Chapter 13

Equities

Corporation

Corporate charter – The legal document establishing a corporation under the laws of its appropriate jurisdiction. It specifies the types of equities and their terms, number of shares that can be issued (authorized), and the par value of these issues. Some states levy a tax based on the par value of its stock. Hence, these values are often very small (i.e., $.10 or $.01 per share).

Characteristics of a Corporation

- Separate legal existence
- Limited liability of stockholders
- Transferable ownership rights
- Ability to acquire capital
- Continuous life
- Corporation management
- Government regulations
- Additional taxes

Corporation

Is a legal entity that is formed through a corporate charter and can operate in various states (must have a license from each state in which it does business), but is incorporated in only one state.

Classified by purpose and ownership
- Purpose - profit or nonprofit
- Ownership - publicly or privately held

Ownership

Publicly Held Corporation

May have thousands of stockholders and its stock is regularly traded on national securities markets.

Privately Held Corporation

May have few stockholders and does not offer its stock for sale to general public.

Separate Legal Existence

Acts under its own name and may buy, own, sell property; borrow money; enter into legally binding contracts; may sue or be sued; pays its own taxes.

Stockholders cannot bind corporation unless the stockholder is acting as an agent of the corporation.

Limited Liability of Stockholders

Creditors have recourse only against corporate assets to satisfy claims. Liability of stockholders limited to investment in corporation. Thus, creditors have no legal claim on personal assets of owners unless fraud has occurred.

Transferable Ownership Rights

Transfer of ownership among stockholders has no effect on corporation's operating activities or assets, liabilities and total stockholders' equity. **Remember** that a corporation does not receive any payments on the transfer (i.e., sale) of shares after the original issuance of the stock.

Continuous Life

Corporation is separate legal entity; thus, a corporation is continuous and is not affected by withdrawal, death, or incapacity of any stockholder.

Corporation Management

- The corporation establishes by-laws upon incorporation.
- Stockholders manage corporation indirectly through board of directors.
- Board of directors
  - formulates operating policies
  - selects officers to execute policy and to perform daily management functions.

Additional Taxes

- Corporations pay federal and state income taxes.
- Stockholders pay taxes on cash dividends. Thus, corporate income is taxed twice.
- This is not the case with proprietorships, partnerships, or S corporations, where the owner's pro rata share of earnings is reported on his or her personal income tax return.

Stockholder Rights

- Vote on the election of Board of Directors
- Can share in corporate profits through dividends – assuming declared
- Entitled to keep the same percentage of ownership if new shares are offered for sale.
- Entitled to pro rata share (based on ownership percentage) of the assets in liquidation

Difference Between Equity and Debt

First, debt agreements specify payments due to their holders. In other words, debt determines the maximum payment a debt holder can receive. This is not the case with equity (i.e., dividends can be unlimited).

Second, debt holders are entitled to receive payments specified in the debt agreement and possess legal recourse if promised payments are not made (i.e., there is no requirement to pay dividends).

Difference Between Equity and Debt

- Third, if a corporation defaults, debt holders have the right to be paid before equity holders (i.e., a senior position).
- Fourth, equity holders possess decision rights in the entity (as discussed in previous slides), as long as a default has not occurred.

Questions in Issuing Stock

- How many shares should be issued?
- At what price should the shares be issued?

Factors Involved in Setting Price of Stock

- Company's anticipated future earnings
- Its expected dividend rate per share
- Its current financial position
- Current state of the economy
- Current state of the securities market

Stock Terms

Authorized Stock
Maximum amount of stock a corporation is allowed to sell as authorized by corporate charter. Amount must be disclosed on balance sheet.

Issued Stock
Number of shares originally sold to stockholders.

Outstanding Stock
Number of shares held by stockholders (i.e.,shares issued minus shares reacquired – treasury stock).

Par Value

Par value is the legal capital per share that must be retained in the business. This is usually low because some states levy a transfer tax on the corporation based on par value.

NOTE: Par value has NO relationship to the market value of the stock.

Stockholders' Equity Section of The Balance Sheet

Stockholders' equity consists of two categories (contributed capital and earned capital):

- Contributed capital
  - Par Value
  - Additional paid-in capital
- Earned capital
  - Retained earnings

Accounting for Common Stock Issues

The issuance of common stock affects only the contributed capital accounts. When the issuance of common stock for cash is recorded, the par value of the shares is credited to Common Stock. The portion of the proceeds above par value is recorded in a separate paid-in account referred to as either additional paid-in capital or paid-in capital in excess of par.

Issuing Stock at Par

Rhody issues 100,000 shares of the $1 par value common stock for cash at $1 per share. The entry is:

Cash	100,000	
Common Stock		100,000

NOTE: Since the stock is issued at par, there is no additional paid-in capital

Issuing Stock Above Par

Assume Rhody issues another 100,000 shares of the $1 par value common stock for cash at $5 per share. The entry is:

Cash	500,000	
Common Stock		100,000
Additional Paid-in Capital		400,000

Rhody's Balance Sheet

Stockholders' Equity	
Paid-in capital	
Common stock	$200,000
Paid-in capital in excess of par	400,000
Total paid-in capital	$600,000
Retained earnings	200,000*
Total stockholders' equity	**$800,000**

***** For illustrative purposes, we assume beginning retained earnings is $200,000.

Treasury Stock

Treasury stock is a corporation's issued and outstanding stock that has been reacquired by the corporation and held in "treasury" for future use.

Why Does A Corporation Reacquire Its Own Stock?

- Reissue shares to officers and employees under bonus and stock compensation plans.
- Increase trading of company's stock in securities market in hopes of enhancing market value.
- Have additional shares available for use in acquisition of other companies.

Why Does A Corporation Reacquire Its Own Stock

- Reduce number of shares outstanding, thereby increasing earnings per share.
- Prevent a hostile takeover.

Purchase of Treasury Stock

On February 1, 2004, Rhody acquires 4,000 shares of its stock at $8 per share.

Treasury Stock	32,000	
Cash		32,000

Treasury Stock

- The Treasury Stock account is debited for the cost ($32,000) of the shares (i.e., contra equity account).
- The original amount of Common Stock is not affected because the number of issued shares does not change.
- Treasury stock is considered a contra equity account (i.e., it has a debit balance when the normal balance is a credit) and thus reduces the stockholders' equity section of the balance sheet.

Rhody's Balance Sheet
After Treasury Stock

Stockholders' equity	
Paid-in capital	
Common stock,$5 par value, 200,000 shares issued and 196,000 outstanding	$ 200,000
Additional Paid-in Capital	400,000
Retained Earnings	200,000
Total stockholders' equity	800,000
Less: Treasury Stock	32,000
Total stockholders' equity	$768,000

Preferred Stock

A type of stock that has contractual preferences over common stock. Preferred stockholders do not have voting rights.

Preferences

- Dividends
- Assets in the event of liquidation

Preferred Stock

Assume Rhody issues 1,000 shares of $100 par value preferred stock for $12 cash per share.

Cash	120,000	
Preferred Stock		100,000
Additional Paid-in Capital - PS		20,000

Rhody's Balance Sheet After Preferred Stock

Stockholders' equity	
Common stock,$5 par value, 200,000 shares issued and 196,000 outstanding	$ 200,000
Additional Paid-in Capital	400,000
Preferred stock, $100 par value 1,000 shares issued and 1,000 outstanding	100,000
Additional Paid-in Capital – PS	20,000
Retained Earnings	200,000
Total stockholders' equity	920,000
Less: Treasury Stock	32,000
Total stockholders' equity	$888,000

Dividend Preferences

- Preferred stockholders have the right to the distribution of corporate income before common stockholders. Therefore, common shareholders will not receive any dividends until preferred stockholders have received their dividends.
- Generally, the per share dividend amount is stated as either a percentage of the par value or as a specified amount.

Cumulative Preferred Stock

As we have discussed, owning common or preferred stock does not guarantee the payment of a dividend. Therefore, to protect preferred stockholders, most preferred stock is cumulative. While being "cumulative" does not guarantee that a company will pay preferred stockholders a dividend in a specific year, it does require that before the company can pay a dividend to common stockholders, it must pay preferred stockholders a dividend for all prior years that they did not receive a dividend (including a dividend for the current year).

Dividends in Arrears

Unpaid prior-year dividends are referred to as dividends in arrears and are not considered a liability. No liability exists until the dividend is declared by the board of directors. However, the amount must be disclosed in the notes to the financial statements. Thus, this is an example of an unrecorded economic liability.

Dividends in Arrears Example

Rhody has 1,000 shares of 7%, $100 par value cumulative preferred stock outstanding. The annual dividend is $7,000 (1,000 x $7 per share). Dividends are 2 years in arrears. What amount must Rhody pay preferred stockholders before common stockholders can receive a dividend?

Dividends in arrears ($7,000 x 2)	$ 14,000
Current-year dividends	7,000
Total preferred dividends	$ 21,000

Dividend

- A dividend is a distribution by a corporation to its stockholders on a pro rata basis.
- Pro rata means that if you own 10% of the common shares, you will receive 10% of the dividend. However, dividends are reported on a per share amount.
- Dividends come in two forms:
  - cash
  - stock.

Cash Dividend

A cash dividend Is a pro rata distribution of cash to stockholders.

Generally, a corporation must have 2 things to pay cash dividends

- Retained earnings
- Adequate cash

Entries for Cash Dividends

Three dates are important in connection with dividends:

- the declaration date
- the record date
- the payment date

The Declaration Date

The declaration date is the date that the board of directors declares the cash dividend and commits the corporation to a binding legal obligation that cannot be rescinded.

Accounting on the Declaration Date

On December 1, 2004, the directors of Rhody declare a $. 25 per share cash dividend on 196,000 shares (200,000 issued – 4,000 treasury) of $1 par value common stock. The dividend is $49,000 (196,000 x $.25).

Retained Earnings	49,000	
Dividends Payable		49,000

NOTE: We don't pay dividends on treasury stock, since that, in essence, would be paying dividends to ourselves.

Accounting on the Date of Record

Represents the date ownership of the outstanding shares is determined for dividend purposes. Since this is an internal not external transaction:

NO ENTRY IS NECESSARY

Rhody's Balance Sheet
After Declaration of Dividend

Stockholders' equity	
Common stock,$5 par value,	
200,000 shares issued and	
196,000 outstanding	$ 200,000
Additional Paid-in Capital	400,000
Preferred stock, $100 par value	
1,000 shares issued and	
1,000 outstanding	100,000
Additional Paid-in Capital – PS	20,000
Retained Earnings	151,000
Total stockholders' equity	921,000
Less: Treasury Stock	32,000
Total stockholders' equity	$839,000

Accounting on the Date of Payment

When the dividend is paid on January 20, 2005, the entry is

Dividends Payable	49,000	
Cash		49,000

A Stock Dividend

A stock dividend Is a pro rata distribution of the corporation's own stock to stockholders.

Results in a decrease in retained earnings and an increase in paid-in capital.Thus, it does not decrease total stockholders' equity or total assets.

Is often issued by companies that do not have adequate cash to issue a cash dividend.

Stock Dividends

Assume you own 2% of Rhody (3,920 of its 196,000 shares of outstanding common stock) and it declares a 10% stock dividend. Rhody would issue an additional 19,600 shares (196,000 x 10%) and you would receive 392 (2% x 19,600) shares. After the stock dividend your ownership interest would remain at 2% (4,312 /215,600). **Note:** You now own more shares of stock, but your ownership interest has not changed.

Reasons for a Stock Dividend

To satisfy stockholders' dividend expectations without spending cash.

To increase marketability of its stock by increasing number of shares outstanding and decreasing market price per share.

To emphasize that a portion of stockholders' equity has been permanently reinvested in business and is unavailable for cash dividends.

Accounting for Stock Dividends

Generally, most stock dividends are considered "small stock" dividends. That is, the number of new shares created does not increase the total number of shares outstanding by more than 25%. A small stock dividend reduces retained earnings by the number of new shares issued multiplied by the fair market value of the stock.

Stock Dividend Example

Rhody's declares a 2% stock dividend on its shares of $1 par value common stock. The current fair market value of the stock is $7 per share. Recall that its balance in retained earnings is $151,000. How many shares will be issued? What is the journal entry to record the stock dividend?

Accounting on the Declaration Date

The number of shares to be issued is 9,800 (200,000 - 4,000) x 2%). The number of new shares is then multiplied by the fair market value ($7) of the stock and Retained Earnings is decreased by $68,600 (9,800 x $7).

Journal Entry:

Retained Earnings	68,600	
Common Stock to be distributed		9,800
Additional Paid-in Capital		58,800

Accounting on the Issuance Date

Journal Entry:

Common Stock to be distributed	9,800	
Common Stock		9,800

Note: Although total stockholders' equity remains the same, a stock dividend rearranges the composition of stockholders' equity.

Rhody's Balance Sheet After Declaration of Dividend

	Before Dividend	After Dividend
Stockholders' equity		
Common stock	$200,000	$209,800
Additional paid-in capital - CS	400,000	458,800
Preferred stock	100,000	100,000
Additional paid-in capital - PS	20,000	20,000
Total paid-in capital	720,000	788,600
Retained earnings	151,000	82,400
Less: Treasury stock	(32,000)	(32,000)
Total stockholders' equity	$839,000	$839,000
Outstanding shares	196,000	205,800

Stock Split

Is the issuance of additional shares of stock to stockholders accompanied by:

– A reduction in the par or stated value.
– An increase in number of shares.

A stock split does not have any effect on total paid-in capital, retained earnings, and total stockholders' equity

Stock Split

Assume that instead of issuing a 2% stock dividend, Rhody issues a 2-for-1 stock split on its 196,000 shares of common stock.

EFFECTS OF STOCK SPLIT

– No journal entry is necessary.
– Par Value per Share decreases and number of shares outstanding increases

Rhody's Balance Sheet After Stock Split

	Before Split	After Split
Stockholders' equity		
Common stock	$200,000	$200,000
Additional paid-in capital - CS	400,000	400,000
Preferred stock	100,000	100,000
Additional paid-in capital - PS	20,000	20,000
Total paid-in capital	720,000	720,000
Retained earnings	151,000	151,000
Less: Treasury stock	(32,000)	(32,000)
Total stockholders' equity	$839,000	$839,000
Outstanding shares	196,000	392,000

Comparison of Stock Dividend and Stock Split

Item	Stock Split	Stock Dividend
Total paid-in capital	No change	Increase
Total retained earnings	No change	Decrease
Total par value	No change	Increase
Par value per share	Decrease	No change

Retained Earnings

Retained earnings represents the net income that is retained in the business. Retained earnings is net income minus dividends paid since the formation of the business.

The balance in retained earnings is part of the stockholders' claim on the total assets of the corporation.

Retained earnings does not represent a claim on any specific asset.

Retained Earnings

For example, a $100,000 balance in retained earnings does not mean that there should be $100,000 in cash.

Retained Earnings Restrictions

Are legal, contractual or voluntary circumstances that make a portion of retained earnings currently unavailable for dividends. This can be due to debt covenants as discussed in Chapter 12.

Stock Options

Generally, compensation expense is not recorded upon issue of the stock options. This is permitted as long as the stock price equaled or was lower than the exercise price at the time the options were issued.

However, the entity must disclose in the pro forma the effect the stock options would have had on net income and diluted EPS if it was recognized as an expense.

Stock Options

On December 1, 2004, Rhody issues 5,000 stock options to the company president. At the time, the fair market value of the stock ($15) is equal to the exercise price ($15). What would Rhody record as compensation expense at the date of issuance?

Stock Options

Rhody would not make a journal entry to record compensation expense. When the stock options are exercised, it would record the entry for the issuance of the stock. However, it must make a footnote disclosure in the financial statements to reflect the effect this would have had on net income and EPS.

Stock Options

On March 1, 2006, the president of Rhody exercises his option to buy the 5,000 shares of stock when the fair market value of the stock is $30. Recall that the exercise price was $15 and the par value of Rhody stock is $1. How does Rhody record the effect of the issuance of stock?

Stock Options

Rhody would make the following journal entry:

Cash	$75,000*	
Common Stock		5,000
Additional paid-in capital		70,000

* ($15 exercise price x 5,000 shares)

Measuring Corporate Performance

One way that companies reward stock investors for their investment is to pay them dividends.

The payout ratio and dividend yield measure a corporation's dividend performance.

The Payout Ratio

Measures the percentage of earnings distributed in the form of cash dividends to common stockholders

$$\frac{\text{Total Cash Dividends on Common Stock}}{\text{Net Income}}$$

The Dividend Yield

The rate of return an investor earns from dividends.

$$\frac{\text{Dividends Per Share of Common Stock}}{\text{Stock Price at Year-End}}$$

Earnings Per Share

Measures the net income earned on each share of common stock.

$$\frac{\text{Net Income - Preferred Stock Dividends}}{\text{Average Number of Shares of Common Stock Outstanding}}$$

Price-Earnings Ratio/Market Cap

The price-earnings ratio reflects the investors‘ assessment of a company's future earnings.

$$\frac{\text{Market Price Per Share}}{\text{Earnings Per Share}}$$

Alternatively as discussed in Chapter 7:

$$\frac{\text{Market Capitalization}}{\text{Book Value}}$$

Return on Common Stockholders' Equity Ratio

Measures the profitability from the stockholders' point of view.

$$\frac{\text{Net Income – Preferred Stock Dividends}}{\text{Average Common Stockholders' Equity}}$$