Capital in Excess of Par Value- Preferred | | xxx | |
| 4. To record issuance of no-par preferred stock. | Cash | xxx | | |
| | Preferred Stock | | xxx | |

journal entries, there are 3 important things to know when issuing stock.

- Cash** is **DEBITED** for the number of shares × market price per share at the time the shares were issued.
- Common Stock** or **Preferred Stock** is **CREDITED** for the number of shares × par value of each share of stock. If no-par stock is issued, then Common Stock or Preferred Stock is CREDITED for the number of shares × stated value of each share of stock if given OR number of shares × market price per share at the time the shares were issued.
- Paid in Capital in Excess of Par** is **CREDITED** for the amount received above par.
(Cash – Common Stock OR Cash – Preferred Stock).

Ex: Cayman Corporation begins operations on March 1 by issuing 100,000 shares of \$1 par value common stock for cash at \$12 per share. On March 28, Cayman issues 1,500 shares of \$10 par value preferred stock for cash at \$30 per share. Journalize the issuance of the common and preferred shares.

| | Date | Debit | Credit |
|---|--------|-----------|---------|
| Cash (100,000 shares × \$12 per share) | Mar. 1 | 1,200,000 | |
| Common Stock (100,000 shares × \$1 par value per share) | | | 100,000 |

| | | | |
|---|---------|--------|-----------|
| Paid-in Capital in Excess of Par Value- Common Stock | | | 1,100,000 |
| Cash (1,500 shares × \$30 per share) | Mar. 28 | 45,000 | |
| Preferred Stock (1,500 shares × \$10 par value per share) | | | 15,000 |
| Paid-in Capital in Excess of Par Value- Preferred Stock | | | 30,000 |

TREASURY STOCK

- **Treasury stock:** a corporation’s own stock that has been reacquired by the corporation and is being held for future use.
- Corporations purchase their outstanding stock:
 1. To reissue shares to officers and employees under bonus and stock compensation plans.
 2. To increase trading of the company’s stock in the securities market.
 3. To have additional shares available for use in acquiring other companies.
 4. To increase earnings per share.
- Treasury stock is a **contra stockholders’ equity account**, not an asset.
- Treasury Stock decreases by the same amount when the company later sells the shares.

| Purchase of Treasury Stock Journal Entry | | | |
|--|----------------|-------|--------|
| | | DEBIT | CREDIT |
| 1. To record the purchase of treasury stock. | Treasury Stock | xxx | |
| | Cash | | xxx |

Ex: On April 1, Company N acquires 4,000 shares of its stock at \$8 per share. Prepare the entry.

| | Date | Debit | Credit |
|---|--------|--------|--------|
| Treasury Stock (4,000 shares × \$8 per share) | Mar. 1 | 32,000 | |
| Cash | | | 32,000 |

| Balance Sheet (partial) | |
|--|------------------|
| Stockholders’ equity | |
| Paid-in capital | |
| Common stock, \$5 par value, 400,000 shares authorized, 100,000 shares issued and 96,000 shares outstanding | \$500,000 |
| Retained earnings | 200,000 |
| Total paid-in capital and retained earnings | 700,000 |
| Less: Treasury stock (4,000 shares) | 32,000 |
| Total stockholders’ equity | <u>\$668,000</u> |

- Companies show treasury stock as a **DEDUCTION** from total paid-in capital and retained earnings in the stockholders’ equity section of the balance sheet.
- The original paid-in capital account, **COMMON STOCK**, would not be affected because the number of issued shares does not change.

- **Dividend:** a distribution by a corporation to its stockholders on Dividends are expressed:
 1. As a percentage of the par or stated value
 - **Par Value of Stock × Dividend Rate (%) × Number of Shares**
 - Ex: 50 shares of 8% \$100 par value preferred stock = \$100 X 0.08 X 50 shares = **\$400**
 2. As a dollar amount per share.
 - **Number of shares of outstanding stock X Dividend rate**
 - 50 shares of common stock with \$3 per share dividend= 50 shares X \$3 = **\$150**

TYPES OF DIVIDENDS

1. **Cash Dividends**
2. **Property Dividends**
3. **Stock Dividends**
4. **Scrip (Promissory Note)**

CASH DIVIDENDS

- “A pro rata (proportional to ownership) distribution of cash to stockholders.”
- For a corporation to pay a cash dividend, it must have:
 1. **Retained earnings** - Payment of dividends from retained earnings is legal in all states.
 2. **Adequate cash.**
 3. **Declaration** by the Board of Directors.

Summary of Cash Dividend Journal Entries

| | | DEBIT | CREDIT |
|---|-------------------------------------|-------|--------|
| 1. Declaration date (the board authorizes the cash dividend and announces it to stockholders). | Cash Dividends Dividends Payable | xxx | xxx |
| NO ENTRY NECESSARY | | | |
| 2. Record date (the stockholders holding the stock on the date of record will receive the dividend.) | | | |
| 3. Payment date (the company makes cash dividend payments to the stockholders on record.) | Dividends Payable Cash | xxx | xxx |

Ex: On December 1, 20X1 the directors of Green Inc. declare a \$1.00 per share cash dividend on 100,000 shares of \$5 par value common stock. The dividend is payable on January 10, 20X2 to shareholders of record on December 28, 20X1. Green Inc. journalizes the transactions as follows:

| | Date | Debit | Credit |
|---|---------|---------|---------|
| Cash Dividends (100,000 shares × \$1 per share cash dividend) | Dec. 1 | 100,000 | |
| Dividends Payable | 20X1 | | 100,000 |
| NO ENTRY NECESSARY | | | |
| | Dec. 28 | | |
| | 20X1 | | |
| Dividends Payable | Jan. 10 | 100,000 | |
| Cash | 20X2 | | 100,000 |

DIVIDEND PREFERENCES

- Preferred stockholders have the right to receive dividends **BEFORE** common stockholders.
 - However, preferred shareholders are NOT guaranteed a dividend each year.
- Preferred stockholders also have preference on corporate assets if the corporation fails.
- Per share dividend amount is stated as a percentage of the preferred stock's par value or as a specified amount.
- Some preferred stock allows for **cumulative dividends** which means the preferred shareholders **have to be paid BOTH THE CURRENT AND ALL PRIOR PERIODS UNPAID DIVIDEND before any dividend is paid to common stockholders.**
 - **Dividends in Arrears:** unpaid dividend amount. If preferred dividends were not declared, but were supposed to be declared in a certain period.
 - NOT a liability. No obligation exists until the board of directors formally "declares" that the corporation will pay a dividend.
- **Noncumulative Preferred Stock:** Has no right to prior periods' dividends if they were not declared in those prior periods.

Ex 1: Sierra has 10,000 shares of preferred stock outstanding of \$100 par, 5% preferred stock. Sierra also has common stock outstanding. Sierra declared a dividend of \$80,000 on December 22 and paid them on December 30.

Divide dividends between common and preferred shareholders

Preferred Dividends: \$100 par X 0.05 X 10,000 shares = **\$50,000 (PAID FIRST)**

Common Shareholders: \$80,000 Total Dividend - \$50,000 Preferred Dividend = **\$30,000**

Ex 2: Sierra has 10,000 shares of 8%, \$100 par value, cumulative preferred stock outstanding at December 31, 20X3. No dividends were declared in 20X1 or 20X2.

If Sierra wants to pay \$375,000 of dividends in 20X3 what will preferred and common stockholders receive?

Step 1: Calculate the preferred dividends that are supposed to be paid out per year.

\$100 par X 0.08 X 10,000 shares = **\$80,000 (EACH YEAR)**

Step 2: Calculate the dividends in arrears (dividends not paid in prior years) for cumulative preferred shareholders.

\$80,000 per year × 2 years = **\$160,000**

Step 3: Add the dividend in arrears to the current year dividend to calculate the amount of dividends preferred shareholders will receive.

\$160,000 + \$80,000 = **\$240,000 PAID TO PREFERRED SHAREHOLDERS**

Step 4: Calculate the amount of dividends paid to common shareholders by taking the **total dividends declared in 20X3 – dividends paid to preferred shareholders.**

\$375,000 Total Dividends - \$240,000 Preferred Dividends =

\$135,000 PAID TO COMMON SHAREHOLDERS

STOCK DIVIDENDS

- “A pro rata (proportional to ownership) distribution of the corporation’s own stock to stockholders.”
- Results in a **DECREASE in RETAINED EARNINGS** and an **INCREASE in PAID-IN CAPITAL.**

***Stock Dividend \$ Amount = Shares Outstanding × % Stock Dividend × Market Price per Share**

- Stockholders own more shares of stock, but ownership interest does not change.
- **Effects of stock dividends**
 1. **Changes the composition** of stockholders’ equity. (Retained Earnings and Paid-in Capital)
 2. Total stockholders’ equity **remains the same.**
 3. **No effect** on the par or stated value per share.
 4. **Increases** the number of shares outstanding.

Ex: Ruffin Corp. declares a 10% stock dividend on its \$10 par common stock when 50,000 shares were outstanding. The market price was \$15 per share. The effects before and after the stock dividend are shown below.

| | Before Stock Dividend | Change | After Stock Dividend |
|----------------------------------|-----------------------|--------------------|----------------------|
| Stockholders' Equity | | | |
| Paid-in Capital | | | |
| Common Stock, \$10 par | \$ 500,000 | \$ 50,000 | \$ 550,000 |
| Paid-in capital in excess of par | \$ - | \$ 25,000 | \$ 25,000 |
| Total paid-in capital | \$ 500,000 | \$ 75,000 | \$ 575,000 |
| Retained Earnings | \$ 300,000 | \$ (75,000) | \$ 225,000 |
| Total Stockholders' Equity | \$ 800,000.00 | \$ - | \$ 800,000.00 |
| Outstanding Shares | 50,000 | 5,000 | 55,000 |
| Par Value per Share | \$ 10.00 | \$ 10.00 | \$ 10.00 |

*Total paid-in capital increase= (50,000 shares x 10% stock dividend x \$15 market price per share)

*Total common stock increase= (50,000 shares x 10% stock dividend x \$10 par value per share)

*Total paid-in capital in excess of par increase= [50,000 shares x 10% stock dividend x (\$15-\$10)]

LO 5: Prepare entries for stock dividends.

| Summary of Stock Dividend Journal Entries | | | |
|---|--|-------|--------|
| | | DEBIT | CREDIT |
| 1. Declaration date (the board authorizes the stock dividend and announces it to stockholders). | Stock Dividends | xxx | |
| | Common Stock Dividends Distributable | | xxx |
| | Paid-in Capital in Excess of Par Value | | xxx |
| NO ENTRY NECESSARY | | | |
| 2. Record date (the stockholders holding the stock on the date of record will receive the dividend.) | | | |
| | | | |
| 3. Issuance date (the company issues the dividend shares to the stockholders on record.) | Common Stock Dividends Distributable | xxx | |
| | Common Stock | | xxx |

Ex

(Cont.): Ruffin Corp. declares a 10% stock dividend on its \$10 par common stock when 50,000 shares were outstanding. The market price was \$15 per share when it was declared on December 10. The dividend shares will be issued on December 30 to shareholders of record on December 20.

Ruffin Corp. journalizes the transactions as follows:

| | Date | Debit | Credit |
|--|---------|--------|--------|
| Stock Dividends (50,000 shares × 10% × \$15 market price) | Dec. 10 | 75,000 | |
| Common Stock Dividends Distributable (50,000 shares × 10% × \$10 par value) | | | 50,000 |
| Paid-in Capital in Excess of Par Value [50,000 shares × 10% × (\$15 market price - \$10 par value)] | | | 25,000 |
| NO ENTRY NECESSARY | Dec. 20 | | |
| Common Stock Dividends Distributable | Dec. 30 | 50,000 | |
| Common Stock | | | 50,000 |

- **Common stock dividends distributable** is a stockholders' equity account, NOT A LIABILITY.

| Balance Sheet (partial) | |
|---|------------------|
| Paid-in capital | |
| Common stock | \$500,000 |
| Common stock dividends distributable | 50,000 |
| Paid-in capital in excess of par—common stock | 25,000 |
| Total paid-in capital | <u>\$575,000</u> |

○ If a balance sheet is prepared BEFORE issuing the

dividend shares, the distributable account is an addition to the common stock issued as part of total paid-in capital.

LO 3: Explain how to account for cash dividends and describe the effect of stock dividends and stock splits. (Cont.)

STOCK SPLITS

- “The distribution of **additional shares** to stockholders according to their percentage of ownership.” They also **reduce the par or stated value**.
- Goal is to reduce the market price per share of stock.
- **THE SPLIT DOES NOT EFFECT ANY STOCKHOLDERS' EQUITY AMOUNTS ON THE BALANCE SHEET. RETAINED EARNINGS, PAID-IN CAPITAL, AND TOTAL STOCKHOLDERS' EQUITY ARE UNCHANGED BY THE SPLIT. NO JOURNAL ENTRY IS REQUIRED.**

| NAME | MATH | PAR VALUE | NUMBER OF SHARES |
|---------|--------------------|------------------------|---------------------------|
| 2 FOR 1 | 2 ÷ 1 = 2 | Par before split ÷ 2 | Shares before split X 2 |
| 3 FOR 1 | 3 ÷ 1 = 3 | Par before split ÷ 3 | Shares before split X 3 |
| 3 FOR 2 | 3 ÷ 2 = 1.5 | Par before split ÷ 1.5 | Shares before split X 1.5 |

Ex 1: ABC Company has 200,000 shares of \$10 par common stock outstanding. ABC issues a 5 for 1 stock split. What are the number of common shares outstanding and what is the par value of those shares after the 5 for 1 stock split?

New Number of Shares = 200,000 shares X 5 = **1,000,000 shares**

New par value = \$10 par ÷ 5 = **\$2 par value**

Ex 2: Ruffin Corp. splits its 50,000 shares of common stock on a 2-for-1 basis. The effect before and after the split is shown below.

| | Before Stock Split | Change | After Stock Split |
|----------------------------------|----------------------|-----------|----------------------|
| Stockholders' Equity | | | |
| Paid-in Capital | | | |
| Common Stock, \$10 par | \$ 500,000 | \$ - | \$ 500,000 |
| Paid-in capital in excess of par | \$ - | \$ - | \$ - |
| Total paid-in capital | \$ 500,000 | \$ - | \$ 500,000 |
| Retained Earnings | \$ 300,000 | \$ - | \$ 300,000 |
| Total Stockholders' Equity | \$ 800,000.00 | \$ - | \$ 800,000.00 |
| Outstanding Shares | 50,000 | 50,000 | 100,000 |
| Par Value per Share | \$ 10.00 | \$ (5.00) | \$ 5.00 |

New Number of Shares = 50,000 shares X 2 = **100,000 shares**

New par value = \$10 par ÷ 2 = **\$5 par value**

STOCK DIVIDENDS VS STOCK SPLITS SUMMARY

| Item | Stock Dividend | Stock Split |
|--------------------------------|----------------|-------------|
| Total paid-in capital | Increase | No change |
| Total retained earnings | Decrease | No change |
| Total par value (common stock) | Increase | No change |
| Par value per share | No change | Decrease |
| Shares outstanding | Increase | Increase |
| Total stockholders' equity | No change | No change |

LO 4: Discuss how stockholders' equity is reported and analyzed.**RETAINED EARNINGS**

- **Retained earnings:** “net income that a company retains for use in the business.”
 - Net income increases Retained Earnings (with a CREDIT) and a net loss decreases Retained Earnings (with a DEBIT).
 - Net Income= Revenues EXCEED Expenses
 - Net Loss= Expenses EXCEED Revenues
 - Retained earnings is part of the stockholders' claim on the total assets of the corporation.
 - A debit balance in Retained Earnings is identified as an **ACCUMULATED DEFICIT**.

- Retained earnings for a company may be restricted for certain uses.
 1. Legal restrictions.
 2. Contractual restrictions.
 3. Voluntary restrictions.

BALANCE SHEET PRESENTATION

Two classifications of paid-in capital:

1. Capital stock

- Consists of preferred and common stock.
- Information that is reported includes par value, shares authorized, shares issued, and shares outstanding for each class of stock.

2. Additional paid-in capital

- Includes the excess of amounts paid in over par or stated value.

- Other comprehensive income items include
 1. Certain adjustments to pension plan assets.
 2. Types of foreign currency gains and losses.
 3. Some gains and losses on investments.

| GRABER INC. Balance Sheet (partial) | |
|---|-------------|
| Stockholders' equity | |
| Paid-in capital | |
| Capital stock | |
| 9% preferred stock, \$100 par value, cumulative, 10,000 shares authorized, 6,000 shares issued and outstanding | \$ 600,000 |
| Common stock, no par, \$5 stated value, 500,000 shares authorized, 400,000 shares issued, and 390,000 outstanding | 2,000,000 |
| Total capital stock | 2,600,000 |
| Additional paid-in capital | |
| Paid-in capital in excess of par value—preferred stock | \$ 30,000 |
| Paid-in capital in excess of stated value—common stock | 1,050,000 |
| Total additional paid-in capital | 1,080,000 |
| Total paid-in capital | 3,680,000 |
| Retained earnings (see Note R) | 1,050,000 |
| Total paid-in capital and retained earnings | 4,730,000 |
| Accumulated other comprehensive income | 110,000 |
| Less: Treasury stock (10,000 common shares) | 80,000 |
| Total stockholders' equity | \$4,760,000 |
| Note R: Retained earnings is restricted for the cost of treasury stock, \$80,000. | |

ANALYSIS OF STOCKHOLDERS' EQUITY

1. **Payout Ratio:** "measures the percentage of earnings a company distributes in the form of cash dividends to common stockholders."

$$\text{Payout Ratio} = \frac{\text{Cash Dividends Declared on Common Stock}}{\text{Net Income}}$$

2. **Return on**

$$\text{Return on Common Stockholders' Equity} = \frac{\text{Net Income} - \text{Preferred Dividends}}{\text{Average Common Stockholders' Equity}}$$

Common Stockholders' Equity (ROE): "measures the percentage of earnings a company distributes in the form of cash dividends to common stockholders."

***Common Equity** = Total Equity – Preferred Stock

** **Average Common Stockholder's Equity (SE)** = (Common Stockholder's Equity Beginning of Year + Common Stockholder's Equity End of Year) ÷ 2

- The HIGHER the ratio, the MORE income the company has earned from the amount invested by the common stockholders (owners of the company.)

Ex: A rate earned on common stockholders' equity of 15% indicates that a company earned \$0.15 of net income from every \$1 invested by the common stockholders.