

Accounting for Equity

Learning Objectives

- Distinguish between a closely or privately held and a publicly held corporation.
- List the advantages and disadvantages of the corporate form of organization.
- Identify characteristics of the corporate form of organization.
- Explain how par value common stock is accounted for when issued at par, above par, or below par or when issued in exchange for something other than cash.
- Explain how dividends are distributed between the owners of common and preferred stock.
- Record transaction involving the issuance of corporate stock: including both common stock and preferred stock.
- Record transactions involving cash dividends, stock dividends, and stock splits.
- Record transactions involving the purchase and sale of treasury stock and the retirement of treasury stock.
- Explain all components of retained earnings and how they are reported in the owners' equity section of a corporate balance sheet.
- Compute earnings per share (EPS), price-earnings (PE) ratio, dividend yield, and book value (BV).
- Explain the likely use and problems, if any, associated with the use of EPS, PE, dividend yield, and BV.

¹ Acknowledgement: An earlier version of this chapter was provided to all accounting faculty on January 19, 2015, for review notes, comments, and recommendations for improvement. Work on this text began in early 2014. The completion of this text was made possible through a spring 2015 sabbatical from West Chester University.

Introductory Financial Accounting – Cataldo (WCU ACC201)

Professor Cataldo and Mr. Louis Toto have known each other for 50 years. Mr. Toto



enlisted and served in the United States Army, where he was a training coordinator for a Field Artillery Battalion and held a Department of Defense Top Secret Security Clearance.



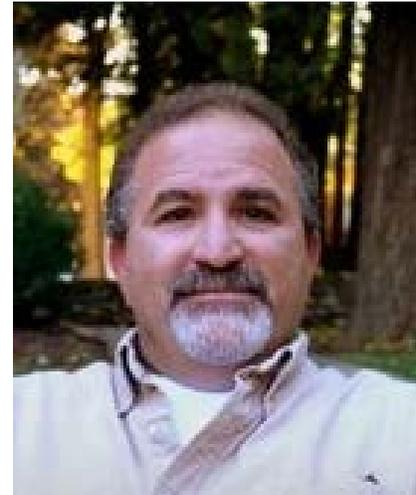
He has over 30 years of expertise working for Fortune 100 technology firms: Storage Technology (STK), Sun Microsystems, and, now, via mergers, Oracle America.



The majority of Lou's experience has been in customer support of computer hardware installations around the United States. He is now a Service Delivery Manager and functions as a single point of contact or liaison for his assigned accounts and the company.



Mr. Toto and his wife live in a wooded area in Northeast Oklahoma where they enjoy the outdoors and the serenity of natural settings. His hobbies include woodworking when time permits. He also enjoys football and follows his favorite teams, the University of Arizona Wildcats and the Kansas City Chiefs.

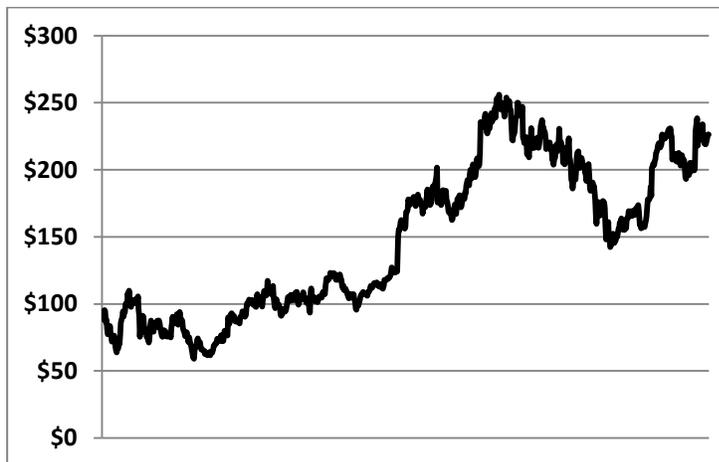


In addition to thousands of hours of corporate training, Mr. Toto holds the following degrees:

- B.S.B.A. Oklahoma Wesleyan University
- M.B.A. Oklahoma Wesleyan University



LinkedIn (NYSE: LNKD) had its initial public offering (IPO) on May 19, 2011. A business-oriented social networking service, it was founded in December 2002. The firm's stock price has done well, more than doubling, through November 2014.



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A corporation is a legal entity, separate from its owners. Owners are called shareholders or stockholders. There are two broad classifications of the corporate form: (1) *closely or privately held*, usually with few stockholders and not trading its stock, publicly, and (2) *publicly held or traded* on an organized stock exchange and stock market. For US tax purposes, closely or privately held corporations are often subchapter S corporations and publicly held or traded corporations are often subchapter C corporations, where the subchapters reference the Internal Revenue Code (IRC).



Corporate Characteristics – Advantages and Disadvantages

The corporate form of organization offers advantages and disadvantages.

<u>Advantages</u>	<u>Disadvantages</u>
Separate legal entity	Government regulation
Limited liability	Corporate taxation
Transferability	
Continuous life	
No mutual agency	
Ease of capital accumulation	

- **Separate legal entity.** The corporation is a legal entity, separate from its board of directors, officers, and other employees (agents).
- **Limited liability.** Stockholders are not liable for corporate acts or debts.
- **Transferability.** Shares of corporate stock can be purchased or sold, transferring ownership or control, all without any interruption in corporate activities.
- **Continuous life.** The death of a director, officer or employee does not result in the termination of corporate activities.
- **No mutual agency.** Corporations act through their agents – officers and managers. Generally, stockholders do not make decisions in the day to day operations of the corporation, and cannot be held liable for corporation decisions.
- **Ease of capital accumulation.** Corporations can be capitalized through the issuance or sale of corporate stock. Stockholders are not agents and, therefore, are not liable for corporate acts, shares are easily transferred, and the corporation's life is unlimited.
- **Government regulation.** Corporations are formed under the laws of the state it selects for incorporation, subjecting it to state regulation and control. Partnerships and sole proprietors avoid many of the government reports and related administrative costs associated with incorporation.²

² Approximately 54% of all publicly traded corporations in the US are incorporated in the state of Delaware, selected because of its long history and predictability of its corporate case law. The filings fees generate tax revenues so significant, that Delaware does not need a state sales tax.

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- **Corporate taxation.** Subchapter C corporation profits are taxed at the corporate level and, again, at the individual level, when dividends are paid by the corporation and received by the stockholder. This results in double-taxation.

Characteristics of the Corporate Form of Organization and Management

Corporations are formed by filing articles of incorporation with the state and filing forms with the appropriate state agency. Fees are paid, the corporate charter is issued, and the corporation is formed. Investors purchase corporate stock, meet, and elect a board of directors. Directors hire executives, executives hire managers, and managers hire and oversee other employees.

- **Organization expenses.** Organization expenses (costs) include legal fees, promoters' fees, and other amounts involved in the acquisition of the corporate charter. These costs are immediately expensed or debited to organization expenses.
- **Corporate management.** Stockholders control the corporation through the election of the board of directors. Generally, each shareholder has one vote for each share of stock owned. The board of directors hires executives, executives hire managers, and managers hire other employees.



Stockholders

Stockholder rights are granted by the state in which the firm is incorporated. While state laws vary, stockholders, generally, have the right to:

1. Vote their shares at stockholder meetings;
2. Sell or dispose of their shares of stock;
3. Purchase shares of additional issues of common stock to avoid dilution of their ownership interest (i.e., preemptive right);
4. Share in the receipt of dividends paid to other shareholders of the same class of stock; and
5. Share in any proceeds from liquidation.

Capital Stock – The Basics

Capital stock is the term used to describe any shares issued to obtain capital or *capitalize* a corporation through equity or owner financing. Corporate stock may be common stock or preferred stock. If only one class of stock is authorized, it is presumed to represent common stock. If more than one class of stock is issued, only one class is common stock.



Whether common stock or preferred stock, these classes of contributed capital may be issued at par, above par (at a premium) or even below par (at a discount). If these terms (i.e., par, premium and discount) sound familiar, they should. As you progress through this chapter, it may be a good time to review the chapter on bonds, where it was illustrated that debt securities may also be issued at par, premium or discount.

Common stock and the rules guiding these “equity securities” are governed by the state of incorporation. Delaware is the most popular state of incorporation for the vast

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majority of publicly traded firms in the US, due to its rich history and predictable, precedent-based laws with respect to shareholder and management rights and obligations. Regardless of the state of incorporation, the firm's corporate charter (which can be amended) provides for a number of *authorized* shares of common stock. No journal entry is required for stock authorization.

In addition to the number of shares authorized, an investor (or potential investor) may be interested in the number of shares *issued* and *outstanding*. Issued shares are those shares issued, but some may have been purchased back from shareholders, by the firm, and may no longer be outstanding. Outstanding shares are those held by stockholders. Generally, all of these measures are disclosed by publicly traded firms on the face of the firm's balance sheet or in the firm's footnotes to their financial statements, as regularly reported to shareholders and filed with the Securities and Exchange Commission. Below is an example of such a disclosure for Facebook (September 30, 2013), where there are two classes of stock:

Stockholders' equity:

Common stock, \$0.000006 par value; 5,000 million Class A shares authorized, 1,869 million and 1,671 million shares issued and outstanding, including 6 million and 2 million outstanding shares subject to repurchase as of September 30, 2013 and December 31, 2012, respectively; 4,141 million Class B shares authorized, 584 million and 701 million shares issued and outstanding, including 7 million and 11 million outstanding shares subject to repurchase as of September 30, 2013 and December 31, 2012, respectively.

Stock is sold directly or indirectly. In both cases, the firm's stock is promoted. In some cases and underwriter, broker/dealer, or investment banker will buy the stock from the corporation at a guaranteed, fixed price per share, and accept the risk associate with any gains or losses from its resale. Below is an example, where the underwriters were listed prior to the Facebook initial public offering (IPO):³

Social media giant Facebook Inc. added 25 new underwriters to the team of banks taking the company public. The deal, which is expected later this spring, expands the list from the six banks that had been on the cover of its prospectus from the start. It's not unusual for 25 to 30 banks to work on large offerings such as Facebook's.

Joining the underwriting team are: Citigroup Inc., Credit Suisse Group, Deutsche Bank AG, RBC Capital Markets, Wells Fargo & Co., Blaylock Robert Van LLC, BMO Capital Markets Corp., C.L. King & Associates, Inc., Cabrera Capital Markets LLC, CastleOak Securities L.P., Cowen & Co., Lazard Capital Markets LLC, Leberthal & Co., Loop Capital Markets LLC, M.R. Beal & Co., Macquarie Capital (USA) Inc., Muriel Siebert & Co., Oppenheimer & Co., Pacific Crest Securities LLC, Piper Jaffray & Co., Raymond James & Associates, Samuel A. Ramirez & Co., Stifel, Nicolaus & Co., The Williams Capital Group L.P., and William Blair & Co. They join the original team of six: Morgan Stanley, JPMorgan Chase & Co., Goldman Sachs Group Inc., Bank of America Merrill Lynch, Barclays PLC's Capital Inc., and Allen & Co.

The stock market comprised of willing buyers and willing sellers of stock, determines the value of the corporation's stock. The price per share at which stock trades between

³ Available at <<http://www.marketwatch.com/story/facebook-adds-25-new-banks-to-ipo-underwriters-2012-03-08>>.

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investors, after issued by the corporation, does not have any impact on the issuing corporation's stockholders' equity. These trades occur in what is referred to as the "secondary" market.

Different classes of stock can have different rights. For example, one class of stock can have one voting right per share, another class of stock can have ten votes per share, and still another class of stock might have no voting rights, but have other rights – perhaps a priority with respect to dividends.

Par value stock establishes a minimum legal capital that buyers must contribute to the corporation or be subject to paying at some future date. In the case of Facebook, the par value is **\$0.000006** per share, as follows:

Stockholders' equity:

Common stock, **\$0.000006 par value**; 5,000 million Class A shares authorized, 1,869 million and 1,671 million shares issued and outstanding, including 6 million and 2 million outstanding shares subject to repurchase as of September 30, 2013 and December 31, 2012, respectively; 4,141 million Class B shares authorized, 584 million and 701 million shares issued and outstanding, including 7 million and 11 million outstanding shares subject to repurchase as of September 30, 2013 and December 31, 2012, respectively.

Par value represents the minimum legal capital required to be retained by the corporation for the protection of corporate creditors. Recall that the corporate shareholders enjoy limited liability to creditors. In the event of corporate bankruptcy and/or liquidation, corporate creditors are paid their claims from the corporate assets. Since $A=L+OE$, these minimum capital amounts provide for a self-imposed restriction on any return of capital to shareholders, prior to the payment of creditor claims.

Some states provide for *no par* stock. No par stock can be issued at any price without any consequences to shareholders, since there is no possibility of any minimum legal capital deficiency. *Stated value* stock is also no par stock. The directors assign a "stated" value per share to establish the minimum amount of legal capital per share.

Stockholders' Equity

A corporation's *equity* or *stockholders' equity* can also be referred to as *shareholders' equity* or *capital*. It includes contributed capital for all classes of stock authorized, issued and outstanding, as well as retained earnings, as follows:

Stockholders' Equity			
Common Stock - \$1 par value; 10,000 shares authorized;			
1,000 shares issued and outstanding	\$1,000		
Common Stock - Paid in Capital in Excess of Par	\$9,000	\$10,000	
Preferred Stock - \$100 par value	\$5,000		
Preferred Stock - Paid in Capital in Excess of Par	\$0	\$5,000	\$15,000
Retained Earnings			\$20,000
Less Cost of Treasury Stock			\$5,000

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Total Stockholders' Equity

\$40,000

Common Stock Issued at, above and below Par Value

Par value is established in a corporation's articles of incorporation. It can be issued at, above or below par value, for cash or for noncash assets.

In practice, a corporation will select a par value that is very low, and stock is likely to be issued at a market price that is above par value.

When issued, the sale of stock must be recorded for both par value and excess of par value components. Amounts in excess of par value can be referred to as *paid in capital in excess of par* or *contributed capital in excess of par*.



Assume that Fuller, Incorporated issues 1,000 shares of \$1 par value common stock, for cash, at the current market price of \$10 per share, as follows:

Feb. 15	Cash	\$10,000	
	Common Stock - Par		\$1,000
	Common Stock - Paid in Capital in Excess of Par		9,000
	To record the sale and issue of 1,000 shares of common stock at \$10 per share.		

Balance sheet presentation of this initial capitalization and the stockholders' equity section of Fuller's balance sheet follow:

<u>Stockholders' Equity</u>			
Common Stock - \$1 par value; 10,000 shares authorized:			
	1,000 shares issued and outstanding	\$1,000	
	Common Stock - Paid in Capital in Excess of Par	<u>9,000</u>	\$10,000
	Retained Earnings		<u>-0-</u>
	Total Stockholders' Equity		<u>\$10,000</u>

Alternatively, to illustrate the impact on these accounts, assume that Fuller, Incorporated issues 1,000 shares of \$1 par value common stock, for cash, but at the current market price of \$9 per share, as follows:

Feb. 15	Cash	\$9,000	
	Common Stock - Par		\$1,000
	Common Stock - Paid in Capital in Excess of Par		8,000
	To record the sale and issue of 1,000 shares of common stock at \$9 per share.		

Balance sheet presentation of this initial capitalization and the stockholders' equity section of Fuller's balance sheet follow:

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<u>Stockholders' Equity</u>		
Common Stock - \$1 par value; 10,000 shares authorized;		
1,000 shares issued and outstanding	\$1,000	
Common Stock - Paid in Capital in Excess of Par	<u>8,000</u>	\$9,000
Retained Earnings		<u>-0-</u>
Total Stockholders' Equity		<u>\$9,000</u>

In both of the above examples, stock was issued at a premium to its par value, and for cash. The below illustrates how to account for a transaction involving the issue of common stock at a premium, but for a noncash asset. The stock is thinly traded or the Fuller, Incorporated is closely held, there is no readily available market for the stock, but the land received in exchange for 1,000 shares of common stock has a recently appraised and fair market value of \$11,000:

Feb. 15	Land	\$11,000	
	Common Stock - Par		\$1,000
	Common Stock - Paid in Capital in Excess of Par		10,000
To record the issue of 1,000 shares of common stock in exchange for land valued at \$11,000.			

Balance sheet presentation of this initial capitalization and the stockholders' equity section of Fuller's balance sheet follow:

<u>Stockholders' Equity</u>		
Common Stock - \$1 par value; 10,000 shares authorized;		
1,000 shares issued and outstanding	\$1,000	
Common Stock - Paid in Capital in Excess of Par	<u>10,000</u>	\$11,000
Retained Earnings		<u>-0-</u>
Total Stockholders' Equity		<u>\$11,000</u>

It is possible, though extraordinarily unlikely, that a firm could sell stock for less than its par (or stated) value. Very low par values are usually selected by firms, just as was the case with Facebook, at \$0.000006 par value per share. While most states prohibit this practice, any buyers at below par are contingently liable to creditors for the amount of the discount. If stock is issued at a discount, the amount by which issue price is below par is debited to a discount on common stock account. This is a contra account, it is not an expense, and it does not appear on the income statement.



Note that in each and every example provided above, the common stock – par account is credited for the par value of the common stock. There are no exceptions to this pattern.

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<u>Stockholders' Equity</u>			
Common Stock - \$1 par value; 10,000 shares authorized;			
1,000 shares issued and outstanding	\$1,000		
Common Stock - Paid in Capital in Excess of Par	<u>\$9,000</u>	\$10,000	
Preferred Stock - \$100 par value	\$5,000		
Preferred Stock - Paid in Capital in Excess of Par	<u>\$0</u>	<u>\$5,000</u>	\$15,000
Retained Earnings			\$20,000
Less Cost of Treasury Stock			<u>\$5,000</u>
Total Stockholders' Equity			<u>\$40,000</u>

Preferred Stock Issued at Par Value

Par value for preferred stock is accounted for in much the same way as accounted for with common stock. Assume that all three of the transactions described, above, in the section on common stock, occurred for preferred stock instead of common stock:

Feb. 15	Cash	\$10,000	
	Preferred Stock - Par		\$1,000
	Preferred Stock - Paid in Capital in Excess of Par		9,000
To record the sale and issue of 1,000 shares of preferred stock at \$10 per share.			

Feb. 15	Cash	\$9,000	
	Preferred Stock - Par		\$1,000
	Preferred Stock - Paid in Capital in Excess of Par		8,000
To record the sale and issue of 1,000 shares of preferred stock at \$9 per share.			

Feb. 15	Land	\$11,000	
	Preferred Stock - Par		\$1,000
	Preferred Stock - Paid in Capital in Excess of Par		10,000
To record the issue of 1,000 shares of preferred stock in exchange for land valued at \$11,000.			

Stockholders' Equity

Stock can be issued at par, no par, or stated value. This will depend on the state law that applies and is in effect for the state in which the corporation has been incorporated. A firm does not have to operate in the same state that it is incorporated in. For example, more than 54% of the publicly traded firms are incorporated in the state of Delaware. More than 8% of the publicly traded firms are incorporated in the state of Nevada. Therefore, more than 62% percent of the publicly traded corporations are incorporated in 2 states, Delaware and Nevada. These states are competing in "the market for corporate law" to attract tax revenues, in the form of corporate filing fees and have very differentiated products.

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Issuing Stock – Par Value

Par value is established by the corporation and has a very specific meaning, based on the state of incorporation and the articles of incorporation or amended articles of incorporation. While state laws vary, generally, par value represents minimum legal capital that must remain in the corporation and may not be distributed to shareholders. This is for the protection of creditors, since creditors receive any distributions, in the event of bankruptcy and/or liquidation, before any remainder may be distributed to shareholders.



Practically, since the corporation establishes par value, it is to the advantage of the corporation to impose, on itself, the least possibly restrictive or lowest possible par value. Still, while par value has little meaning practical meaning or value, the legal distinction has resulted in an accounting distinction that is established, maintained, and disclosed.

Stock or “Common Stock Issued at Discount” (\$500), represents a stock sale below par value. This condition is only likely to occur in the event of the initial issuance or stock sale when the worst possible news has been released and/or bankruptcy is anticipated and little or no residual or distribution from the liquidation is anticipated for the shareholder.

Issuing Stock – No Par Value

If a stock, trading at \$25 per share has a “no par” stock and 1,000 shares are issued, you would make the following journal entry:

Cash	\$25,000	
Common Stock		\$25,000

All of the \$25,000 is “legal capital.”

Issuing Stock – Stated Value

Everything that applies to issuing stock at par value applies to stock issued at stated value. This represents nothing more than a change in the term or account title used. This term may be used in cases where a stock has no par value.

If a stock, trading at \$25 per share has a “stated” value of \$1, and 1,000 shares are issued, you would make the following journal entry:

Cash	\$25,000	
Common Stock - Stated Value		\$1,000
Common Stock - Paid in Capital in Excess of Stated Value		24,000

If a stock, trading at \$25 per share has a “stated” value of \$1, and 1,000 shares are issued, you would make the following journal entry:

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Cash	\$25,000
Common Stock - Stated Value	\$1,000
Common Stock - Paid in Capital in Excess of Stated Value	24,000

Issuing Stock for Noncash or Nonmonetary Assets

When a corporation issues stock in exchange for noncash or nonmonetary assets other than cash, you simply debit the noncash or nonmonetary account. Assume the same fact pattern that was used above, but instead of issuing shares for \$25,000 cash; you issued the same number of shares of stock in exchange for land with an appraised and fair market value of \$25,000:

Land	\$25,000
Common Stock - Par Value	\$1,000
Common Stock - Paid in Capital in Excess of Par Value	24,000

Alternatively, a corporation might issue shares of stock to stock promoters in exchange for services and toward the organization of the corporation. Again, assuming the same fact patterns used above, assume that the fair value of these services are \$25,000:

Organization Expenses	\$25,000
Common Stock - Par Value	\$1,000
Common Stock - Paid in Capital in Excess of Par Value	24,000

As the above examples illustrate, stock can be issued for cash, other noncash or nonmonetary assets, or expenses. Since assets are increased with a debit and expenses are increased with a debit, the debit and credit mechanics work in both cases.

Dividends

Cash or stock dividends may be paid to stockholders.

Cash Dividends

A firm might decide to pay cash dividends to stockholders. This decision is made by the corporation's board of directors. The board of directors will evaluate and consider amounts needed to fund ongoing operations and available in cash and retained earnings accounts, the firm's growth rates and opportunities, anticipated emergencies, expected opportunities, and the need to repay debt.



The payment of cash dividends involves three important dates:

1. **Date of declaration** is that date when the directors of the corporation vote to declare and pay a dividend. It is at this point in time when a legal liability is created between the corporation and its shareholders. An accounting entry is required to record this dividend payable, a liability.
2. **Date of record** is the effective date of stock ownership associated with the receipt of the dividend. If you own the stock on this date of record, you will receive the

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dividend declared by the corporation's board of directors. No accounting entry is required on this date.

3. **Date of payment** is the date on which the payment of the dividend is made. The date after the date of payment is referred to as an ex-dividend date. An accounting entry is required to record the payment of the dividend payable on this date.

An actual example of a dividend announcement follows:

Boston, MA, 11/25/2013 (nysepost) - Nike Inc (NYSE:NKE) announced that the company's Board of Directors has declared its quarterly cash-dividend of \$0.24/share on its outstanding Class A & Class B Common-Stock. This dividend is payable on 6th January 2014, to shareholders of record on 16th December 2013.⁴

The date of declaration was November 25, 2013. The date of record is December 16, 2013. The date of payment is January 6, 2014. To keep the illustration simple, assume that Nike has only 1,000 shares of stock issued and outstanding (\$1,000 multiplied by \$0.24 per share equals \$240). The necessary journal entries follow:



On the date of declaration:

Nov. 25	Retained Earnings	\$240	
	Dividends Payable		\$240

On the date of record refers to "stockholders" at this date of record. So, if you own a stock on December 16 and December 16 is the "date of record," you, as the stockholder, will receive the dividend, even if you sell the stock on December 17, or the "ex-dividend" date. Therefore, there is no entry on the corporate books for this date or record event date:

Dec. 16	No Entry		
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On the date of payment:

Jan. 6	Dividends Payable	\$240	
	Cash		\$240

Cash Dividends in Cases of a Retained Earnings Deficit

Retained earnings, for a profitable firm, should have a credit balance. However, it is possible for a corporation with accumulated losses and/or a history of paying dividends to have a debit balance in their retained earnings account. These firms have a retained earnings deficit.

⁴ Available at <<http://nysepost.com/nike-inc-nysenke-declared-its-quarterly-cash-dividend-13482>>.

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Most states have produced a corporate law that prohibits the payment of cash dividends to stockholders in cases where they have a retained earnings deficit. This legal restriction preserves capital and protects creditors by preventing the corporation from liquidating and distributing assets to stockholders when a firm is under financial stress.

Depending on the state, however, some states permit the distribution of a “liquidating” cash dividend, which is nothing more than a “return of capital” contributed by shareholders. These represent atypical or unusual cases, but must be addressed.

Stock Dividends

A stock dividend is declared by a corporation’s board of directors. It is a distribution of additional shares to stockholders. A stock dividend does not reduce assets and equity, but a portion of equity from retained earnings is transferred from earned capital to contributed capital or “capitalized.”

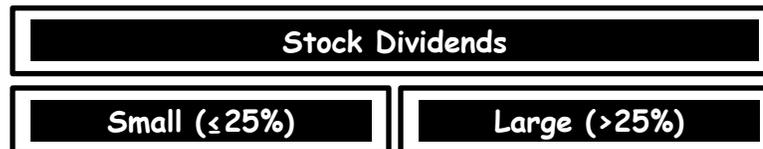
Why Do a Stock Dividend?

When you go grocery shopping, you probably buy a 6-pack or 12-pack or 24-pack of soft drinks. You could, of course, purchase a single can or bottle of Pepsi or Coke or other soft drinks. A comparable practice exists in the stock market. Most think in terms of 100 share blocks of stock. Lesser numbers of shares are referred to as “odd lots.”

While many may be able to purchase 100 share blocks of a \$20 stock, at a total cost of \$2,000 plus brokerage buying commission, others cannot. For this reason, a firm might decide to, effectively, reduce the price per share for a 100 share block of stock. They could prefer to do a stock split, but that topic will be covered in the next section.

Two Types of Stock Dividends

There are two types of stock dividends and their accounting treatment differs; they are small and large stock dividends:



A small stock dividend is operationally defined as a stock dividend of 25% or less. A large stock dividend is operationally defined as a stock dividend of more than 25%. In both cases, retained earnings are debited or capitalized for the par value of the stock dividend.

The Small Stock Dividend ($\leq 25\%$)

Assume a firm has common stock with a par value of \$1 per share, trading at a market price of \$25 per share. There are 1,000 shares issued and outstanding when the Board of Directors issues a 10% stock dividend (1,000 shares multiplied by 10% equals an additional 100 shares). The following journal entry would be required.

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Retained Earnings	\$2,500
Common Stock Dividend Distributable - par value	\$100
Paid in Capital in Excess of par value - Common Stock	\$2,400

For a small stock dividend: (1) retained earnings are capitalized at the market price per share of \$25, (2) common stock dividend distributable is a temporary classification that will be closed out to the common stock – par value account, when the stock dividend is issued, and (3) paid in capital in excess of par value – common stock, is the plug or excess of market value over par value for the common stock.

Common Stock Dividend Distributable - par value	\$100
Common Stock - par value	\$100

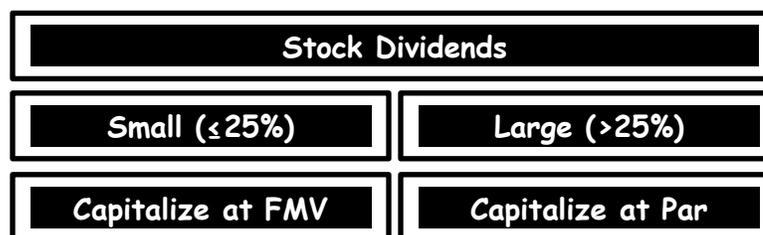
When issued, the common stock – par value account is credited and the temporary, common stock dividend distributable account is zeroed out or debited. Amount going into and out of the common stock dividend distributable account are always at par.

The Large Stock Dividend (>25%)

For a large stock dividend, most states require that par or stated value be capitalized from retained earnings. Using the same fact pattern, the journal entry follows:

Retained Earnings	\$100
Common Stock - par value	\$100

To summarize, a small stock dividend results in the capitalization of retained earnings at the stock price or fair market value; a large stock dividend results in the capitalization of retained earnings at the stock par value, as follows:



A large stock dividend is sometimes confused with a stock split, which is accounting for differently, as explained in the next section.

Stock Splits

A stock split results in the distribution of additional shares to shareholders and can be done in any ratio. An actual example for MasterCard (NYSE: MA), announced on December 10, 2013, illustrates the motivation for a stock split, as follows:



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As part of the 10-for-1 stock split, shareholders will receive nine additional shares of MasterCard common stock for each share they own. The move is aimed at making MasterCard's share price, which exceeds \$760, more accessible to retail investors.⁵

No journal entry is made for a stock split. If you owned 100 shares prior to the stock split, you will own 1,000 shares after the stock split. However, the par value per share is modified. In the above case, the par value per share for MasterCard stock will be one-tenth of the pre-split price after the stock split. No change occurs to the retained earnings or related paid-in-capital accounts.

Preferred Stock

The two basic classifications of stock issued to shareholders are common stock and preferred stock. However, there can be more than one class of preferred stock. Preferred stock provides for preferential treatment, usually with respect to the payment of dividends and the distribution of assets in the event of liquidation. Accounting for preferred stock is very similar to accounting for common stock, with slightly modified account titles.



If a preferred stock, trading at \$25 per share has a “par” value of \$1, and 1,000 shares are issued, you would make the following journal entry:

Cash	\$25,000	
Preferred Stock - Par Value		\$1,000
Preferred Stock - Paid in Capital in Excess of Par Value		24,000

Preferred Stock – Preferential Treatment with respect to Dividends

Preferred stock usually provides preferred stock shareholders with a preference with respect to dividends. Effectively, dividends must, first, be paid to preferred stock shareholders, before any payment is made to common shareholders. This, of course, does not guarantee a payment of dividends for either preferred or common shareholders. The dividend preference is usually stated as a percentage of preferred stock par values.

For example, a preferred stock with a par value of \$10 might have a dividend preference stated at 8%. Before any dividend can be paid to a common shareholder, a dividend must, first, be paid to the preferred shareholder, at \$0.80 (\$10 multiplied by 8%) per year or \$0.20 per quarter.

Preferred stock can be cumulative or noncumulative, as follows:

⁵ Available at <<http://www.foxbusiness.com/industries/2013/12/10/mastercard-launches-10-for-1-stock-split-boosts-dividend-83/>>.

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Preferred Stock Dividend

Cumulative

Noncumulative

A cumulative preferred stock dividend accumulates and a “passed” dividend or failure to pay this preferred stock dividend results in an “arrearage” that must be paid, first, again, before any dividend is paid to the common shareholders. A noncumulative preferred stock dividend does not accumulate.

Assume that a firm has a preferred stock with a par value of \$10 and a stated dividend preference at 8% of par. The firm had a net loss for 2012, 2013, and 2014, and the board of directors decided to “pass” on the dividend for all 3 years. Again, before any dividend can be paid to a common shareholder, a dividend must, first, be paid to the preferred shareholder, at \$0.80 (\$10 multiplied by 8%) per year or \$0.20 per quarter. If the firm has a very good 2015, and net income, the below illustrates a case where the board of directors approves a dividend for the common shareholder, in both cumulative and noncumulative preferred stock cases, where the common shareholder receives a dividend of \$0.10 per share for 2015:

<u>Calendar Year</u>	<u>Preferred Cumulative</u>	<u>Preferred Noncumulative</u>	<u>Common</u>
2012	\$0.00	\$0.00	\$0.00
2013	\$0.00	\$0.00	\$0.00
2014	\$0.00	\$0.00	\$0.00
2015	\$3.20	\$0.80	\$0.10

<u>Calendar Year</u>	<u>Preferred Cumulative</u>	<u>Preferred Noncumulative</u>	<u>Common</u>
2012	\$0.80 arrearage	no arrearage	\$0.00
2013	\$0.80 arrearage	no arrearage	\$0.00
2014	\$0.80 arrearage	no arrearage	\$0.00
2015	\$3.20	\$0.80	\$0.10

Note that the cumulative preferred stock accumulates an arrearage that need not be paid, but must be paid before any dividends are paid to common shareholders.

A participating preferred stock can participate in dividends beyond stated amounts. A nonparticipating preferred stock cannot participate in dividends exceeding stated amounts, as follows:

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A participating preferred stock can receive more than \$0.80 per year. A nonparticipating preferred stock cannot receive more than the stated amount of \$0.80 per year.

Preferred Stock – Convertibles

A firm might decide to issue convertible preferred stock. This stock would have a conversion feature, at a fixed conversion ratio (e.g., 1 preferred share converts to 10 common shares).

Preferred Stock – Callable

A firm might decide to issue callable preferred stock. Effectively, this is an explicitly stated stock retirement feature. The call feature has a “call price” or redemption value. Use of this feature might be combined with and include a requirement to pay any dividend arrearage.

Preferred Stock – Reasons for Issuing

Corporations issue preferred stock for a variety of reasons. Since it is more typical for common stock to represent “voting” shares, the issuance of preferred shares without voting rights allows common shareholders to retain votes and control of the firm, its board of directors, and the management team.

Alternatively, since earnings per share is computed and based only on the number of common shares outstanding, issuing preferred stock avoids dilution of common stockholder earnings per share measures.

Below is an example of the presentation of the stockholders’ equity section of a balance sheet. In this case, the firm has issued (1) common stock, (2) preferred stock, and (3) has purchased common stock in the open market to reduce the number of common shares outstanding for the computation of earnings per share, which is based on common shares outstanding.

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<u>Stockholders' Equity</u>			
Common Stock - \$1 par value; 10,000 shares authorized;			
1,000 shares issued and outstanding	\$1,000		
Common Stock - Paid in Capital in Excess of Par	<u>\$9,000</u>	\$10,000	
Preferred Stock - \$100 par value	\$5,000		
Preferred Stock - Paid in Capital in Excess of Par	<u>\$0</u>	<u>\$5,000</u>	\$15,000
Retained Earnings			\$20,000
Less Cost of Treasury Stock			<u>\$5,000</u>
Total Stockholders' Equity			<u>\$30,000</u>

The next section introduces the accounting treatment for treasury stock, which is illustrated in the above.

Treasury Stock

Treasury stock is stock that has been issued, but was reacquired by the corporation. Reasons why a firm might reacquire its own stock are not limited to, but include:

1. the consumption of surplus cash not otherwise required for operations or expansion;
2. the purchase of shares at a favorable price and to show that management is confident in the future appreciation of the stock price per share and corporate operations;
3. the purchase of shares for reissuance for the acquisition of another firm; and
4. the purchase of shares to increase the price per share and block a hostile takeover, which is more likely to occur when a firm's stock price is trading too low or at a favorable price per share.

Treasure stock purchases reduce the corporation's assets and equity by equal amounts, as the below example, using the *cost method* of accounting for treasury stock, illustrates:

Dec. 20	Treasury stock	\$25,000
	Cash	\$25,000

In the above example, the corporation purchased 1,000 shares of its own stock at \$25 per share. Treasury stock is a contra equity account, and the open market purchase resulted in a debit to equity and a credit to cash. The following table illustrates how the \$25,000 purchase of treasury stock is presented in the equity section of the firm's balance sheet, both before and after the open market purchase.

<u>Before treasury stock purchase</u>		<u>After treasury stock purchase</u>	
Common stock	\$1,000,000	Common stock	\$1,000,000
Retained earnings	<u>\$250,000</u>	Retained earnings	\$250,000
		Less: Cost of treasury stock	<u>(\$25,000)</u>
Total stockholders' equity	<u>\$1,250,000</u>	Total stockholders' equity	<u>\$1,225,000</u>

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An alternative to the *cost method* of accounting for treasury stock is the *par value method*. This latter method is covered in intermediate financial accounting courses.

Treasury Stock – Reissued

Treasury stock can be reissued or resold (1) at cost, (2) above cost, or (3) below cost.

Recall that 1,000 shares of the firm's stock were purchased in the open market at \$25 per share in the above example and on December 20. We will assume that these same 1,000 shares of stock is reissued or resold (1) at cost (\$25 per share), (2) above cost (\$30 per share), or (3) below cost (\$20 per share), as follows:

1,000 shares of stock is reissued or resold (1) at cost (\$25 per share) on the following January 20:

Jan. 20	Cash	\$25,000	
	Treasury stock		\$25,000

1,000 shares of stock is reissued or resold (2) above cost (\$30 per share) on the following January 20:

Jan. 20	Cash	\$30,000	
	Paid-in-capital, Treasury stock		\$5,000
	Treasury stock		\$25,000

Note that a gain is not (and is never) reported on the sale or reissuance of treasury stock. The additional \$5 per share increased equity, as it is credited to the paid-in-capital, treasury stock account.

1,000 shares of stock is reissued or resold (3) below cost (\$20 per share) on the following January 20:

Jan. 20	Cash	\$20,000	
	Paid-in-capital, Treasury stock	\$-0-	
	Retained earnings	\$5,000	
	Cash		\$25,000

In the above case, the reissuance at \$5 less per share results in a debit to retained earnings. If, however, this had not been the first and only purchase of treasury stock, any balance in the paid-in-capital, treasury stock account would, first, be debited and exhausted, and any remaining balance would be debited to the retained earnings account. It is, for this reason, the paid-in-capital, treasury stock account is included in the above journal entry and shown, even though at a zero (\$-0-).

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Think in terms of “contributed capital” and “earned capital,” where both common and preferred stock have par and paid-in-capital in excess of par contributed capital components or partitions. Paid-in-capital in excess of par components can be exhausted and retained earnings, in cases where related paid-in-capital in excess of par accounts have been exhausted, can be “capitalized.”

Treasury Stock – Retirement

Corporations buy and retire stock when they believe that the stock is trading at a discount to its true value. After all, executives are “insiders” and should understand these matters. These retirements are permitted when they do not jeopardize creditors and stockholders.

When stock is purchased, in the secondary market, and purchased for retirement, all capital amounts relating to the retired shares are removed. If the purchase price exceeds the amount removed, this amount is debited to retained earnings. If the purchase price falls short of the amount removed, this amount is credited to the “paid-in capital from retirement of stock” account. Effectively, the firm’s assets and equity are reduced by the amount paid for the stock retirement.

Statement of Retained Earnings

Retained earnings are earnings retained, and not paid out in dividends, since the inception of the corporation. Retained earnings are part of the stockholders’ equity section of the balance sheet and all amounts in the retained earnings account are in “after tax” dollars.

Restricted and Appropriated Retained Earnings

Retained earnings might be restricted by statute or law, in that treasury stock may only be purchased up to the amount of the amount of retained earnings. Similarly, loan agreements may contain contractual restrictions on the amount of retained earnings the corporation is permitted to pay to stockholders’ to avoid risk or high debt-to-equity ratios. Retained earnings might be appropriated, as required by the board of directors, to assure the retention of economic resources for long-term corporate needs.

Prior Period Adjustments

Changes in accounting principles or the correction of errors may require prior period adjustments. They are reported net of tax. All inflows and outflows to retained earnings are in after-tax terms.

Prior period adjustments require a change in the beginning balance of retained earnings for events that occurred prior to the earliest period reported in the latest publication of financial statements. An example follows:

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XYZ Corporation
Statement of Retained Earnings
For the Year Ended December 31, 2015

Retained earnings, December 31, 2014, as previously reported	\$10,000
Prior period adjustment	
Cost of property, plant & equipment incorrectly expensed	<u>\$15,000</u>
Retained earnings, December 31, 2014, as adjusted	\$25,000
Plus net income	\$3,000
Less cash dividends declared	<u>(\$1,000)</u>
Retained earnings, December 31, 2015	<u>\$27,000</u>

Items reported and based on estimates that are later revised (e.g., depreciable life or salvage value of an asset) are not corrected and do not result in prior period adjustments. These changes in accounting estimate are accounted for in current and future (prospective) periods.

Statement of Stockholders' Equity

A statement of stockholders' equity lists the beginning and ending balances of key equity accounts, describing changes occurring during the period.

Reporting Stock Options

Most publicly traded corporations issue stock options – the right to purchase shares of common stock at a fixed price over a specified period and/or prior to some expiration date. As the firm's stock price increases, the value of the stock option increases. Stock options are issued to executives and employees to motivate them to improve the corporation's performance in the long-run, and might even assist the firm in retaining top-performing and/or key personnel. High tech, biotech and cash poor start-up firms prefer this form of compensation for these reasons.

Measurement of the value of stock options and their impact on the firm's financial statements is a topic covered in intermediate financial and managerial/cost accounting courses. There have been some highly publicized problems with improper stock option back-dating in the past decade or so.⁶

⁶ Available at <<http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html>> and <<http://online.wsj.com/articles/SB114265075068802118>>.

Appendix A

Earnings per Share

Earnings per share (EPS) are computed by dividing the net income available to common shareholders by the weighted-average number of common shares issued and outstanding during the period. EPS is the same as a firm's *net income per share*. Below is the formula for basic EPS.

$$\text{Basic Earnings per Share} = \frac{\text{Net Income} - \text{Preferred Dividends}}{\text{Weighted-Average Common Shares Outstanding}}$$

Preferred dividends are, first, deducted from net income, since preferred shareholders have preferential treatment with respect to dividends to be paid out of earnings. The weighted-average number of common shares issued and outstanding are measured and matched to these earnings available to common shareholders over the same period.

For example, a firm with net income of \$1 million, preferred dividends of \$200,000, and ½ million weighted-average number of common shares has basic or common earnings per share of \$1.60, as follows:

$$\$1.60 = (\$1,000,000 - \$200,000) \div 500,000$$

Appendix B

Price-Earnings Ratio

Anticipated or expected future cash flows determine a firm's market value or market capitalization (i.e., market cap). A firm's *price-earnings* (or PE) *ratio* is a term frequently examined in the financial press, and is computed, as follows:

$$\text{Price-Earnings Ratio} = \text{Market Value (Price) per Share} \div \text{Earnings per Share}$$

For example, a firm with annual earnings per share at \$1 might be trading at \$25 per share. If so, the *PE* ratio is 25, as follows:

$$25 = \$25 \div \$1$$

Appendix C

Dividend Yield

Dividends yield is computed by dividing annual cash dividends per share by market value or price per share.

$$\text{Dividend Yield} = \text{Annual Cash Dividends per Share} \div \text{Market Value (Price) per Share}$$

For example, a firm with annual cash dividends of \$0.25 per share and trading at \$25 per share has a dividend yield of 0.01 or 1%, as follows:

$$1\% = \$0.25 \div \$25.00$$

Appendix D

Book Value per Share

Book value per common share is an interesting measure, but is based on historical cost and can include intangibles that may or may not have retained their original, historical cost-based value, as follows:

$$\text{Book Value per Common Share} = \frac{\text{Stockholders' Equity Available for Common Shares}}{\text{Number of Common Shares Outstanding}}$$

The reverse is also true. The book value per common share may understate the fair market value of a firm. For example, land that was purchased in 1950 for \$1,000 may have a fair market value of \$100,000, but will remain on the firm's books at the \$1,000 historical cost measure. In this case, book value is a measure that is misleading and understates the value of the firm.

Book value per preferred share is an infrequently used measure, but is provided for completeness, as follows:

$$\text{Book Value per Preferred Share} = \frac{\text{Stockholders' Equity Available for Preferred Shares}}{\text{Number of Preferred Shares Outstanding}}$$