Introduction to Accounting 2

Modul 6

Chapter 14

CORPORATIONS: Organization and Capital Stock Transactions

After studying this chapter, you should be able to:

1. Identify the major characteristics of a corporation.
2. Differentiate between paid-in capital and retained earnings.
3. Record the issuance of common stock.
4. Explain the accounting for treasury stock.
5. Differentiate preferred stock from common stock.
6. Prepare a stockholders' equity section.
7. Compute book value per share.

The Corporate Form of Organization

- Corporation
  - Entity created by law
  - *Separate and distinct* from its owners
  - Continued existence is dependent upon the statutes of the state in which it is incorporated
- Two common bases for classification of corporations are:
  1. By purpose
  2. By ownership

Classifications of Corporations

- ***Purpose***
  - To earn a **profit**
  - Or **nonprofit**
- Classification by ***ownership***
  - **Publicly-held corporations**
  - **Privately-held corporations**
- Publicly-held corporations
  - May have thousands of stockholders
  - Stock is regularly traded on a national securities exchange.
- Privately-held corporations
  - Often referred to as closely held corporations, usually have only a few stockholders

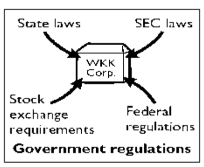
- Does not offer its stock for sale to the general public

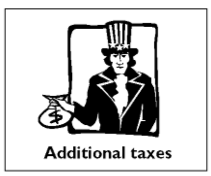
CHARACTERISTICS OF A CORPORATION (STUDY OBJECTIVE)

- Separate legal existence from its owners
- Stockholders have limited liability
- Ownership held in shares of capital stock
    - transferable units.
- Ability to acquire capital through the issuance of stock
- Continuous life

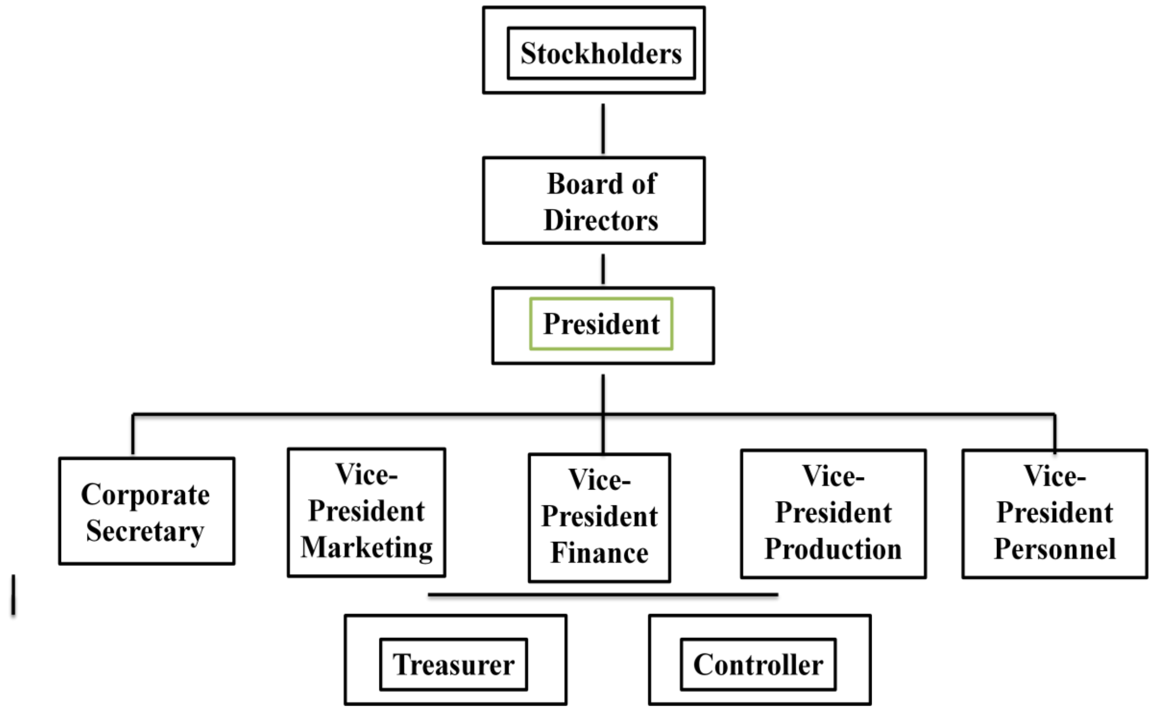
Characteristics of a Corporation

- Corporate management
    - is at the discretion of the board of directors who are elected by the stockholders
- Subject to numerous government regulations
- Must pay an income tax on its earnings
- Stockholders required to pay taxes on the dividends they receive: the result is double taxation





Corporation Organization Char



Advantages and Disadvantages of a Corporation

Advantages	**Disadvantages**
Separate legal existence Limited liability of stockholders	Corporation management-separation of ownership and management
Transferable ownership rights	Government regulations
Ability to acquire capital	Additional taxes
Continuous life	
Corporation management – professional managers	

Forming a Corporation

1. File application with the Secretary of State
   in the state in which incorporation is desired
2. Articles of Incorporation
   charter creates the corporation
3. By-laws
   establishes the internal rules and procedures for conducting the affairs of the corporation and indicates the powers of parties involved

Organization Costs

- Costs incurred in forming a corporation
- Includes legal fees, state fees and promotional expenditures

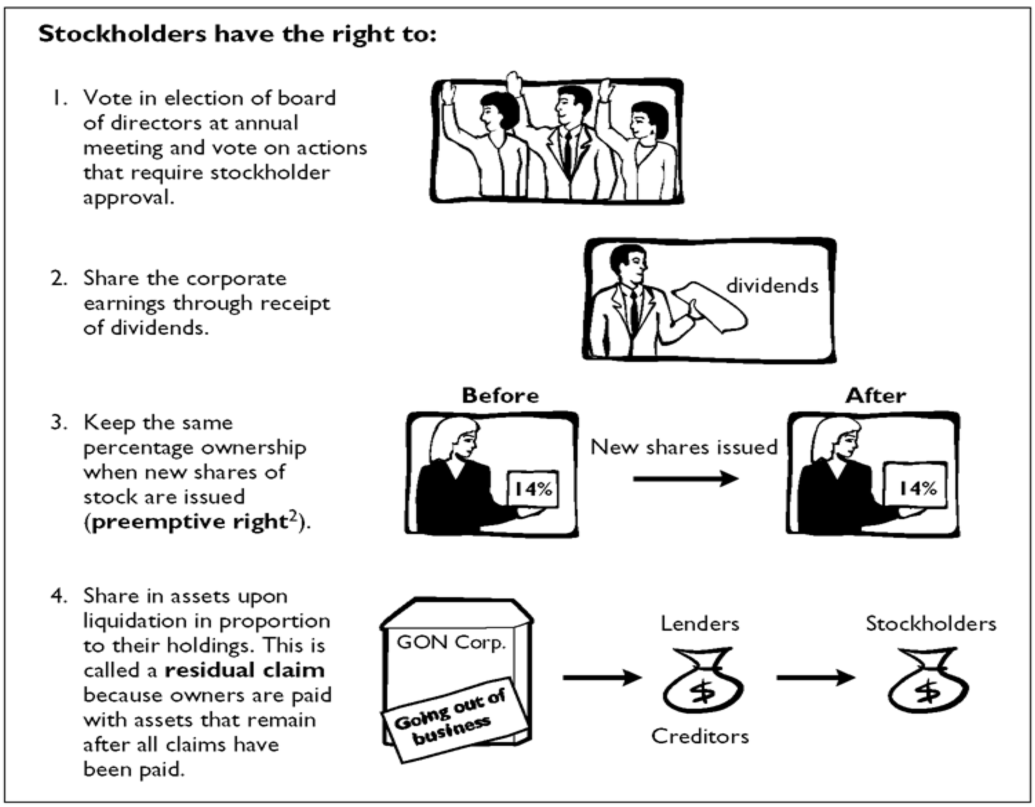
- *Expensed as incurred* since it is so difficult to determine the amount and timing of future benefits.

Ownership Rights of Stockholders

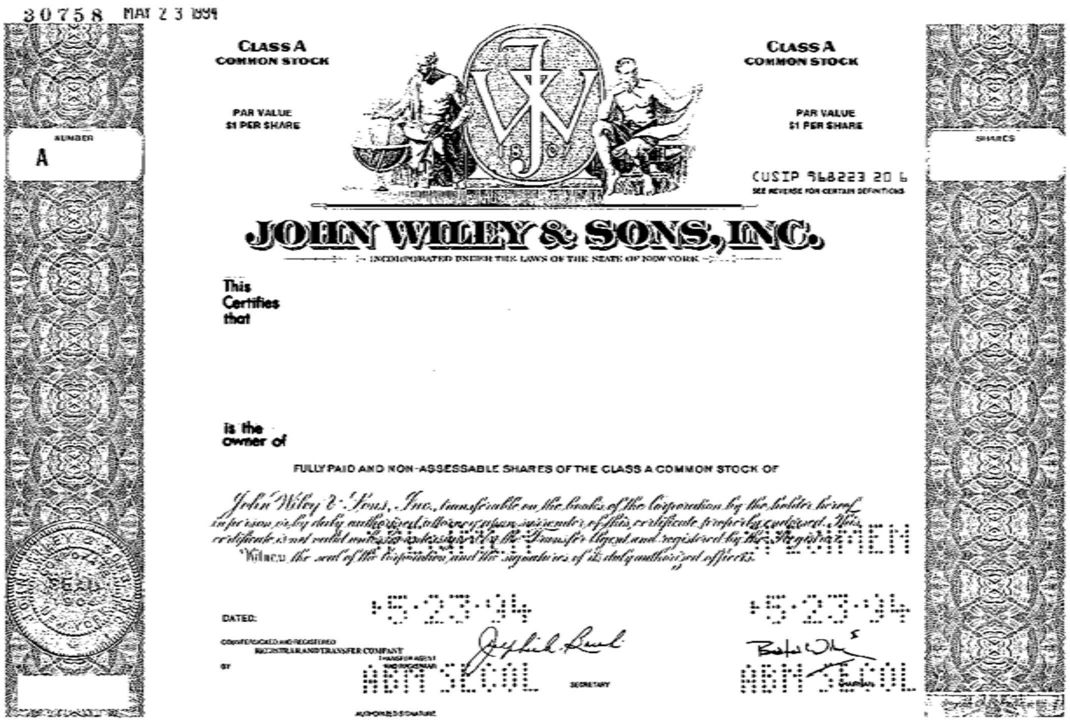
1. Vote
2. Share in corporate earnings through the receipt of dividends
3. Preemptive right maintain the same percentage ownership when additional shares of common
4. Residual claim

   Share in assets upon liquidation

Ownership Rights of Stockholders



A Stock Certificate



Stock Issue Considerations Authorized Stock

Authorized stock

- Amount Of Stock A Corporation Is Allowed To Sell As Indicated By Its Charter

The authorization of capital stock does not result in a formal accounting entry. This event has no immediate effect on either corporate assets or stockholders' equity.

Stock Issue Considerations Issuance of Stock

A corporation can issue common stock *directly* to investors or *indirectly* through an investment banking firm (brokerage house).

- Direct issue is typical in closely held companies.
- Indirect issue is customary for a publicly held corporation.
  - In an indirect issue, the investment banking firm may agree to *underwrite* the entire stock issue

Stock Market Price Information

- Publicly held companies
  - traded on organized exchanges

  - dollar prices per share are established by the interaction between buyers and sellers
- The prices set by the marketplace generally follow the trend of a company's earnings and dividends.
- A recent listing for PepsiCo is shown below:

Stock	Volume	High	Low	Close	Net Change
PepsiCo	**2,942.4m**	**48,88**	**47,31**	**47,5**	**-1,19**

Par Value & No-Par Value Stock

- Par value stock
  - capital stock that *has been* assigned a value per share in the corporate charter
  - represents the legal capital per share that must be retained in the business for the protection of corporate creditors

- No-par stock
  - capital stock that *has not been* assigned a value in the corporate charter
    In many states the board of directors can assign a stated value to the shares which then becomes the legal capital per share. When there is no assigned stated value, the entire proceeds are considered to be legal capital.

Relationship Of Par And No-Par Value Stock To Legal Capital

Stock	Legal Capital per Share
Par value →	**Par value**
No-par value with stated value →	**Stated value**
No-par value without stated value →	**Entire proceeds**

CORPORATE CAPITAL (STUDY OBJECTIVE 2)

- Stockholders' equity, shareholders' equity, or corporate capital.
  - Owner's equity in a corporation
- Stockholders' equity section of a corporation's balance sheet
- Paid-in (contributed) capital –

    - Total amount of cash and other assets paid in to the corporation by stockholders in exchange for capital stock.
- Retained earnings
    - Net income that is retained in a corporation.

Retained Earnings

Retained earnings is net income that is retained in the corporation. Net income is recorded in Retained Earnings by a closing entry in which Income Summary is debited and Retained Earnings is credited. For example, if net income for Delta Robotics is $130,000 in its first year of operations, the closing entry is:

Account Titles and Explanation	Debit	Credit
Income Summary	130,000	
Retained Earnings		130,000
(To close income summary and transfer net income to retained earnings)		

Stockholders' Equity Section

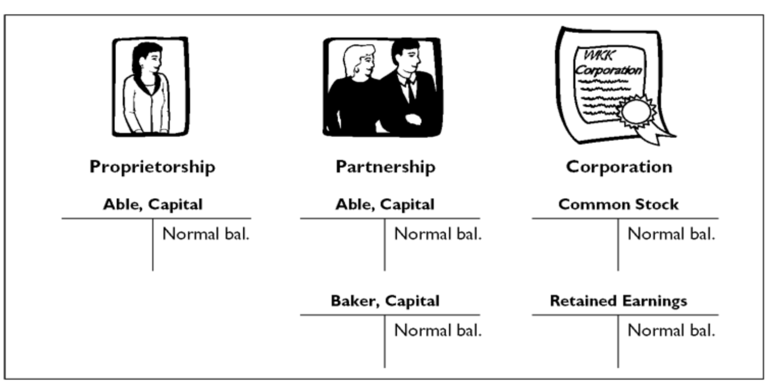
If Delta Robotics has a balance of $800,000 in common stock at the end of its first year, its stockholders' equity section is as follows:

Delta Robotics Balance Sheet (partial)

Stockholders' equity	
Paid-in capital	
Common stock	$800,000
Retained earnings	130,000
Total Stockholders' equity	$930,000

From previous slide

Comparison of Owners' Equity Accounts



COMMON STOCK ISSUES (STUDY OBJECTIVE 3)

The primary objectives in accounting for the issuance of common stock are:

1. to identify the specific sources of paid-in capital
2. to maintain the distinction between paid-in capital and retained earnings.

Issuing Par Value Common Stock for Cash

When the issuance of common stock for cash is recorded, and the issue price is the same as the par value of the stock, the par value of the shares is credited to Common Stock and debited to Cash.

If Hydro-Slide, Inc. issues 1,000 shares of $1 par value common stock at par for cash, the entry to record this transaction is:

Account Titles and Explanation	Debit	Credit
Cash Common Stock (To record issuance of 1,000 shares of $1 par common stock at par)	1,000	1,000

When the issuance of common stock for cash is recorded, and the par value of the shares is NOT the same as the cash price, the par value is credited to Common Stock, and the portion of the proceeds that is above or below par value is recorded in a separate paid-in-capital account.

Account Titles and Explanation	Debit	Credit
Cash	5,000	
Common Stock		1,000
Paid-in capital in Excess of Par Value (To record issuance of 1,000 shares of $1 par common stock in excess of par)		4,000

STOCKHOLDERS' EQUITY: PAID-IN CAPITAL IN EXCESS OF PAR VALUE BALANCE SHEET PRESENTATION

The total paid-in-capital from these transactions is $6,000, and the legal capital is $2,000. If Hydro-Slide, Inc. has retained earnings of $27,000, the stockholders' equity section is as follows:

Hydro-Slide, Inc.

Balance Sheet (partial)

Stockholders' equity	
Paid-in-capital	
Common Stock	$2,000
Paid-in capital in excess of par	4,000
Total paid-in-capital	6,000
Retained earnings	27,000
Total stockholders' equity	$33,000

Issuing No-Par Common Stock for Cash

When no-par common stock has a stated value, the stated value is credited to Common Stock. When the selling price exceeds the stated value, the excess is credited to Paid-in Capital in Excess of Stated Value**.**

Assume that instead of $1 par value stock, Hydro-Slide Inc. has $5 stated value no-par stock and the company issues 5,000 shares at $8 per share for cash. The entry is:

Account Titles and Explanation	Debit	Credit
Cash	40,000	
Common Stock		25,000
Paid-in capital in Excess of Stated Value		15,000
(To record issuance of 5,000 shares of $5 stated value no-par stock)		

When no-par stock does not have a stated value, the entire proceeds from the issue are credited to Common Stock.

If Hydro-Slide Inc. does not assign a stated value to its no-par stock, the issuance of the 5,000 shares at $8 per share for cash if recorded as follows:

Account Titles and Explanation	Debit	Credit
Cash	40,000	
Common Stock		40,000
(To record issuance of 5,000 shares of no-par stock)		

Issuing Common Stock for Services or Noncash Assets

- Issued for services
  - Example: compensation to attorneys or consultants, or for noncash assets, such as land
- Common stock issued for services or non-cash assets
  - Cost is either the fair market value of the consideration *given up,* or the consideration *received*, whichever is more clearly determinable.

Athletic Research Inc. is a publicly held corporation. Its $5 par value is actively traded at $8 per share. The company issues 10,000 shares of stock to acquire land recently advertised for sale at $90,000. The most clearly evident value is the *MARKET VALUE* of the consideration given, which is $80,000.

Account Titles and Explanation	Debit	Credit
Land	80,000	
Common Stock		50,000
Paid-in capital in Excess of Par Value		30,000
(To record issuance of 10,000 shares of $5 par value stock for land)		

NOTE: The par value of the stock is NEVER a factor in determining the cost of the assets received.

TREASURY STOCK (STUDY OBJECTIVE 4)

Corporation's own stock that has been issued, fully paid for, and reacquired *but not retired. Why???*

1. To reissue the shares to officers or employees
2. To increase trading thereby enhancing market value
3. To have additional shares available for use in acquisitions of other companies
4. To reduce the number of shares outstanding and thereby increase earnings per share
5. To rid the company of disgruntled investors, perhaps to avoid a takeover

Stockholders' Equity with No Treasury Stock

Before the purchase of the treasury stock, the stockholders' equity is as follows:

Mead, Inc.
Balance Sheet (partial)

Stockholders' equity		
Paid-in capital		
Common stock, $5 par, 100,000 shares		
Issued and outstanding	$	500.000,00
Retained earnings	$	200.000,00
Total stockholders' equity	**$**	**700.000,00**

Purchase of Treasury Stock

Under the cost method, Treasury Stock is debited for the price paid for the shares. The same amount is credited to Treasury Stock when the shares are disposed of.

If Mead, Inc. has 100,000 shares of $5 par value common stock outstanding (all issued at par value) and it decides to acquire 4,000 shares of its stock at $8 per share, the entry is:

Account Titles and Explanation	Debit	Credit
Treasury Stock	32,000	
Cash		32,000
(To record purchase of 4,000 shares of treasury stock at $8 per share)		

Stockholders' Equity With Treasury Stock

The stockholders' equity section of Mead, Inc. after purchase of treasury stock is as follows

Mead, Inc.
Balance Sheet (partial)

Stockholders' equity		
Paid-in capital		
Common stock, $5 par, 100,000 shares		
Issued and outstanding	$	500.000,00
Retained earnings	$	200.000,00
Total stockholders' equity	**$**	**700.000,00**
Less: Treasury stock (4,000 shares)	$	32.000,00
Total Stockholder's equity	$	668.000,00

The acquisition of treasury stock REDUCES stockholders' equity.

Disposal of Treasury Stock

Treasury stock resold

- Selling price of the shares is greater than cost
  - The difference is *credited* to paid-in capital from treasury stock
- Selling price is less than cost
  - The excess of cost over selling price is usually *debited* to paid-in capital from treasury stock
- When there is no remaining balance in paid-in capital from treasury stock, the remainder is *debited* to retained earnings.

Sale of Treasury Stock Above Cost

Assume that 1,000 shares of treasury stock of Mead, Inc., previously acquired at $8 per share, are sold at $10 per share on July 1. The entry is:

Account Titles and Explanation	Debit	Credit
Cash	**10,000**	
Treasury Stock		**8,000**
Paid-in capital from Treasury Stock	**2,000**	
(To record sale of 1,000 shares of treasury stock above cost)		

Note: The $2,000 credit in the entry would not be considered a Gain on Sale of Treasury Stock.

Sale of Treasury Stock Below Cost

Assume instead that Mead, Inc. sells an additional 800 shares of treasury stock on October 1 at $7 per share, the entry is**:**

Date	Account Titles and Explanation	Debit	Credit
Oct. 1	**Cash**	**5,600**	
	Paid-in Capital from Treasury Stock	**800**	
	Treasury Stock		**6,400**
	(To record sale of 800 shares of treasury stock below cost)		

When treasury stock is sold *below* its cost, the excess of cost over selling price is usually debited to Paid-in Capital from Treasury Stock.

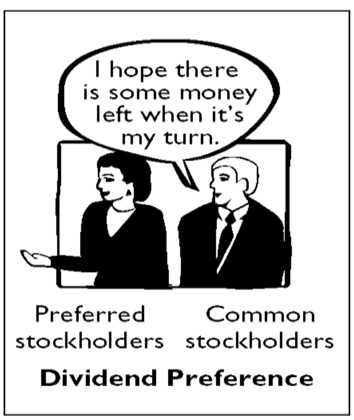
PREFERRED STOCK (STUDY OBJECTIVE 5)

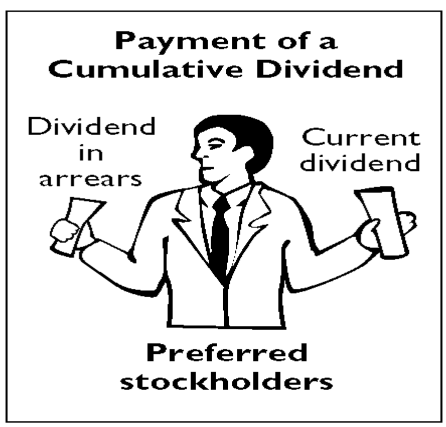
- Contractual provisions give it priority over common stock in certain areas:
  1. Distribution of earnings
  2. Assets in the event of liquidation.
- Usually do not have voting rights
- Shown first in the stockholders' equity section
- Identified separately from other stock and paid-in capital accounts.

Dividend Preferences Cumulative Dividend

- Cumulative dividend
  - Preferred stockholders must be paid *both current and prior year* dividends before common stockholders receive any dividends
- Dividends in arrears
  - Preferred dividends not declared in a given period
  - Not considered a liability, but the amount of the dividends in arrears should be disclosed in the notes to the financial statements

Dividend Preferences





Computation of Total Dividends to Preferred Stock

If Scientific-Leasing has 5,000 shares of 7%, $100 par value cumulative preferred stock outstanding, then the annual dividend is $ 35,000 (5,000 shares x $7 per share). If dividends were two years in arrears, preferred stockholders are entitled to receive the following before any dividends are paid to common stockholders.

Dividends in arrears ($35,000 x 2)	**$ 70,000**
Current-year dividends	**35,000**
	$ 105,000

STOCKHOLDERS’ EQUITY PRESENTATION AND ANALYSIS (STUDY OBJECTIVE 6)

- Stockholders’ equity section of the balance sheet
  - paid-in capital and retained earnings are reported
  - specific sources of paid-in capital are identified
- Paid-in capital
  - Capital stock
  - Additional paid-in capital
- Paid-in capital is sometimes called contributed capital.

Stockholders’ Equity Presentation

Connally Inc. Balance Sheet (partial)		
Stockholders’ equity		
Paid-in capital		
Capital Stock		
9% preferred stock, $100 par value, callable at $120, cumulative, 10,000 shares authorized, 6,000 shares issued and outstanding		$ 600,000
Common Stock, no par, $5 stated value, 500,000 shares authorized, 400,000 shares issued, and 390,000 outstanding		2,000,000
Additional paid-in capital		
In excess of par value-preferred stock	$ 30,000	
In excess of par value-common stock	860,000	
From treasury stock	140,000	
Total additional paid-in capital		1,030,000
Total paid-in capital		3,630,000
Retained Earnings		1,058,000
Total paid-in capital and retained earnings		4,688,000
Less: Treasury stock-common (10,000 shares at cost)		
Total stockholders’ equity		$4,608,000

Published Stockholders’ Equity Section

KELLOGG COMPANY
Balance Sheet (partial)
(in millions, except per share data)

Stockholders' equity	
Common stock $.0.25 par value, 1,000,00,000,000 shares authorized Issued: 415,343 shares	$ 104.1
Capital in excess of par value	49.9
Retained earnings	1,873.0
Treasury stock, at cost 7,598,923 shares	(272.8)
Accumulated other comprehensive income	(853.4)
Total stockholders' equity	$ 895.4

BOOK VALUE PER SHARE FORMULA (STUDY OBJECTIVE 7)

- Represents the *equity a common stockholder has in the net assets of the corporation* from owning one share of stock
- Formula for computing book value per share
    - *If corporation has only one class of stock is:*

$$\boxed{\textbf{Total Stockholders' Equity}} \;/\; \boxed{\textbf{Number of Common Shares Outstanding}} = \boxed{\textbf{Book Value per Share}}$$

Book Value *versus* **Market Value**

- Book value per share
    - Based on recorded costs
- Market value per share
    - Reflects subjective judgments of thousands of stockholders and prospective investors about the company's potential for future earnings and dividends
    - May exceed book value per share, but that fact does not necessarily mean that the stock is overpriced

Book and Market Values Compared

The correlation between book value and the annual range of a company's market value per share is often remote, as indicated by the following data:

Company	Book Value (year-end)	Market Range (for year)
Limited, Inc.	$8.25	$22.34-$12.53
HJ Heinz Company	$5.25	$43.48-$29.60
Cisco Systems	$3.92	$21.84-$12.24
Wal-Mart Stores	$9.10	$63.90-$43.70

REVIEW

1. Stockholders have all of the following rights except to:
   a. Share corporate earnings through receipt of dividends.
   b. Vote for the corporate officers.
   c. Keep the same percentage ownership when new shares of stock are issued.
   d. Share in assets upon liquidation.

2. ABC Corporation issues 1,000 shares of $10 par value common stock at $12 per share. In recording the transaction, credits are made to:
   a. Common Stock $10,000 and Paid-in Capital in Excess of Stated Value $2,000.
   b. Common Stock $12,000.
   c. Common Stock $10,000 and Paid-in Capital in Excess of Par Value $2,000.
   d. Common Stock $10,000 and Retained Earnings $2,000

3. On July 6, PT Antik issued for cash 800.000 share of no-par common stock at Rp1.200,00. On August 30, PT Antik issued at par 10.000 shares of 2%, Rp50.000,00 par preferred stock for cash. On October 14, PT Antik issued for cash 7.500 shares of 2%, Rp50.000,00 par preferred stock at Rp54.000,00
   Instructions:
   Journalized the entries to record those transactions

Reference

Weigandt, Kieso, and Kimmel. (2005). Accounting Principles, 6th Ed. Canada: John Wiley and Sons.

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