

ACCT 101
LECTURE NOTES – CH. 11
Corporate Reporting and Analysis

Goals:

- 1) Be familiar with characteristics of a corporation and with different sources of equity.
- 2) Be familiar with various common stock transactions, and related journal entries, including:
 - Issuance of Stock
 - Calculating and Distributing Dividends
 - Calculating Dividends per share
- 3) Be familiar with other common stock transactions, including:
 - Treasury Stock
 - Stock Splits
 - Stock Dividends
- 4) Be familiar with the ratios addressed in the chapter.

THE CORPORATE FORM OF ORGANIZATION

Characteristics of Corporations

A corporation is a business entity that is legally separate from its owners. Ownership in a corporation by its stockholders is evidenced by owning shares of stock. The owners are called stockholders.

The following are important characteristics of corporations:

- Stockholders have limited liability. Should the corporation go bankrupt the most a stockholder can lose is his investment.
- Stockholders may transfer their shares to someone else.
- Due to the limited liability feature of stock ownership, corporations can usually accumulate financing from stockholders more easily than other forms of business entities.
- Corporations pay a corporate income tax, in addition to payroll taxes and property taxes. Dividends paid to stockholders are not tax-deductible for the corporation, but are taxable to the shareholder recipient of the dividend.

Stockholders vote for a Board of Directors. The directors have ultimate control of the corporation, and must act in the best interest of the stockholders.

Basics of Capital Stock

Capital stock refers to any shares issued to obtain funding from owners. The following are important terms associated with capital stock.

1. **Authorized stock**—the total amount of stock that the charter authorizes for sale.
 - a. *Outstanding stock* refers to issued stock held by stockholders.
 - b. No formal journal entry is required for stock authorization; the number of shares authorized is disclosed in the financial statements.
2. Selling (issuing) stock—can be sold directly or indirectly to stockholders
 - a. To sell *directly*, the corporation advertises its stock issuance to potential buyers.
 - b. To sell *indirectly*, a corporation pays a brokerage house (investment banker) to issue its stock.
 - c. A brokerage house may *underwrite* issuance (buy the stock from the corporation and take all gains or losses from its resale).
3. **Market value per share**—the price at which a stock is bought or sold.
 - a. Influenced by expected future earnings, dividends, growth, and other company and economic events.
 - b. Current market value of previously issued shares does not impact that corporation's stockholders' equity accounts.

4. **Classes of stock**
 - a. Common—stock is called **common stock** when all classes have same rights and privileges.
 - b. Additional classes—corporation is sometimes authorized to issue more than one class of stock, such as **preferred stock**.
5. **Par value stock**—assigned a value per share by the corporation in its charter.
 - a. Printed on the stock certificate.
 - b. Establishes the minimum legal capital.
6. **No-par value stock**—*not* assigned a value per share by the corporate charter.
7. **Stated value stock**—no-par stock that is assigned a “stated” value per share by the directors; becomes the minimum legal capital per share.
8. Stockholder’s Equity—has two parts
 - a. **Paid-in** (or contributed) **capital**—the total amount of cash and other assets received by the corporation from its stockholders in exchange for stock.
 - b. **Retained earnings**—the cumulative net income (and loss) retained by a corporation.

COMMON STOCK

Issuing stock with a par value

When issuing common stock with a par value, the stock is usually issued at par or above par. Here are examples of the journal entries required for each of these situations.

I-Tech Corporation has authorized 100,000 shares of \$1 par common stock. It issues 1,000 shares at par to its founders. The journal entry would be:

Cash (1,000 * \$1 par)	1,000	
Common Stock (1,000 * \$1 par)		1,000

Later, I-Tech issues 5,000 shares to additional investors at a price of \$11 per share. The journal entry to record this stock issuance would be:

Cash (5,000 * \$11)	55,000	
Common Stock (5,000 * \$1 par)		5,000
Paid-in Capital in Excess of Par Value, Common Stock		50,000

Paid-in Capital in Excess of Par Value, Common Stock is classified as a stockholders’ equity account. Generally accepted accounting principles prohibit recognizing gains or losses when transacting their own stock.

Corporations can also give its promoters, or founders, shares of stock in exchange for their services in organizing the corporation. For example, if I-Tech gave its founders 500

shares of common stock, at par, in exchange for such services, the journal entry would be:

Organization Expense (500 * \$1 par)	500	
Common Stock (500 * \$1 par)		500

Additionally, corporations can exchange their stock for assets. If I-Tech acquired equipment with a market value of \$10,000 by exchanging 6,000 shares of its common stock, the journal entry to record the purchase of the equipment is:

Equipment (market value)	10,000	
Common Stock (6,000 * \$1 par)		6,000
Paid-in Capital in Excess of Par Value, Common Stock		4,000

Issuing no-par value stock

Some corporations do not assign a par value to stock. In this case, the Common Stock account is credited for the cash, services, or other asset received in exchange for the stock.

If a corporation has no-par value stock with an assigned stated value, then the stated value is treated just like a par value.

DIVIDENDS

Dividend payments must be approved by the Board of Directors. Additionally, the corporation must have a positive (credit) balance in Retained Earnings to pay a dividend. Dividends have three important dates:

1. declaration date, the date the Board of Directors declares (approves) the dividend
2. date of record, the date stockholders are identified who will receive the dividend
3. payment date, the date the dividend payment is actually made

Journal entries are made on the declaration and payment dates. For example, I-Tech has 12,500 shares of common stock outstanding. The corporation wishes to pay a dividend of \$0.10 per share. The Board declares the dividend on November 1, payable on November 15. The journal entries to record the declaration and payment follow.

Declaration on November 1:

Retained Earnings (12,500 * \$0.10)	1,250	
Cash Dividends Payable		1,250

Payment on November 15:

Cash Dividends Payable	1,250	
Cash		1,250

Some corporations issue stock dividends. In a stock dividend, additional shares of stock are distributed to stockholders. In a small stock dividend, where the stock issued is less than 25% of shares outstanding, the dividend is valued using the market value of the stock. In a large stock dividend, where the stock issued is more than 25% of shares outstanding, the dividend is valued at par. Examples of each follow.

Small stock dividend: assume I-Tech has 12,500 shares of common stock outstanding, and declares a 10% stock dividend on December 1, payable on December 31. The market value of I-Tech stock on December 1 is \$10 per share. The journal entries for declaration and payment are:

Declaration on December 1:

Retained Earnings (12,500 * 10% * \$10)	12,500	
Common Stock Dividend		
Distributable (12,500 * 10% * \$1 par)		1,250
Paid-in Capital in Excess of Par		
Value, Common Stock		11,250

Payment on December 31:

Common Stock Dividend		
Distributable	1,250	
Common Stock		1,250

Large stock dividend: assume I-Tech has 12,500 shares of common stock outstanding, and declares a 40% stock dividend on December 1, instead of 10%. The stock dividend is payable on December 31. The journal entries for declaration and payment are:

Declaration on December 1:

Retained Earnings (12,500 * 40% * \$1 par)	5,000	
Common Stock Dividend		
Distributable		5,000

Payment on December 31:

Common Stock Dividend		
Distributable	5,000	
Common Stock		5,000

All accounts involved in issuing a stock dividend, whether large or small, are part of stockholders' equity. The issuance and payment of a stock dividend has no effect on assets, liabilities, or total stockholders' equity.

Stock Splits

Many corporations "split" their stock. A stock split is the distribution of additional shares to existing stockholders. For example, in a 2-for-1 stock split, the par value is reduced by half and the number of shares outstanding is doubled. Most stock splits are made to decrease the market value per share. No journal entry is made to record a stock split.

PREFERRED STOCK

Preferred Stock has special rights that give it priority over common stock in one or more areas such as preference for receiving dividends and for the distribution of assets if the

corporation is liquidated. Preferred stockholders usually do not have the right to vote. By issuing preferred stock, the company can raise funds without giving up control.

Preferred Stock usually has a par value. As with common stock it can be sold at a price different from par. Separate paid-in capital accounts are used to account for preferred stock. The Preferred Stock account is used to record the par value of shares issued; Paid-In Capital in Excess of Par Value, Preferred Stock is used to record any value received above par value.

Preferred stockholders are allocated their dividends before any dividends are allocated to common stockholders.

Characteristics of preferred stocks

Dividend rights:

- a. **Cumulative preferred stock** has a right to be paid both current and all prior periods' unpaid dividends before any dividend is paid to common stockholders. These unpaid dividends are referred to as “dividends in arrears.”
- b. **Noncumulative preferred stock** has no right to prior periods' unpaid dividends if they were not declared.
- c. **Nonparticipating preferred stock**—dividends are limited *each year to a maximum amount determined by applying the preferred percentage to the par value.*
- d. **Participating preferred stock**—gives its owners the right to share in dividends in excess of the stated percentage or amount. This stock is used as a poison pill against unfriendly or hostile takeovers.

The *full disclosure principle* requires that the amount of preferred dividends in arrears be reported as of the balance sheet date, normally in a note to the financial statements.

Convertible preferred stock gives holders the option of exchanging their preferred shares into common shares at a specified rate. If a company's common stock increases in value, the convertible preferred stockholders can share in this success by converting their preferred stock into more valuable common stock.

Callable preferred stock gives the issuing corporation the right to purchase (retire) this stock from its holders at specified future prices and dates. Amount paid to call and retire a preferred share is its **call price**, or *redemption value*, and is set when the stock is issued. Any dividends in arrears must also be paid when stock is called.

TREASURY STOCK

When a corporation acquires shares of its own stock, those shares are called Treasury Stock. A corporation usually buys back its own stock in order to raise the market price of the stock. The corporation may also acquire their own shares for other reasons, such as to acquire another company, avoid a hostile takeover, or to use for employee compensation.

Once purchased, the corporation can reissue the treasury stock. Examples of how such transactions would be recorded are below.

Assume I-Tech Corporation purchases 1,000 of its shares at a price of \$5.00 per share on November 15, and then sells 500 of these shares for \$6.00 on December 18. The transactions would be recorded as follows.

Purchase of 1,000 treasury shares on November 15:

Treasury Stock (1,000 * \$5)	5,000	
Cash		5,000

Sale of 500 treasury shares on December 18:

Cash (500 * \$6)	3,000	
Treasury Stock (500 * \$5 cost)		2,500
Paid-in Capital, Treasury Stock		500

Paid-in Capital, Treasury stock is classified as a stockholders' equity account. Although I-Tech sold the treasury stock on December 18 for \$500 more than they paid for the stock, GAAP prohibits recording gains or losses from transacting the corporation's own stock.

When sold below cost, entry depends on whether the Paid-in Capital, Treasury Stock account has a balance. If the Paid-in Capital, Treasury Stock account has no balance, the excess of cost over sales price is debited to Retained Earnings.

If the Paid-in Capital, Treasury Stock account has a balance, then it is debited for the excess of the cost over the sales price, but not to exceed the balance in the account.

Retiring Stock

When stock is purchased for retirement, all contributed capital amounts that relate to the retired shares are removed from the accounts. If the cost to retire the stock is less than the amount the stock was originally issued for, the difference should be credited to Paid-In Capital from Retirement of Stock. If the cost to retire the stock was more than the amount the stock was originally issued for, the difference would be debited to Retained Earnings.

REPORTING OF EQUITY

Retained Earnings Statement

Retained Earnings generally consist of the company's accumulated net income, less any net losses and less any dividends, since its beginning. If a corporation has transactions involving stocks, it will need to prepare a Statement of Stockholders' Equity (see below). If a corporation has no transactions involving stocks during the year, it will report changes in its Retained Earnings account using a Statement of Retained Earnings. The Statement of Retained Earnings was covered earlier in the course.

Retained Earnings may be appropriated voluntarily by the corporation, or restricted legally. If so, the appropriated or restricted Retained Earnings may not be used for dividends.

If a corporation discovers a material error in its prior year(s) financial statements, it must correct the error with a prior period adjustment. Prior period adjustments are reported in the Statement of Retained Earnings, net of any income tax effects.

Statement of Stockholders' Equity

A Statement of Stockholders' Equity is provided by most companies rather than a separate statement of retained earnings. The Statement of Stockholders' Equity presents the beginning and ending balances of each equity account, including Retained Earnings, and describes the changes that occurred during the year in each account.

Stock Options

A stock option is a right to purchase common stock at a fixed price over a specified period of time. Many corporations issue stock options to key employees. Recording stock options is explained in the Intermediate Accounting course.

IMPORTANT EQUITY RATIOS

The following table summarizes key equity ratios.

<i>Name</i>	<i>Purpose</i>	<i>Formula</i>
Earnings per share	The amount of income earned per each share of common stock.	$\frac{\text{Net Income} - \text{Preferred Stock Dividends}}{\text{Weighted-avg. \# of common shares}}$
Price-earnings ratio	Indicates how much the market is willing to pay for a company's earnings.	$\frac{\text{Market Price of Stock}}{\text{Earnings per Share}}$
Dividend yield	Shows the annual amount of cash dividends relative to the stock's market value.	$\frac{\text{Dividends per Share}}{\text{Market Price of Stock}}$
Book value per share (common only)	How much equity each share of common stock owns.	$\frac{\text{Stockholders' Equity}}{\text{Number of Common Shares}}$