chapter

13

Corporations: Organization, Stock Transactions, and Dividends

OPENING COMMENTS

This chapter explains the characteristics of a corporation. It also introduces many of the terms related to stock: common, preferred, par value, stated value, no-par, cumulative, and noncumulative. Additional topics covered in Chapter 13 are treasury stock (cost method), stock splits, dividends, and computation and significance of earnings per share.

After studying the chapter, your students should be able to:

1. Describe the nature of the corporate form of organization.
2. Describe the two main sources of stockholders' equity.
3. Describe and illustrate the characteristics of stock, classes of stock, and entries for issuing stock.
4. Describe and illustrate the accounting for cash dividends and stock dividends.
5. Describe the effect of stock splits on corporate financial statements.
6. Describe and illustrate the accounting for treasury stock transactions.
7. Describe and illustrate the reporting of stockholders' equity.
8. Describe and illustrate the use of earnings per share in evaluating a company's profitability.

KEY TERMS

cash dividend
common stock
cumulative preferred stock
deficit
discount
dividends
earnings per common share (EPS)
in arrears
outstanding stock
paid-in capital
par value
preferred stock
premium
prior period adjustments
restrictions
retained earnings
retained earnings statement
statement of stockholders' equity
stock
stock dividend
stock split
stockholders
stockholders' equity
treasury stock

STUDENT FAQS

- Why is there a difference between issued and outstanding stock?
- When you sell stock above par value, why can you not have a gain instead of having to put it in paid-in capital in excess of par value?
- Treasury stock cannot be a good name for ownership of stock in our own company. Can we call it by some other name, and why can we not record a gain/loss on the sale of treasury stock?
- Treasury stock is not an asset, but I do not understand why. Can you explain?
- Does common stock always have to be sold before preferred stock?
- Why is the normal balance for Treasury Stock a debit?
- By using par or stated value, aren't corporations just playing around with the value of their stock?
- Would it be better for a company to issue 10 shares of $1,000 par value stock or 10,000 shares of $1 par value stock?
- Why can't you pay dividends on treasury stock?
- Why would a company consider issuing preferred stock? If it needs to raise capital, wouldn't it be better just to borrow the money from a bank?

- If "dividends in arrears" means we still owe the preferred shareholders a dividend, why are we not required to book it as a liability? After all, isn't it a debt or obligation of the company?
- What is the most number of shares a company can issue? Is there a limit on the number besides what is listed as authorized stock?
- How is it that common stock investors have a greater potential for earning more dividends than do investors in preferred stock?
- When a corporation buys back its own stock, the cash account is credited—where does the cash physically "go"?

OBJECTIVE 1

Describe the nature of the corporate form of organization.

SYNOPSIS

A corporation is a distinct, separate legal entity. Many large businesses are corporations; as a result, they generate 90% of the total business dollars in the United States. Corporations have the ability to generate large amounts of capital. A corporation can also sell shares of ownership called stock. Stock can be bought and sold without affecting the operation or continued existence of the corporation. Stockholders have limited liability; they can only lose the amount they have invested in the stock. Stockholders control a corporation by electing a board of directors. As a separate entity, a corporation must pay taxes on its income. Income is distributed to stockholders as dividends, and stockholders must pay taxes on the dividends they receive. This double taxation is a disadvantage of the corporate form of business. Corporations are formed by filing an application of incorporation with the state. Different states have differing corporate laws, and businesses usually incorporate in the state that has the most advantageous laws. The management then prepares a set of bylaws, which are the rules and procedures for conducting the corporation's affairs. Costs incurred in forming a corporation are journalized as organizational expenses.

Key Terms and Definitions

- **Stock -** Shares of ownership of a corporation.
- **Stockholders -** The owners of a corporation.

Relevant Exhibits

- Exhibit 1 – Organizational Structure of a Corporation
- Exhibit 2 – Advantages and Disadvantages of the Corporate Form
- Exhibit 3 – Examples of Corporations and Their States of Incorporation

SUGGESTED APPROACH

Objective 1 opens with the characteristics of a corporation. Use Handout 13-1 to review these characteristics. When covering the concept of limited liability, point out that it is common for owners of small private corporations to pledge their personal assets in order to obtain bank loans. Also, emphasize the penalty resulting from double taxation of corporate earnings; this is one of the main disadvantages of the corporate form of business.

The following is an interesting real-world note you can share with your students: Nonprofit entities often organize as corporations to limit their legal liability and to obtain favorable tax treatment under federal tax laws. Examples of nonprofit corporations include the United Way and the Salvation Army.

This objective also explains the steps necessary to form a corporation and the accounting treatment for the resulting organizational costs. The Lecture Aid and Group Learning Activity below will help you present this material.

LECTURE AID—Organization Costs

To begin the process of forming a corporation, a business must file an application of incorporation with the state in which the company will incorporate. After approving this application, the state grants a charter (or articles of incorporation) that formally creates the corporation. You may wish to point out that state incorporation laws differ. Since Delaware has more favorable incorporation laws than other states, more than half of the largest companies are incorporated in Delaware. Exhibit 3 in the text lists some of them.

Organization costs are the costs incurred during the process of incorporating a business. These costs can be significant. They include the following:

1. Legal fees
2. Taxes
3. State incorporation fees
4. License fees
5. Promotional costs

Organization costs are recorded as an expense as they are incurred.

GROUP LEARNING ACTIVITY—Organization Costs

Ask your students to record the following entry for Hoover Corporation (see Handout 13-2). The correct journal entry is listed on Handout 13-3.

> Hoover Corporation was organized early in 20Y4. Legal costs and other fees associated with incorporation totaled $3,500.

OBJECTIVE 2

Describe the two main sources of stockholders' equity.

SYNOPSIS

The owners' equity in a corporation is called stockholders' equity, shareholders' equity, shareholders' investment, or capital. It is reported on the balance sheet as paid-in capital and retained earnings. Corporations sometimes have different classes of stock: common or preferred. If there is only one class of stock, it is common stock. Retained earnings are the corporations' cumulative net income; dividends are the distributions of this income. If retained earnings are not distributed, they are referred to as earnings retained for use in the business or earnings reinvested in the business. Net income increases the balance in retained earnings, and net loss and dividends decrease the balance in retained earnings. A retained earnings account normally has a credit balance and is not related to the cash balance.

Key Terms and Definitions

- **Deficit** - A debit balance in the retained earnings account.
- **Dividends -** Distribution of a corporation's earnings to stockholders.
- **Paid-In Capital -** Capital contributed to a corporation by the stockholders and others.
- **Retained Earnings -** Net income retained in a corporation.
- **Stockholders' Equity -** The owners' equity in a corporation.

Relevant Exhibit

- Exhibit 4 – Sources of Stockholders' Equity

SUGGESTED APPROACH

Ask your class the following question: If you need money, what legal methods can you use to get it? Usually, students' responses will fit into one of the following categories:

1. You can borrow money.
2. You can earn it by getting a job.
3. Someone (such as a parent) can give it to you.

This will allow you to point out that a corporation has the same options to obtain the cash it needs for operations. It can borrow money, creating a liability. It can also get cash by making a profit from its operations. Finally, it may be given cash by its shareholders as they invest in the corporation by purchasing shares of stock.

Therefore, the two sources of owner's equity are as follows:

1. Paid-in capital (also called contributed capital): funds invested by the shareholders

2. Retained earnings: the net income of the corporation less the dividends that have been paid to the shareholders. If the business has sustained net losses, Retained Earnings may have a negative (or deficit) balance.

OBJECTIVE 3

Describe and illustrate the characteristics of stock, classes of stock, and entries for issuing stock.

SYNOPSIS

Authorized stock is the number of shares of stock that a corporation is authorized to issue in its charter. Issued stock refers to the number of shares sold to stockholders. Sometimes a corporation may reacquire its own stock; stock still in the hands of stockholders is then known as outstanding stock. Some states that incorporate businesses require the stock to have a par value or stated value per share; the stock may not be sold under the par value. Some states also have a minimum requirement for capital, called the legal capital; this usually includes the par value of the stock. A corporation may have different classes of stock: common stock, preferred stock, and cumulative preferred stock. Stock rights include the right to vote on corporate matters, share in distribution of earnings, and share in the assets upon liquidation. Stock rights may vary with the class of stock. Preferred stock gives a shareholder preference to any dividends. Cumulative preferred stock gives holders the right to dividends every year, even when they are not declared. Separate accounts are used to record the amount of each class of stock issued to investors. Stock is often issued at a price different from par. Stock sold above par is issued at a premium, and stock sold below par is sold at a discount. Many states do not permit the corporation to sell stock below par. Stock sold at a premium is recorded as a debit to Cash and a credit to the stock account and a credit to Paid-In Capital in Excess of Par. When stock is issued for assets other than cash, the assets are recorded at their fair market value. If this cannot be determined, then the fair market value of the stock is used. If the state does not require par, sometimes a stated value is assigned. These stocks are recorded the same way as par stock, except the name of the account changes to Paid-In Capital in Excess of Stated Value. If the stock has no par value, its sale is recorded as a debit to Cash and a credit to Common Stock.

Key Terms and Definitions

- **Common Stock -** The stock outstanding when a corporation has issued only one class of stock.
- **Cumulative Preferred Stock -** Stock that has a right to receive regular dividends that were not declared (paid) in prior years.
- **Discount -** The interest deducted from the maturity value of a note or the excess of the face amount of bonds over their issue price.
- **In Arrears -** Cumulative preferred stock dividends that have not been paid in prior years are said to be in arrears.
- **Outstanding Stock -** The stock in the hands of stockholders.
- **Par Value -** A dollar amount assigned to each share of stock.
- **Preferred Stock -** A class of stock with preferential rights over common stock.
- **Premium -** The excess of the issue price of a stock over its par value or the excess of the issue price of bonds over their face amount.

Relevant Example Exercises and Exhibits

- Exhibit 5 – Authorized, Issued, and Outstanding Stock
- Exhibit 6 – Dividend Preferences
- Example Exercise 13-1 – Dividends per Share
- Example Exercise 13-2 – Entries for Issuing Stock

SUGGESTED APPROACH

As you can see from the list of key terms above, this objective presents a number of definitions. Use the following Lecture Aid to explain the difference between common and preferred stock. You will also need to reinforce the difference between cumulative and noncumulative preferred stock, using a Demonstration Problem.

Other terms that merit special emphasis are "legal capital" and "outstanding shares." Legal capital is the amount invested by shareholders that cannot be returned in the form of dividends. In most states, the par or stated value of the stock establishes legal capital. Legal capital provides protection to creditors because, even in liquidation, it cannot be returned to stockholders until all debts are paid.

Stock that is "issued" has been sold to stockholders. Stock is "outstanding" if it is still owned by stockholders. Stock that has been reacquired by a corporation (introduced in Objective 6 as treasury stock) is issued, but it is not outstanding. This can be expressed through the following equation:

Issued Stock – Stock Reacquired (Treasury Stock) = Outstanding Stock

Ask your students to solve the following problem: XYZ Corporation is authorized to sell 1 million shares of common stock; 750,000 shares have been issued, and 50,000 shares have been reacquired by XYZ. How many shares are outstanding? (Answer: 700,000)

LECTURE AID—Classes of Capital Stock

A corporation may have different classes of stockholders. The most common class of stock is called common stock. The major rights usually granted to a common shareholder are:

1. The right to vote in matters concerning the corporation
2. The right to share in distributions of earnings
3. The right to share in assets upon liquidation

A corporation may establish additional classes of stock by granting certain shareholders preferential treatment in one or more of these rights. In many cases, the corporation will issue stock that is given preferential treatment in the area of dividends, called preferred stock. A corporation can even establish more than one class of preferred stock. Ask your students to check *The Wall Street Journal* and identify corporations that have multiple classes of preferred stock.

LECTURE AID—Preferred Stock

Before discussing the dividend characteristics of preferred stock, stress that dividends are not a liability of a corporation until declared by the board of directors. Corporations are not required to pay dividends.

Cumulative vs. Noncumulative Preferred Stock: Although preferred shareholders are "first in line" for dividends, they are not guaranteed dividends. If a corporation determines that it needs to keep its earnings to finance growth, or if earnings are low, the preferred dividend may be passed in one or more years. These passed dividends are called "dividends in arrears."

If the preferred stock is cumulative, all dividends in arrears must be paid before any dividends are granted to the common shareholder. If the preferred stock is noncumulative, the preferred stockholder forfeits any passed dividends.

Investors in common stock run a greater risk of not receiving dividends than do investors in preferred stock. On the other hand, common stock investors have a greater potential for earning more dividends than do investors in preferred stock.

DEMONSTRATION PROBLEM—Distributing Dividends

Belson Corporation has 10,000 common shareholders and 5,000 preferred shareholders. The preferred stock has a $5 dividend rate. Two years of dividends are currently in arrears. Assume that the preferred stock is cumulative. Belson has $155,000 to distribute in the form of dividends. Use this information to calculate the dividends distributed to the preferred and common shareholders.

	Preferred Shareholders	Common Shareholders	Total Distributed
Dividends in arrears (5,000 × $5 × 2)	$50,000		$ 50,000
Regular dividend	25,000		75,000
Remainder		$80,000	
Total dividends paid	$75,000	$80,000	$155,000
Per-share dividends	$15	$8	

You may want to illustrate an example of noncumulative preferred stock to emphasize the impact this feature can have on dividend distribution. Use the data above, but assume that the preferred stock is noncumulative. In this case, dividends would be distributed as follows:

	Preferred Shareholders	Common Shareholders	Total Distributed
Regular dividend	$25,000		$ 25,000
Remainder		$130,000	130,000
Total dividends paid	$25,000	$130,000	$155,000
Per-share dividends	$5	$13	

GROUP LEARNING ACTIVITY—Distributing Dividends

Ask your students to work in groups to distribute $65,000 of dividends to be paid by Belson Corporation under each of the following assumptions:

1. There is one year of preferred dividends in arrears. The preferred stock is cumulative.
2. There are three years of preferred dividends in arrears. The preferred stock is noncumulative.

The solutions are shown on Handouts 13-4 and 13-5.

WRITING EXERCISE—Characteristics of Preferred Stock

Ask your students to respond to the following question (Handout 13-6):

> Assume that you have decided to invest a portion of your money in the stock market. You ask your broker to recommend several preferred stocks for you to consider as an investment. Your broker recommends the following two companies. Both are start-up corporations, but you agree with your broker that both have excellent potential for the future.
>
> > Company A: Noncumulative, preferred stock with a $4-per-year dividend rate. Each share of this stock will cost you $20.
> >
> > Company B: Cumulative, preferred stock with a $4-per-year dividend rate. Each share of this stock will cost you $25.
>
> You have decided to invest in only one of the companies. State which company you would choose and why.

Possible response: Both Company A and Company B stocks will provide the same dividend per share, assuming dividends are paid. However, since Company A stock is less expensive, the investor can obtain more of Company A stock. Company B provides the additional guarantee that if dividends are not declared in a given year, they will be paid in future years. In order to receive this additional "peace of mind," the investor must pay a premium of $5 per share to invest in Company B. The answer will depend on the comfort level of the individual that dividends will be paid each year. If that comfort level is not there, it might be worth the additional investment and forfeiture of potential additional dividends (more shares of Company A means more dividends) to invest in Company B. You can provide an example by assuming the investor has $100 to invest. With a $100 investment, the investor will purchase 5 shares of Company A and only 4 shares of Company B. If dividends are paid each year, the Company A investment will yield $20 dividend, while the Company B investment would yield only $16 per year. Assuming a year passes where dividend are not paid for both companies, in the second year the Company A investment would again receive the $20 dividend, while Company B would receive a $32 dividend (current year and last year's in arrears).

SUGGESTED APPROACH—Journalizing the Entries for Issuing Stock

Explain the terms "par value" and "stated value." Illustrate how these stock characteristics affect the journal entries for issuing stock, using the Demonstration Problem below.

DEMONSTRATION PROBLEM—Entries for Issuance of Capital Stock

Par value is an arbitrary amount assigned to shares of stock. When preferred or common stock is issued, the par value of the stock is credited to the stock account. Any amount received above par (called a "premium") is credited to Paid-In Capital in Excess of Par.

Example: Belson Corporation sold 1,000 shares of $10 par value common stock for $17 per share.

Cash……………………………………………………….……	17,000	
Common Stock……………………………………………		10,000
Paid-In Capital in Excess of Par—Common Stock……….		7,000

Ask your students to record the following entry in their notes:

Belson sold 1,000 shares of $25 par value preferred stock for $30 per share.

Cash…………………………………………………………….	30,000	
Preferred Stock……………………………………………		25,000
Paid-In Capital in Excess of Par—Preferred Stock……….		5,000

To emphasize that par value is not related to market value, compare the par value of the sample annual report for common stock found in Appendix D to the current selling price from *The Wall Street Journal.*

No-par stock does not have an assigned par value. Some states require that a stated value be assigned to any no-par stock. If a stock has a stated value, it is treated the same as a par value in recording the stock. The stock account is credited for the stated value, and any premium is recorded in Paid-In Capital in Excess of Stated Value. If a no-par stock does not have a stated value, the full proceeds from issuing the stock are recorded in the stock account.

Ask your students to record the following entry in their notes:

1. Camden Corporation issued 100 shares of no-par preferred stock for $50 per share.

Cash…………………………………………………………..…	5,000	
Preferred Stock……………………………………………		5,000

2. Camden Corporation also issued 500 shares of common stock with a stated value of $5 per share for $7 per share.

Cash……………………………………………….……………	3,500	
Common Stock………………………..…………………		2,500
Paid-In Capital in Excess of Stated Value—Common Stock		1,000

3. Camden Corporation also issued 1,000 shares of $5 stated value common stock in exchange for equipment with a fair market value of $8,500.

Equipment………………………………………………………	8,500	
Common Stock……………………………………………		5,000
Paid-In Capital in Excess of Stated Value—Common Stock		3,500

You may want to contrast this last entry to the entry in the text for a corporation that receives land in exchange for shares of stock. Point out that the corporation knew the value of its stock, but the value of the land was not given. Therefore, the transaction was recorded at the fair market value of the stock. When stock is exchanged for another asset, use the fair market value that is most easily determined: the value of the asset received or the stock given up.

Optional discussion: *International Financial Reporting Standards (IFRSs).* You may want to mention that in 2010 the IASB issued a set of accounting standards specifically designed for small- and medium-sized enterprises (SMEs). These standards require less of SMEs than large enterprises and were designed to be cost effective for them. Since the AICPA accepted IFRSs for SMEs as part of GAAP for private companies not reporting to the SEC, they may become popular in the United States.

OBJECTIVE 4

Describe and illustrate the accounting for cash dividends and stock dividends.

SYNOPSIS

The board of directors of a corporation declares dividends. A cash dividend requires the authorization of cash to stockholders. A stock dividend requires the authorization of a stock distribution. In both cases, declaring a dividend reduces the retained earnings. In order to receive a cash dividend, there must be sufficient retained earnings, sufficient cash, and a formal action by the board. Three dates are important to the declaration: the date of declaration, the date of record, and the date of payment. On the date of declaration, the business formally incurs the liability to pay the amount of the dividend. The date of record is the date the business uses to determine who will receive the dividend. The date of payment is the date the stockholders receive their payment. On the date of declaration, the transaction is recorded as a debit to Cash Dividends and a credit to Cash Dividends Payable. No entry needs recorded on the date of record. On the date of payment, Cash Dividends Payable is debited, and Cash is credited. During the closing process, the balance in Cash Dividends is transferred to Retained Earnings.

A stock dividend is normally only declared on common stock. Additional shares of common stock are distributed to common stockholders. A stock dividend affects only the stockholders' equity. The amount of stock dividend is transferred from Retained Earnings to Paid-In Capital; the amount transferred is normally the fair value of the shares issued in the stock dividend. The transaction is recorded as a debit to Stock Dividends, a credit to Stock Dividends Distributable, and a credit to Paid-In Capital in Excess of Par. After this entry, Stock Dividends will have a debit balance; the closure of this account at the end of the period will reduce the retained earnings account.

Key Terms and Definitions

- **Cash Dividend -** A cash distribution of earnings by a corporation to its shareholders.
- **Stock Dividend -** A distribution of shares of stock to its stockholders.

Relevant Example Exercises

- Example Exercise 13-3 – Entries for Cash Dividends
- Example Exercise 13-4 – Entries for Stock Dividends

SUGGESTED APPROACH

Begin this topic by commenting on dividend policies. Point out that some companies make it a policy not to pay dividends at all, plowing all profits back into the company. Stockholders in these corporations count on share appreciation in order to receive a return on their investment. Companies that do pay dividends usually try to maintain a stable regular dividend, generally paid quarterly.

Next, review the entries for cash dividends, stressing the importance of the three dividend dates (declaration, record, and payment). Use the Demonstration Problem covering cash dividends for this purpose.

When covering stock dividends, it is important to discuss the motivation behind a stock dividend. Hints to lead this discussion are found in the Lecture Aid that follows. A Demonstration Problem to use in journalizing stock dividends is also included here.

The text discusses but does not illustrate the closing entries for these accounts. You may want to illustrate closing entries for a corporation at this point to emphasize the final disposition of the cash dividend and stock dividend accounts and to demonstrate how the balance of retained earnings is obtained.

DEMONSTRATION PROBLEM—Cash Dividends

On January 15, the board of directors of Barns Incorporated declared a $0.25-per-share dividend on its common stock to shareholders of record on January 31, payable on February 15. Barns has 25,000 shares of stock authorized, 10,000 shares issued, and 8,000 shares outstanding.

1. Date of Declaration: Once declared, the dividend becomes a liability of the corporation. Therefore, it is credited to a liability account.

January 15	Cash Dividends……………………..	2,000	
	Cash Dividends Payable….		2,000

The cash dividends account is the corporate counterpart to the sole proprietor’s drawing account. It is closed to Retained Earnings at year-end.

Also, note that the total dollar amount of the dividend is $2,000 (8,000 shares × $0.25). Dividends are not paid on the 2,000 treasury shares.

2. Date of Record: No journal entry is required. This date determines who will receive the dividend. Anyone owning stock in Barns at the close of business that day will receive the dividend.

3. Date of Payment: The liability is paid by mailing the dividend checks.

February 15	Cash Dividends Payable………….	2,000	
	Cash………………………		2,000

LECTURE AID—Stock Dividends

When stock dividends are "paid," additional shares of stock are mailed to the shareholders (or credited to their account, actual paper shares of stock being rare these days). This allows the corporation to give a return to its shareholders without using any of its cash.

In reality, shareholders own exactly the same portion of the corporation after the stock dividend as they did before the dividend was issued. You can compare the corporation to a pie. Let's say that you cut a pie into six pieces. If you have three pieces, you have half of the pie. If you originally cut that same pie into eight pieces, four pieces equal half the pie. Four pieces may seem like more than three, but because they are smaller pieces, you still get the same amount of dessert (and calories).

A corporation issuing a stock dividend doesn't get any bigger because the dividend doesn't bring in any new assets. The corporation also doesn't get any smaller because a stock dividend doesn't use up any assets. The corporation is just divided into smaller pieces. All shareholders have more pieces, but they're still getting the same share of the pie.

How do shareholders profit from stock dividends? In theory, a 10% stock dividend should reduce the market price of the stock by 10% since each share represents a 10% smaller piece of the pie. However, in many cases, the market price of the stock does not decline the full 10%. Therefore, the total market value of each shareholder's stock increases.

Even if the market price does fall the full 10%, shareholders have more shares on which to realize any future share appreciation. They also have more shares on which to receive any future cash dividend payments.

DEMONSTRATION PROBLEM—Stock Dividends

On June 20, the board of directors of Carlisle Corporation declares a 4% stock dividend on its 50,000 shares of common stock. The shares will be issued on July 14. The par value of the stock is $10 per share; the market value on June 20 is $16 per share.

1. *Declaration Date*: A liability to distribute the dividends is established with a credit to the stock dividends distributable account.

June 20	Stock Dividends…………………………………	32,000	
	Stock Dividends Distributable…………………..		20,000
	Paid-In Capital in Excess of Par —Common Stock……………………………..		12,000

Note that the stock dividends account is debited for the market value of the stock (2,000 shares × $16). This is the case for stock dividends declared by most large public corporations; the market price of the stock is easily determined, and the dividend usually does not alter the stock price dramatically. For small, private corporations, stock dividends are usually recorded at the par value of the stock.

The stock dividends account will be closed to Retained Earnings at year-end. Therefore, the effect of a stock dividend is to capitalize a portion of the corporation's earnings.

The stock dividends distributable account is credited for the par value of the stock. The balance in this account will be transferred to Common Stock (which is also carried at par) when the shares are distributed. If a balance sheet is prepared before distributing the dividend, Stock Dividends Distributable is listed as part of paid-in capital.

2. *Distribution Date*: The additional shares are mailed to the shareholders, relieving the corporation's liability. The shares are recorded as outstanding by crediting the common stock account.

July 14	Stock Dividends Distributable……………	20,000	
	Common Stock……………………		20,000

It is important to distinguish between a stock dividend and a stock split. A stock dividend is usually small in relation to the total shares outstanding. A stock dividend also transfers an amount from retained earnings to paid-in capital. A stock split applies to all shares (unissued, issued, and treasury) and does not transfer any amounts from retained earnings to paid-in capital.

WRITING EXERCISE—Stock Dividends

Ask your students to explain the following (shown on Handout 13-7):

> Explain the benefits of a stock dividend, both to the corporation issuing the dividend and to the shareholder receiving the dividend.

Answer from Lecture Aid above: A corporation issuing a stock dividend does not get any bigger because the dividend does not bring in any new assets. The corporation also does not get any smaller because a stock dividend does not use up any assets. The corporation is just divided into smaller pieces. All shareholders have more pieces, but they are still getting the same share of the pie.

How do shareholders profit from stock dividends? In theory, a 10% stock dividend should reduce the market price of the stock by 10% since each share represents a 10% smaller piece of the pie. However, in many cases, the market price of the stock does not decline the full 10%. Therefore, the total market value of each shareholder's stock increases.

DEMONSTRATION PROBLEM—Closing Entries for a Corporation

Assume a corporation had the following account balances at the end of a fiscal year. (For simplicity, all expenses are assumed to be recorded in one expense account.)

Revenues	$200,000
Expenses	150,000
Cash Dividends	12,000
Stock Dividends	8,000

Use these accounts to demonstrate closing entries for a corporation.

Revenues

	Bal. 200,000
Clos. 200,000	

Expenses

Bal. 150,000	
	Clos. 150,000

Retained Earnings

	Clos. 50,000
Clos. 12,000	
Clos. 8,000	
	Bal. 30,000*

* *Note:* The ending balance of Retained Earnings = Net Income – Dividends

Cash Dividends

Bal. 12,000	
	Clos. 12,000

Stock Dividends

Bal. 8,000	
	Clos. 8,000

OBJECTIVE 5

Describe the effect of stock splits on corporate financial statements.

SYNOPSIS

A stock split is the process by which a corporation reduces the pay of stated value of the common stock and issues a proportionate number of additional shares. Sometimes this is done to make the stock more appealing in the open market. If the market value of a stock gets too high, a limited number of investors can afford the stock. A stock split requires no journal entry.

Key Term and Definition

- **Stock Split -** A reduction in the par or stated value of a common stock and the issuance of a proportionate number of additional shares.

Relevant Exhibit

- Exhibit 7 – Stock Split: Before and After

SUGGESTED APPROACH

With a stock split, one share of stock is split into two or more shares. When this occurs, the par value of the stock decreases, and the number of shares increases. The market value of the stock should also fall.

Under this objective, you will need to explain why a corporation would choose to split its stock. Also, illustrate the effect of a stock split on the number of shares and par value.

DEMONSTRATION PROBLEM—Stock Splits

Bravara Corporation has 10,000 shares of $20 par value common stock selling at $100 per share. Determine the new number of shares, par value, and market price under each of the following independent assumptions:

Split	**New Par Value (Current Par Value = $20)**	**New No. of Shares (Current No. of Shares = 10,000)**	**"Theoretical" New Market Price (Current Market Price = $100)**
2:1	$10	20,000	$50
4:1	5	40,000	25
10:1	2	100,000	10
5:2	8	25,000	40

The new market price is what the stock should sell for in theory after the stock split. However, many factors other than the split may affect the price of the stock. For example, favorable news about the economy may keep the price of the stock from dropping as low as it should.

Stock splits tend to be very good for shareholders. The split will lower the price, making stock affordable for more investors. More investors will enter the market, creating demand. Additional demand will begin to drive the stock price back up, and the shareholders will enjoy the profits resulting from the share appreciation.

Emphasize that no journal entry is required for a stock split.

INTERNET ACTIVITY—Stock Splits

Since stock splits create excitement in the stock market, many investors track which companies have announced stock splits. The following website provides a "Stock Split Calendar."

https://biz.yahoo.com/c/s.html

Have your students visit this site or perform a search on "stock splits" for more information.

WRITING EXERCISE—Stock Splits

Ask your students to answer the following question (shown on Handout 13-8):

Why would a company choose to split its stock?

Possible response: Stock splits tend to be very good for shareholders. The split will lower the price, making stock affordable for more investors. More investors will enter the market, creating demand. Additional demand will begin to drive the stock price back up, and the shareholders will enjoy the profits resulting from the share appreciation.

OBJECTIVE 6

Describe and illustrate the accounting for treasury stock transactions.

SYNOPSIS

Treasury stock is stock the corporation has issued or sold and then repurchased. A business may do this for a variety of reasons: to provide shares for resale to employees, to reissue as bonuses, or to support the market price of the stock. The method for recording this purchase is known as the cost method. When purchased, the stock is debited as cost to Treasury Stock. When the stock is resold, this account is credited for its cost; any difference between the cost and the selling price is debited or credited to Paid-In Capital from Sale of Treasury Stock.

Key Term and Definition

- **Treasury Stock -** Stock that a corporation has once issued and then reacquires.

Relevant Example Exercise

- Example Exercise 13-5 – Entries for Treasury Stock

SUGGESTED APPROACH

The term “treasury stock” originated because the treasurer’s office of a corporation usually has the responsibility for purchasing and maintaining custody of such stock. The text presents the cost method of accounting for treasury stock. The par value method is mentioned only in a footnote. The following Demonstration Problem presents sample entries that you can review with your class.

You will want to stress that the treasury stock account is a contra equity account, reducing shareholders’ equity for the amount returned to shareholders through the purchase of treasury stock. Many students are under the false impression that Treasury Stock is an asset, because it has a debit balance. Point out that a corporation does not (1) pay dividends on treasury stock, (2) vote treasury stock, or (3) recognize gains or losses if the treasury stock is reissued. Therefore, a corporation does not purchase its own stock as an investment, and it is not recorded as an asset.

You should also stress that treasury stock is the only "stock" account that is not recorded at par. The cost of treasury stock, not the par value, is debited to the account.

Before covering the entries for treasury stock, you may want to discuss the reasons that a corporation would purchase shares of its own stock (Handout 13-9).

DEMONSTRATION PROBLEM—Entries for Treasury Stock

Record the following entries for Lawry Corporation:

Lawry purchased 1,000 shares of $5 par value common stock for $10 per share.

Treasury Stock………………………………………..	10,000	
Cash………………………………………..		10,000

Lawry sold 100 shares of its treasury stock at $12 per share.

Cash………………………………………………..	1,200	
Treasury Stock…………………………………..		1,000
Paid-In Capital from Sale of Treasury Stock		200

Emphasize that paid-in capital from the sale of treasury stock is not reported on the income statement. A corporation cannot report a gain as the result of buying and selling its own stock. This would encourage insider trading. Paid-in capital from treasury stock is reported as an increase in stockholders' equity. When purchasers of treasury stock pay more than the cost of the stock, they have contributed additional capital to the corporation.

Lawry sold 100 shares of its treasury stock at $9 per share.

Cash…………………………………………………	900	
Paid-In Capital from Sale of Treasury Stock……….	100	
Treasury Stock……………………………………		1,000

After demonstrating these entries, ask your students to record the following three transactions in their notes:

Lawry sold 100 shares of its treasury stock at $14 per share.

Cash………………………………………………..	1,400	
Treasury Stock…………………………….		1,000
Paid-In Capital from Sale of Treasury Stock		400

Lawry sold 100 shares of its treasury stock at $8 per share.

Cash………………………………………………..	800	
Paid-In Capital from Sale of Treasury Stock………	200	
Treasury Stock…………………………….		1,000

Lawry sold 100 shares of its treasury stock at $10 per share.

Cash………………………………………………..	1,000	
Treasury Stock……………………………..		1,000

WRITING EXERCISE—Treasury Stock

Ask your students to respond to the following (shown on Handout 13-10):

> Name and explain two reasons that a corporation might choose to repurchase its own stock.

Answers are found on Handout 13-9.

OBJECTIVE 7

Describe and illustrate the reporting of stockholders' equity.

SYNOPSIS

There are two methods to report stockholders' equity on the balance sheet. In Method 1, each stock is reported separately along with its related paid-in capital account. In Method 2, each stock is reported separately but the paid-in capital account is combined for all classes of stock. In both methods, retained earnings are presented last followed by the deduction for treasury stock. Relevant rights and privileges of each class of stock should also be disclosed in the notes to the financial statements. Changes in the retained earnings may be reported using a separate retained earnings statement, a combined income and retained earnings statement, or a statement of stockholders' equity. Appropriations of retained earnings by the board of directors may restrict its use for the payment of dividends. The three ways retained earnings may be appropriated are legal, contractual, and discretionary. If any errors are made in the reporting of retained earnings, it is reported as an adjustment to the beginning balance of retained earnings. If the only changes to the retained earnings are due to net income or loss, a retained earnings statement is sufficient. However, when there are also changes to stock and paid-in capital, a statement of stockholders' equity is prepared.

Key Terms and Definitions

- **Prior Period Adjustments -** Corrections of material errors related to a prior period or periods, excluded from the determination of net income.
- **Restrictions** - Amounts of retained earnings that have been limited for use as dividends.
- **Retained Earnings Statement -** A summary of the changes in the retained earnings in a corporation for a specific period of time, such as a month or a year.
- **Statement of Stockholders' Equity -** A summary of the changes in the stockholders' equity in a corporation that have occurred during a specific period of time.

Relevant Example Exercises and Exhibits

- Exhibit 8 – Stockholders' Equity Section of a Balance Sheet
- Example Exercise 13-6 – Reporting Stockholders' Equity
- Exhibit 9 – Retained Earnings Statement
- Example Exercise 13-7 – Retained Earnings Statement
- Exhibit 10 – Statement of Stockholders' Equity

SUGGESTED APPROACH

This objective covers paid-in capital, retained earnings, and treasury stock on the balance sheet. It also illustrates the retained earnings statement, describes restrictions on retained earnings, and describes prior period adjustments. Lecture Aids to cover each of these items are discussed below.

LECTURE AID—Paid-In Capital on the Balance Sheet

Paid-in capital and retained earnings are the two major sources of stockholders' equity; therefore, they are the two major sections on a corporation's balance sheet.

You will probably need to remind your students that paid-in capital consists of the following accounts:

Preferred Stock
Paid-In Capital in Excess of Par—Preferred Stock
Common Stock
Paid-In Capital in Excess of Par—Common Stock
Paid-In Capital from Treasury Stock

Handout 13-11 lists the stockholders' equity accounts that are reported in the Paid-in capital section of the balance sheet.

Refer your students to Exhibit 8 in the text to see two examples of how these accounts are reported. Stress that the second format for Stockholder's Equity summarizes all of the paid-in capital accounts as one total, labeled "Additional paid-in capital."

To make sure your students see the "big picture," remind them that the Stockholders' equity section of the balance sheet consists of the following:

Paid-In Capital
\+ Retained Earnings
– <u>Treasury Stock</u>
Total Stockholders' Equity

Emphasize that treasury stock is deducted because it is a contra equity account.

DEMONSTRATION PROBLEM—Retained Earnings Statement

Begin by reviewing the concept of retained earnings. Retained earnings are profits that have been kept (retained) by a corporation. They are profits that have not been returned to shareholders through dividends. Therefore, retained earnings are increased by a corporation's net income and reduced by dividends declared.

Ask your students to compute the retained earnings balance at the end of the year for Parks Corporation, based on the following data:

Retained earnings, January 1	$ 50,000
Net income	100,000
Dividends declared	30,000

(Answer: $120,000)

Handout 13-12 presents a retained earnings statement for Parks Corporation.

LECTURE AID—Restrictions on Retained Earnings

Many students have the following misconception: Restricting retained earnings sets aside cash for a specific purpose. You must work to dispel the notion that restricting retained earnings affects a corporation's cash.

Use the following story to introduce the concept of restricted retained earnings:

Let's say that you have decided to treat yourself to a nice lunch off campus today. You have $30 in your pocket. When you get to the restaurant where you plan to eat, you notice that your car's gas tank is on empty. You don't have any credit cards with you, and you know you will have to purchase at least $10 in gas. How much can you afford to spend on lunch? Of course, the answer is $20.

In your mind, you have just restricted $10 of your money to purchase gas. As a result, you know that you have a maximum of $20 to spend on lunch.

A corporation may find itself in a position in which it needs to restrict a portion of its retained earnings. The retained earnings account shows the profits of a corporation less any profits returned to shareholders in the form of dividends. Under normal conditions, the corporation is free to distribute all of its earnings to its shareholders if it chooses to do so, just as you are free to spend your entire $30 on lunch. However, some conditions limit the earnings that may be returned to the shareholders, just as your need for gas limited what you could spend on lunch.

Restricting retained earnings does not set aside any cash in a special account. For example, assume that a corporation with a net income of $500,000 must restrict $100,000 of retained earnings due to the terms of a bank loan. The restriction informs shareholders that $100,000 in profits is needed to repay the bank loan. However, the corporation must also consciously save $100,000 in cash to make the loan payments. The fact that you restricted $10 for gas doesn't do any good if you spend the $10 on dessert.

Remind students that some states require a corporation to restrict retained earnings for an amount equal to the cost of any treasury stock that has been purchased.

WRITING EXERCISE—Restriction of Retained Earnings

Ask your students to write a response to the following question (shown on Handout 13-13):

> Technograph Corporation discovered that some hazardous material was buried on a parcel of land currently owned by the corporation. A former owner of the property buried the material. It will cost Technograph $1 million to remove the material and dispose of it properly.
>
> Would it be appropriate for Technograph's board of directors to restrict $1 million for cleanup of the hazardous material? If so, what would the restriction accomplish?

Possible response: Since it is possible that the EPA would require that such hazardous materials be cleaned up, the board of directors could restrict retained earnings for the cleanup. This would be categorized as a "legal" restriction.

DEMONSTRATION PROBLEM—Prior Period Adjustments

When an error in a prior year's net income is discovered, it is reported as a prior period adjustment. Prior period adjustments are shown on the retained earnings statement as a correction to the beginning balance of retained earnings.

The text does not illustrate a retained earnings statement with a prior period adjustment. The following example will help you give a brief practical example of this concept:

At the end of 20Y4, E & M Corporation discovered that several errors were made in the physical inventory count taken at the end of 20Y3. As a result, the cost of merchandise sold was understated by $10,000 in 20Y3, causing income before taxes to be overstated by the same amount. E & M reported $100,000 in retained earnings on December 31, 20Y3.

E & M made $80,000 of net income after taxes in 20Y4. The company declared $30,000 in dividends.
E & M's tax rate is 40%.

E & M Corporation
Retained Earnings Statement
For the Year Ended December 31, 20Y4

Retained earnings, January 1, 20Y4		$100,000
Less prior period adjustment for 20Y3 error in calculating cost of merchandise sold, net of $4,000 in taxes		6,000
Corrected retained earnings, January 1, 20Y4		$ 94,000
Net income for 20Y4	$ 80,000	
Dividends	(30,000)	
Increase in retained earnings		50,000
Retained earnings, December 31, 20Y4		$144,000

In practice, only material errors from prior periods are reported as a prior period adjustment. Errors arising from the use of estimates are never treated as prior period adjustments.

OBJECTIVE 8

Describe and illustrate the use of earnings per share in evaluating a company's profitability.

SYNOPSIS

The earnings per share ratio is used to evaluate the company's profitability. Net income alone can be difficult to compare across different size companies. This ratio is used to determine earnings per common share sometimes called basic earnings per share. The ratio is calculated as: earnings per share = (net income – preferred dividends)/average number of common shares outstanding.

Key Term and Definition

- **Earnings per Common Share (EPS) -** Net income per share of common stock outstanding during a period.

Relevant Example Exercise

- Example Exercise 13-8 – Earnings per Share

SUGGESTED APPROACH

Explain the significance of earnings per share data and present the formula for basic earnings per share.

LECTURE AID—Earnings per Share

Assume that two couples residing in the same city each have combined incomes of $70,000. Would you expect both couples to have about the same lifestyle? If you knew that one of those couples had no children and the other couple had seven children, would you still expect both couples to have the same lifestyle? In this case, the per-person income of the two families is dramatically different.

Couple A—No Children

$$\text{Earnings per Person} = \frac{\$70{,}000}{2} = \$35{,}000$$

Couple B—Seven Children

$$\text{Earnings per Person} = \frac{\$70{,}000}{9} = \$7{,}778$$

This same concept can be applied to corporations. Assume that two corporations both made $100,000 of net income last year. Corporation A has 1,000 shares of stock, and Corporation B has 100,000 shares. Would you rather have a share of stock in Corporation A or Corporation B? Corporation A has more income for each share of stock.

Corporation A

$$\text{Earnings per Share} = \frac{\$100{,}000}{1{,}000} = \$100$$

Corporation B

$$\text{Earnings per Share} = \frac{\$100{,}000}{100{,}000} = \$1$$

The formula for earnings per share is as follows:

$$\text{Earnings per Share} = \frac{\text{Net Income} - \text{Preferred Dividends}}{\text{Number of Common Shares Outstanding}}$$

Remind your students that if a company has no preferred stock, earnings per share is simply:

$$\text{Earnings per Share} = \frac{\text{Net Income}}{\text{Number of Common Shares Outstanding}}$$

Stress that earnings per share does not normally represent the amount that stockholders can expect to receive in dividends. It would only represent this amount if the corporation paid out all its earnings in dividends.

GROUP LEARNING ACTIVITY—Earnings per Share

Ask your class to work end-of-chapter Practice Exercise 13-8A or 13-8B to calculate and report earnings-per-share data.

Handout 13-1

CHARACTERISTICS OF A CORPORATION

1. Separate legal existence
2. Ownership evidenced by shares of stock
3. Ownership is easily transferred through sale of stock
4. Limited liability
5. Owners elect a board of directors to set corporate policies and select officers to manage the corporation
6. Separate taxable entity (leading to double taxation)
7. Earnings distributed in the form of dividends

Handout 13-2

ORGANIZATION COSTS

Record the following entry for Hoover Corporation:

Hoover Corporation was organized early in 20Y4. Legal costs and other fees associated with incorporation totaled $3,500.

Handout 13-3

ORGANIZATION COSTS

(Solution)

Hoover Corporation was organized early in 20Y4. Legal costs and other fees associated with incorporation totaled $3,500.

Organization Expenses	3,500	
Cash		3,500

Handout 13-4

DISTRIBUTION OF DIVIDENDS—COMMON AND PREFERRED SHAREHOLDERS

Belson Corporation
Preferred stock is cumulative.
Dividend = $65,000

	Preferred Shareholders	Common Shareholders	Total Distributed
Dividends in arrears (5,000 × $5 × 1 year)	$25,000		$25,000
Regular dividend (5,000 × $5)	25,000		50,000
Remainder to common	______	$15,000	65,000
Total dividends paid............	$50,000	$15,000	
Per-share dividends	$10	$1.50	

Handout 13-5

DISTRIBUTION OF DIVIDENDS—COMMON AND PREFERRED SHAREHOLDERS

Belson Corporation
Preferred stock is noncumulative.
Dividend = $65,000

	Preferred Shareholders	Common Shareholders	Total Distributed
Regular dividend (5,000 × $5)	$25,000		$25,000
Remainder to common	______	$40,000	65,000
Total dividends paid	$25,000	$40,000	
Per-share dividends	$5	$4	

Handout 13-6

WRITING EXERCISE

Assume that you have decided to invest a portion of your money in the stock market. You ask your broker to recommend several preferred stocks for you to consider as an investment. Your broker recommends the following two companies. Both are start-up corporations, but you agree with your broker that both have excellent potential for the future.

Company A:	Noncumulative, preferred stock with a $4-per-year dividend rate. Each share of this stock will cost you $20.
Company B:	Cumulative, preferred stock with a $4-per-year dividend rate. Each share of this stock will cost you $25.

You have decided to invest in only one of the companies. State which company you would choose and why.

Handout 13-7

WRITING EXERCISE

Explain the benefits of a stock dividend, both to the corporation issuing the dividend and to the shareholder receiving the dividend.

Handout 13-8

WRITING EXERCISE

Why would a company choose to split its stock?

Handout 13-9

WHY PURCHASE TREASURY STOCK?

1. To have shares to issue to employees under stock purchase plans

2. To have shares to issue to employees under bonus plans (such as stock options awarded to executives)

3. To create demand for the stock to maintain the stock's price in a down market

Handout 13-10

WRITING EXERCISE

Name and explain two reasons that a corporation might choose to repurchase its own stock.

STOCKHOLDERS' EQUITY

Paid-in capital:

Preferred Stock (show par value, dividend rate, shares authorized and issued)

Paid-In Capital in Excess of Par—Preferred

Common Stock (show par value, shares authorized, and shares issued)

Paid-In Capital in Excess of Par—Common

Paid-In Capital from Treasury Stock

Handout 13-12

RETAINED EARNINGS STATEMENT

Parks Corporation
Retained Earnings Statement
For the Year Ended December 31

Retained earnings, January 1		$ 50,000
Net income	$100,000	
Dividends	(30,000)	
Increase in retained earnings		70,000
Retained earnings, December 31		$120,000

Handout 13-13

WRITING EXERCISE

Technograph Corporation discovered that some hazardous material was buried on a parcel of land currently owned by the corporation. A former owner of the property buried the material. It will cost Technograph $1 million to remove the material and dispose of it properly.

Would it be appropriate for Technograph's board of directors to restrict $1 million for cleanup of the hazardous material? If so, what would the restriction accomplish?