Financial Accounting

L21,22

LO 8
Shareholders' Equity

Chapter Ten: Stockholders' Equity
Learning Objectives

1. **Explain** the features of a corporation
2. **Account** for the issuance of stock
3. **Explain** how treasury stock affects a company
4. **Account** for retained earnings, dividends, and splits

Learning Objective One

Explain the features of a corporation

1 Explain the Features of a Corporation

- Separate legal entity
- Continuous life and transferability of ownership
- Limited liability
- Separation of ownership and management
- Corporate taxation
- Government regulation

1 Exhibit 10-1|Advantages and Disadvantages of a Corporation

Advantages
1. Can raise more capital than a proprietorship or partnership can
2. Continuous life
3. Ease of transferring ownership
4. Limited liability of stockholders

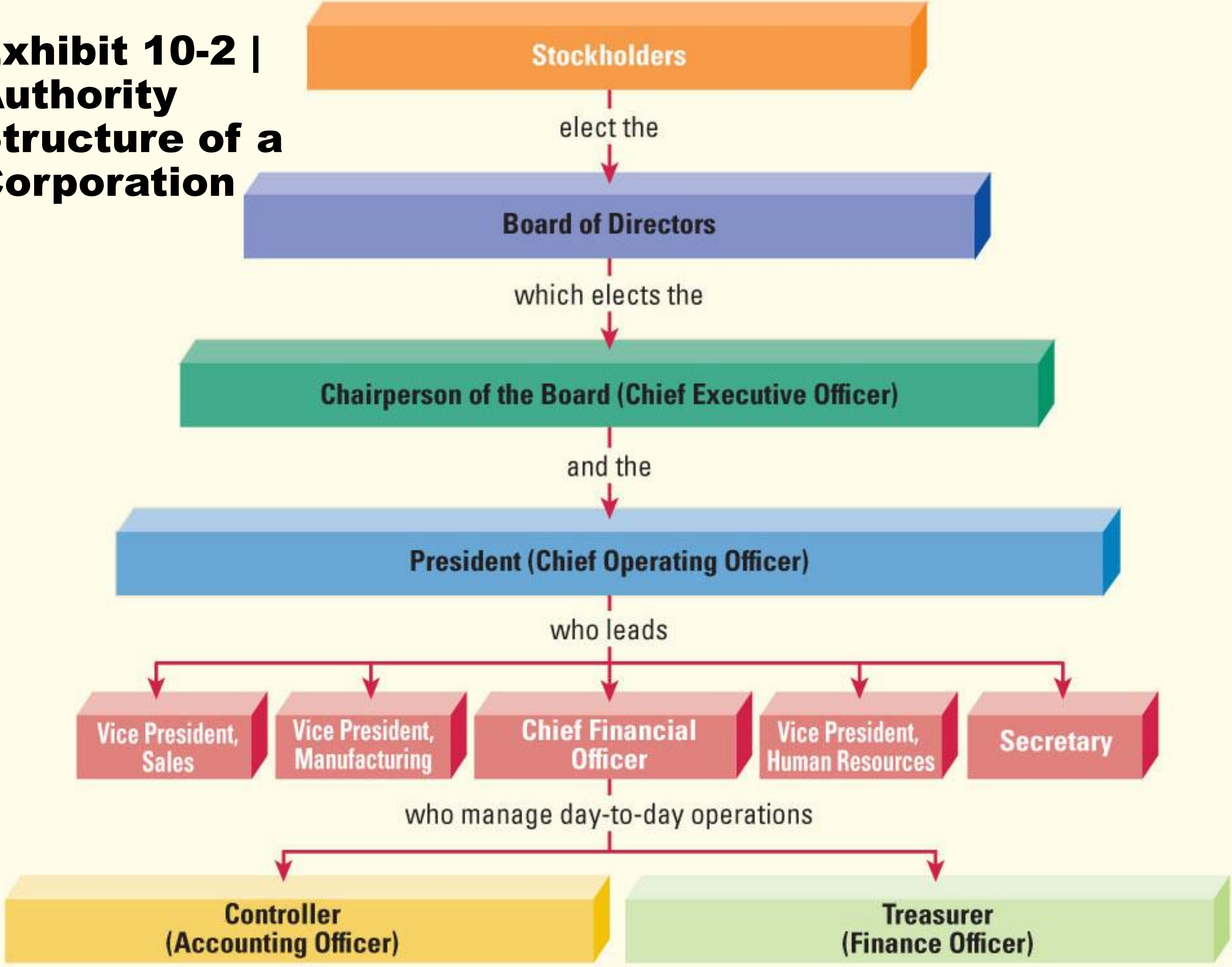
Disadvantages
1. Separation of ownership and management
2. Double taxation of distributed profits
3. Government regulation

1 Explain the Features of a Corporation

Organizing a Corporation

- Corporate organizers (incorporators) obtain a charter from the state
  - Charter – authorizes corporation to issue a certain number of shares of stock
- Incorporators
  - Pay fees
  - Sign charter
  - File documents with the state
  - Agree to set of bylaws

Exhibit 10-2 | Authority Structure of a Corporation



1 Organizing a Corporation

Organizers obtain a charter

1 Explain the Features of a Corporation

Stockholders' Rights

- Vote → right to vote on matters that come before the stockholders
- Dividends → right to receive a proportionate part of any dividend
- Liquidation → right to receive a proportionate share of any assets remaining upon liquidation
- Preemption → right to maintain one's proportionate ownership in the corporation

1 Explain the Features of a Corporation

Stockholders’ Equity

- **Paid-in capital (contributed capital)**
  - Amount of stockholders’ equity the stockholders have contributed to the corporation
  - Includes stock accounts and additional paid-in capital
- **Retained earnings**
  - Amount of stockholders’ equity the corporation has earned through profitable operations
  - Reduced by dividends

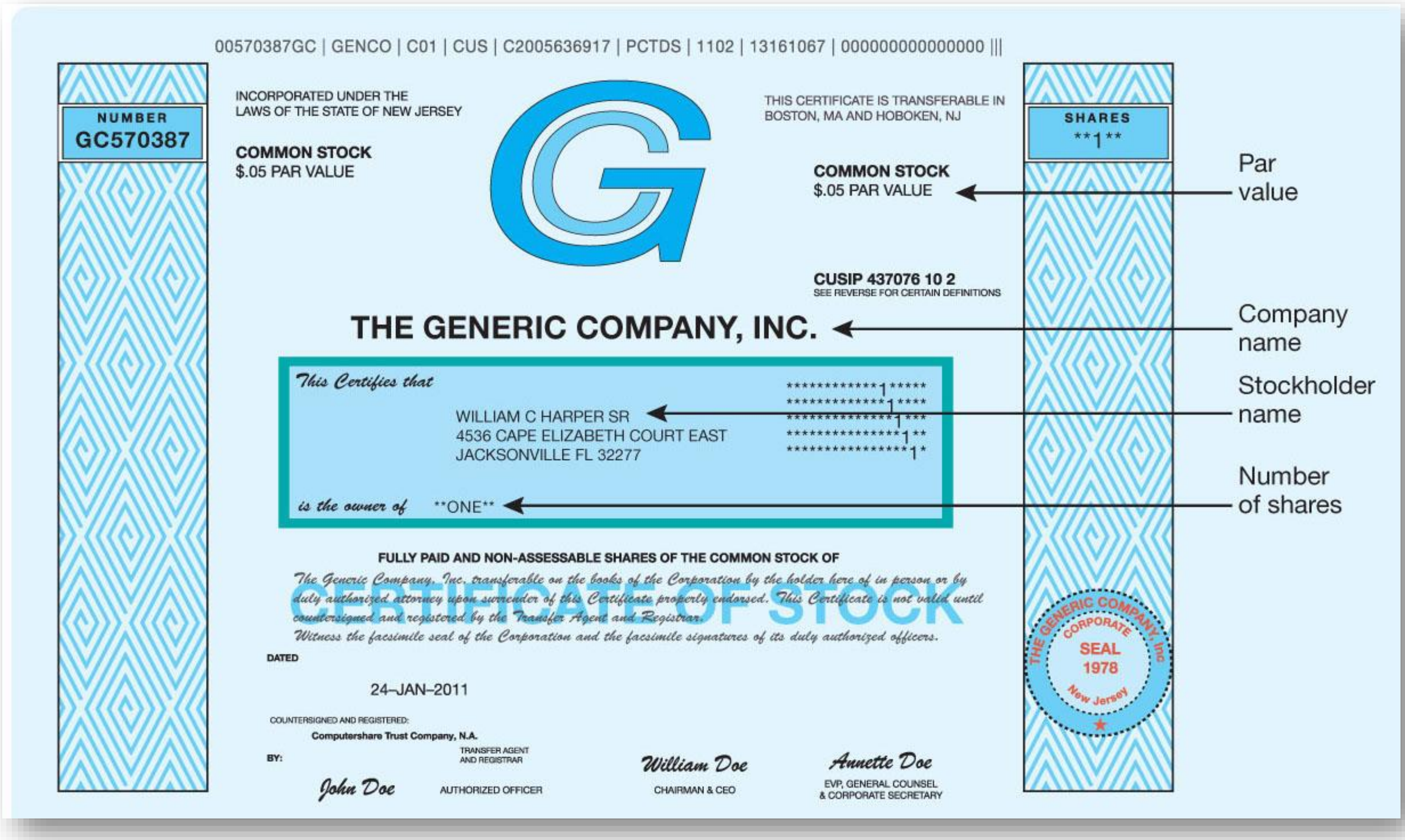


Exhibit 10-3 | Hypothetical Corporate Stock Certificate

1 Classes of Stock

Common Stock

- Basic form of stock
- The owners of the corporation
- Four basic rights
- Stand to benefit most if corporation succeeds

Preferred Stock

- Certain advantages over common stock
  - Receive dividends first
  - Receive assets first in liquidation
- Four basic rights
- Rare in practice

	Common Stock	Preferred Stock	Long-Term Debt
1. Obligation to repay principal	No	No	Yes
2. Dividends/interest	Dividends are not tax-deductible	Dividends are not tax-deductible	Interest expense is tax-deductible
3. Obligation to pay dividends/interest	Only after declaration	Only after declaration	At fixed rates and dates

Exhibit 10-4 | Comparison of Common Stock, Preferred Stock, and Long-Term Debt

1 Explain the Features of a Corporation

Classes of Stock

- Par Value and No-Par
  - Par – arbitrary amount assigned by a company upon issuing stock
  - Usually set low to avoid legal issues
  - No-Par stock does not have a par value
    - May have a stated value
    - Rare in practice

Learning Objective Two

Account for the issuance of stock

2 Account for the Issuance of Stock

Common Stock at Par. Home Depot needs to raise $100 million through issuance of stock. Suppose Home Depot's common stock had carried a par value equal to its issuance price of $10 per share. The entry for issuance of 10 million shares of stock at par would be:

2

Account for the Issuance of Stock

Common Stock Above Par. Home Depot needs to raise $100 million through issuance of stock. Suppose Home Depot's common stock had a par value of $0.05. The entry for issuance of 10 million shares of stock at $10 per share would be:

2 Account for the Issuance of Stock

Common Stock Above Par. Stockholders' Equity section of Home Depot balance sheet might appear as follows (figures assumed):

	A	B
1	**Stockholders' Equity**	
2	Common stock, $.05 par, 10 billion shares	
3	authorized, 10 million shares issued and outstanding	$ 500,000
4	Paid-in Capital	99,500,000
5	Total paid-in capital	100,000,000
6	Retained earnings	500,000,000
7	Total stockholders' equity	$ 600,000,000
8		

2 Account for the Issuance of Stock

No-Par Common Stock. Krispy Kreme Doughnuts, Inc. issues 63,069 million shares of no-par common stock for $266,724,000. The entry is as follows (in millions):

2 Account for the Issuance of Stock

No-Par Common Stock. Krispy Kreme Doughnuts reports stockholders' equity on its balance sheet as follows (in millions):

	A	B
1	**Stockholders' Equity**	
2	**(in millions)**	
3	Common stock, no par, 300,000,000 shares	
4	authorized, 63,069,000 shares issued and outstanding	$ 266,724,000
5	Accumulated deficit	(10,584,000)
6	Total stockholders' equity	$ 256,140,000
7		

2 Account for the Issuance of Stock

Common Stock Issued for Assets Other Than Cash. On November 12, Kahn Corp. issued 15,000 shares of $1 par common stock for equipment with a market value of $4,000 and a building with a market value of $120,000.

Account for the Issuance of Stock

Common Stock Issued for Services. Kahn engages an attorney. The attorney bills the corporation $25,000 for services and agrees to accept 2,500 shares of $1 par common stock, in settlement of the fee. The fair market value of the stock is $10 per share.

A1

	A	B	C	D
1		Legal Expense	25,000	
2		Common Stock (2,500 × $1 par)		2,500
3		Paid-in Capital in Excess of Par—Common		
4		($25,000 – $2,500)		22,500
5				

2 Account for the Issuance of Stock

Stock Issuance for Other Than Cash – Ethical Challenge. When corporations receive an asset other than cash, the corporation must record the asset received and the stock issued at fair market value. If software worth $500,000 is received for common stock, the following entry would be appropriate:

2 Account for the Issuance of Stock

Stock Issuance for Other Than Cash – Ethical Challenge. Suppose your computer-whiz friend invites you to invest in the new business and shows you this balance sheet:

	A	B	C	D
1	**Gee-Whiz Computer Solutions, Inc.** **Balance Sheet** **December 31, 2018**			
2	**Assets**		**Liabilities and Stockholders' Equity**	
3	Computer software	$ 500,000	Total liabilities	$ -0-
4			**Stockholders' Equity**	
5			Common stock	500,000
6	Total assets	$ 500,000	Total liabilities and stockholders' equity	$ 500,000
7				

2 Account for the Issuance of Stock

Preferred Stock

- Follows same pattern as accounting for common stock
- May be separate accounts for paid-in capital in excess of par for preferred and common
- Can be issued with conversion feature to allow preferred shareholders to exchange preferred shares for common

2 Account for the Issuance of Stock

Issue Preferred Stock. Convertible preferred stock, $1 par, 50,000 shares issued at par value:

2 Account for the Issuance of Stock

Convert Preferred Stock. Converted preferred stock to common stock at the rate of 6.25 to 1 (8,000 shares of $1 par-value common stock issued in exchange for 50,000 shares of preferred stock).

2 Account for the Issuance of Stock

Authorized, Issued, and Outstanding Stock

- Authorized – maximum number of shares the company can issue under its charter
- Issued – number of shares the company has issued to its stockholders
- Outstanding – number of shares that the stockholders own

Issued stock – Treasury stock = Outstanding

3 Learning Objective Three

Explain how treasury stock affects a company

3 Explain How Treasury Stock Affects a Company

- **Treasury stock** – a company's own stock that it had issued and later reacquired
- Reasons to buy treasury stock:
  - Need stock for distributions to employees
  - Buying its stock low and selling at a higher price
  - Avoid takeover
  - Increase earnings per share (EPS)
  - Repurchase program to return excess cash to shareholders

3 Explain How Treasury Stock Affects a Company

How is Treasury Stock Recorded?

- Recorded at cost on the date of purchase
- Disregard par value
- Contra stockholders' equity account
  - Debit balance
- Reported beneath Retained Earnings on the balance sheet

3 Explain How Treasury Stock Affects a Company

	A	B
1	**The Home Depot, Inc. Stockholders' Equity January 31, 2016**	
2	**(in millions)**	
3	Common stock	88
4	Paid-in capital	9,347
5	Retained earnings	30,973
6	Accumulated other comprehensive loss	(898)
7	Treasury stock (520,000,000 shares)	(33,194)
8	Total stockholders' equity	$ 6,316
9		

3 Explain How Treasury Stock Affects a Company

Treasury Stock. The following entry records the repurchase of 53 million shares for $7 billion.

3 Explain How Treasury Stock Affects a Company

Retirement of Treasury Stock

- Cancel stock certificates
- Retired stocks cannot be reissued
- Once repurchased, neither total assets nor total liabilities are affected
- Memorandum entry to decrease the number of shares issued in stockholders' equity

3 Explain How Treasury Stock Affects a Company

Resale of Treasury Stock

- Increases assets and equity by amount of cash received
- Never a gain or loss on treasury stock transactions
- Amounts received in excess (or short) of original amount paid are recorded as Paid-in Capital from Treasury Stock Transactions

3 Explain How Treasury Stock Affects a Company

Resale of Treasury Stock. On July 22, 2016, Home Depot resold a million shares of treasury stock for $90 per share. Assuming that the average cost of treasury shares is $70.15, the journal entry to record the resale of treasury shares would have been as follows:

Explain How Treasury Stock Affects a Company

Issuing Stock for Employee Compensation. Home Depot issued 4 million new (not treasury) shares in conjunction with an employee stock compensation plan. Par value was $0.05. The entry the company made was:

3 Explain How Treasury Stock Affects a Company

	A	B
1	**The Home Depot, Inc.** **Stockholders' Equity** **January 29, 2017**	
2	(in millions)	
3	Common stock	88
4	Paid-in capital	9,787
5	Retained earnings	35,519
6	Accumulated other comprehensive income (loss)	(867)
7	Less Treasury stock (at cost) 573 million shares	(40,194)
8	Total stockholders' equity	$ 4,333
9		

3 Explain How Treasury Stock Affects a Company

Summary of Treasury-Stock Transactions

- **Buying treasury stock** – assets and equity decrease by the cost of treasury stock purchased
- **Reselling treasury stock** – assets and equity increase by the sale price of treasury stock sold
- **Retiring treasury stock** – remove it from common stock and treasury
- **Issuing stock for employee compensation** – expenses, capital stock, and additional paid-in capital all increase

Learning Objective Four

Account for retained earnings, dividends, and splits

4 Account for Retained Earnings, Dividends, and Splits

Retained Earnings

- Net income less net losses less dividends declared
- Accumulated over corporation's life
- Credit balance → lifetime earnings exceed lifetime losses and dividends
- Debit balance → lifetime losses and dividends exceed earnings (deficit)

4 Account for Retained Earnings, Dividends, and Splits

Dividends

- Distribution by a corporation to its stockholders, usually based on earnings
- Usually take one of three forms:
  - Cash
  - Stock
  - Noncash assets

4 Account for Retained Earnings, Dividends, and Splits

Cash Dividends

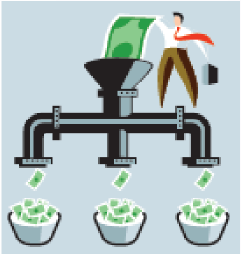
- Most common type of dividend
- Must have enough retained earnings to declare dividend and cash to pay the dividend
- Board of directors has the authority to declare
  - Corporation has no obligation until declared
- Three relevant dates:
  - Declaration date
  - Date of record
  - Payment date

4 Dividends

(Learning Objective 3) (2 of 2)

Dividends reduce Retained Earnings.

Cash dividends distribute cash to stockholders.



Stock dividends distribute additional shares to stockholders.

Stock splits transfer additional shares to stockholders without changing equity.

4 Account for Retained Earnings, Dividends, and Splits

Declaration Date: On June 19, the board of directors declares a $50,000 cash dividend. The company records the dividend as follows:

4 Account for Retained Earnings, Dividends, and Splits

Date of Record: July 1 – As part of the declaration, the corporation announces the record date, which follows the declaration date by a few weeks. The stockholders on the record date will receive the dividend. There is **no journal entry** for the date of record.

4 Account for Retained Earnings, Dividends, and Splits

Payment Date. On July 10, the company paid the dividend declared on June 19. The entry to record the payment is as follows:

4 Account for Retained Earnings, Dividends, and Splits

Analyzing Stockholders' Equity Accounts

- Net income is the only item that increases retained earnings
- Net losses decrease retained earnings
- Dividends declared decrease retained earnings
- Other adjustments to retained earnings are usually minor and rare

4 Account for Retained Earnings, Dividends, and Splits

Retained earnings			
Other adjustments	7	Beg bal	30,973
Dividends	*X*	Net income	7,957
		End bal	35,519

$30,973 + $7,957 - $7 - X = $35,519

X = $3,404

4 Account for Retained Earnings, Dividends, and Splits

Dividends on Preferred Stock

- Receive dividends before common stockholders
- Stated as either:
  - Percent of par value, or
  - Dollar amount per share
- May be cumulative
  - Receive all dividends in arrears before common stockholders get any dividend

4 Account for Retained Earnings, Dividends, and Splits

Dividends on Preferred Stock. The preferred stock of Avant Garde, Inc., is cumulative. Avant Garde passed the preferred dividend of $150,000 in 2017. Before paying dividends to common in 2018, Avant Garde must first pay preferred dividends of $150,000 for both 2017 and 2018—a total of $300,000. On September 6, Avant Garde declares a $500,000 dividend.

4 Account for Retained Earnings, Dividends, and Splits

Stock Dividends

- Proportional distribution of corporation’s stock to its shareholders
- Increase Common Stock and Paid-in Capital in Excess of Par – Common
- Decrease Retained Earnings
- Total equity is unchanged

4 Account for Retained Earnings, Dividends, and Splits

Stock Dividends

- Reasons for stock dividends:
  - Continue dividends, but conserve cash
  - Reduce the per-share market price of stock
- Small stock dividend
  - 25% or less
  - Record at market value
- Large stock dividend
  - Greater than 25%
  - Record at par value

4 Account for Retained Earnings, Dividends, and Splits

Stock Dividends. Home Depot declared and distributed a 10% common stock dividend on February 3, 2017. Home Depot had 1,203 million shares outstanding and the stock was trading for $140 per share. Home Depot records the stock dividend:

	A	B	C	D
1	2017	Retained Earnings[4] (1,203,000,000 shares of		
2	Feb. 3	common outstanding × 0.10 stock dividend × $140		
3		market value per share of common)	16,842,000,000	
4		Common Stock (1,203,000,000 × 0.10 × $0.05		
5		par value per share)		6,015,000
6		Paid-in Capital		16,835,985,000
7		*Declared and distributed a 10% stock dividend.*		
8				

4 Account for Retained Earnings, Dividends, and Splits

Stock Splits

- An increase in the number of shares of stock issued and outstanding
- Proportionate reduction in par value
- Decreases the market price of the stock
    - Makes stock more attractive in the market
- No accounts affected

4 Account for Retained Earnings, Dividends, and Splits

Stock Split. Before the split, Home Depot had 500 million shares of $0.10 par common stock issued and outstanding. Home Depot records a 2-for-1 stock split, as shown below:

The Home Depot, Inc., Stockholders' Equity (Adapted, Assumed Numbers)			
Before 2-for-1 Stock Split	**(In millions)**	**After 2-for-1 Stock Split**	**(In millions)**
Common stock, $0.10 par, 1,000 shares authorized, 500 shares issued and outstanding	$ 50	Common stock, $0.05 par, 1,000 shares authorized, 1,000 shares issued and outstanding	$ 50
Additional paid-in capital	643	Additional paid-in capital	643
Retained earnings	4,304	Retained earnings	4,304
Other equity	260	Other equity	260
Total stockholders' equity	$ 5,257	Total stockholders' equity	$ 5,257

Exhibit 10-5 | Effects of Stock Transactions

Transaction	Assets	=	Liabilities	+	Stockholders' Equity
			Effect on Total		
Issuance of stock—common and preferred	Increase		No effect		Increase
Purchase of treasury stock	Decrease		No effect		Decrease
Sale of treasury stock	Increase		No effect		Increase
Declaration of cash dividend	No effect		Increase		Decrease
Payment of cash dividend	Decrease		Decrease		No effect
Stock dividend—large and small	No effect		No effect		No effect*
Stock split	No effect		No effect		No effect