


Chapter 11

















Corporations: Organization, Stock Transactions, Dividends, and Retained Earnings

STUDY OBJECTIVES

After studying this chapter, you should be able to:

- 1 Identify the major characteristics of a corporation.
- 2 Record the issuance of common stock.
- 3 Explain the accounting for treasury stock.
- 4 Differentiate preferred stock from common stock.
- 5 Prepare the entries for cash dividends and stock dividends.
- 6 Identify the items that are reported in a retained earnings statement.
- 7 Prepare and analyze a comprehensive stockholders' equity section. 

The Navigator

Understand Concepts for Review	
Read Feature Story	
Scan Study Objectives	
Read Preview	
Read text and answer Do it!	
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Work Comprehensive Do it! p. 541	
Review Summary of Study Objectives	
Answer Self-Study Questions	
Complete Assignments	

Feature Story

"HAVE YOU DRIVEN A FORD LATELY?"

A company that has produced such renowned successes as the Model T and the Mustang, and such a dismal failure as the Edsel, would have some interesting tales to tell. Henry Ford was a defiant visionary from the day

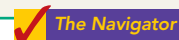
Ford Motor Company (www.ford.com) was formed in 1903. His goal from day one was to design a car he could mass-produce and sell at a price that was affordable to the masses. In short order he accomplished this goal. By 1920, 60% of all vehicles on U.S. roads were Fords.



Henry Ford was intolerant of anything that stood between him and success. In the early years Ford had issued shares to the public in order to finance the company's exponential growth. In 1916 he decided not to pay a dividend in order to increase the funds available to expand the company.

The shareholders sued. Henry Ford's reaction was swift and direct: If the shareholders didn't see things his way, he would get rid of them. In 1919 the Ford family purchased 100 percent of the outstanding shares of Ford, eliminating any outside "interference." It was over 35 years before shares were again issued to the public.

Ford Motor Company has continued to evolve and grow over the years into one of the largest international corporations. Today there are nearly a billion shares of publicly traded Ford stock outstanding. But some aspects of the company have changed very little. The Ford family still retains a significant stake in Ford Motor Company. In a move Henry Ford might have supported, top management recently decided to centralize decision making—that is, to have more key decisions made by top management, rather than by division managers. And, reminiscent of Henry Ford's most famous car, the company is attempting to make a "global car"—a mass-produced car that can be sold around the world with only minor changes.



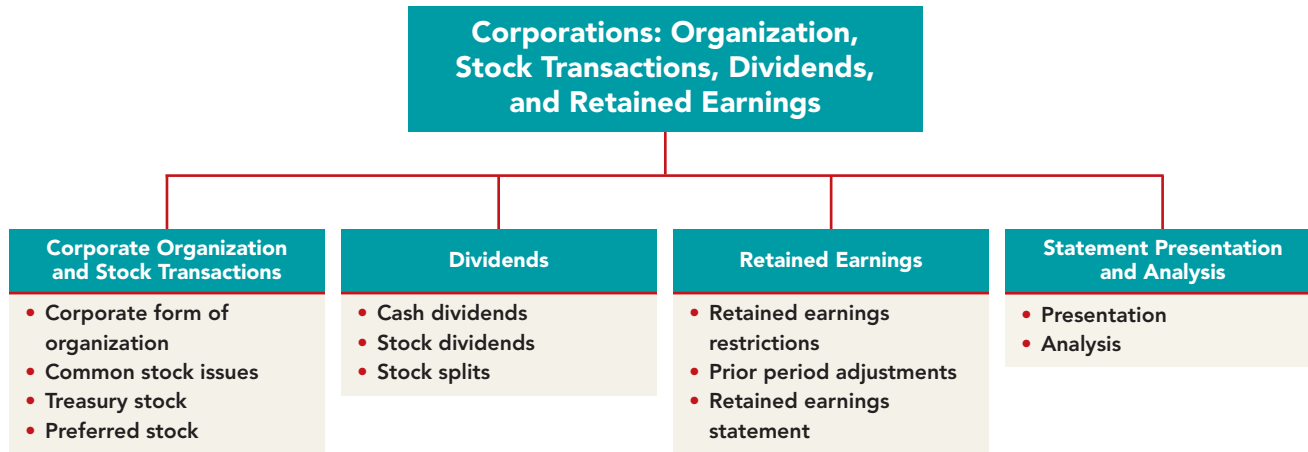
Inside Chapter 11...

- **Directors Take on More Accountability** (p. 511)
- **How to Read Stock Quotes** (p. 515)
- **Why Did Reebok Buy Its Own Stock?** (p. 522)
- **What's Happening to Dividends?** (p. 529)
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Preview of Chapter 11

Corporations like **Nike** have substantial resources. In fact, the corporation is the dominant form of business organization in the United States in terms of dollar volume of sales and earnings, and number of employees. All of the 500 largest companies in the United States are corporations. In this chapter we will explain the essential features of a corporation and the accounting for a corporation's capital stock transactions, dividends, and retained earnings.

The content and organization of Chapter 11 are as follows.



SECTION 1 The Corporate Organization and Stock Transactions

THE CORPORATE FORM OF ORGANIZATION

In 1819, Chief Justice John Marshall defined a corporation as “an artificial being, invisible, intangible, and existing only in contemplation of law.” This definition is the foundation for the prevailing legal interpretation that a **corporation** is an **entity separate and distinct from its owners**.

A corporation is created by law, and its continued existence depends upon the statutes of the state in which it is incorporated. As a legal entity, a corporation has most of the rights and privileges of a person. The major exceptions relate to privileges that only a living person can exercise, such as the right to vote or to hold public office. A corporation is subject to the same duties and responsibilities as a person. For example, it must abide by the laws, and it must pay taxes.

Two common ways to classify corporations are by purpose and by ownership. A corporation may be organized for the purpose of making a **profit**, or it may be **not-for-profit**. For-profit corporations include such well-known companies as **McDonald's**, **Ford Motor Company**, **PepsiCo**, and **Google**. Not-for-profit corporations are organized for charitable, medical, or educational purposes. Examples are the **Salvation Army**, the **American Cancer Society**, and the **Bill & Melinda Gates Foundation**.

ALTERNATIVE TERMINOLOGY

Privately held corporations are also referred to as *closely held corporations*.

Classification by **ownership** distinguishes between publicly held and privately held corporations. A **publicly held corporation** may have thousands of stockholders. Its stock is regularly traded on a national securities exchange such as the

New York Stock Exchange. Most of the largest U.S. corporations are publicly held. Examples of publicly held corporations are **Intel**, **IBM**, **Caterpillar Inc.**, and **General Electric**.

In contrast, a **privately held corporation** usually has only a few stockholders, and does not offer its stock for sale to the general public. Privately held companies are generally much smaller than publicly held companies, although some notable exceptions exist. **Cargill Inc.**, a private corporation that trades in grain and other commodities, is one of the largest companies in the United States.

Characteristics of a Corporation

A number of characteristics distinguish corporations from proprietorships and partnerships. We explain the most important of these characteristics below.

STUDY OBJECTIVE 1

Identify the major characteristics of a corporation.

SEPARATE LEGAL EXISTENCE

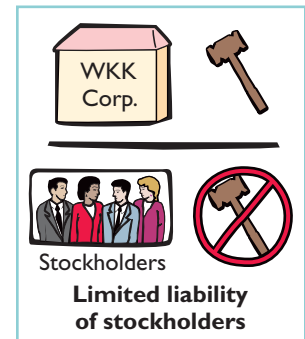
As an entity separate and distinct from its owners, the corporation acts under its own name rather than in the name of its stockholders. **Ford Motor Company** may buy, own, and sell property. It may borrow money, and may enter into legally binding contracts in its own name. It may also sue or be sued, and it pays its own taxes.

Remember that in a partnership the acts of the owners (partners) bind the partnership. In contrast, the acts of its owners (stockholders) do not bind the corporation unless such owners are **agents** of the corporation. For example, if you owned shares of Ford Motor Company stock, you would not have the right to purchase automobile parts for the company unless you were appointed as an agent of the company, such as a purchasing manager.



LIMITED LIABILITY OF STOCKHOLDERS

Since a corporation is a separate legal entity, creditors have recourse only to corporate assets to satisfy their claims. The liability of stockholders is normally limited to their investment in the corporation. Creditors have no legal claim on the personal assets of the owners unless fraud has occurred. Even in the event of bankruptcy, stockholders' losses are generally limited to their capital investment in the corporation.



TRANSFERABLE OWNERSHIP RIGHTS

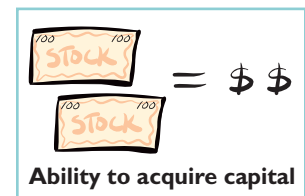
Shares of capital stock give ownership in a corporation. These shares are transferable units. Stockholders may dispose of part or all of their interest in a corporation simply by selling their stock. Remember that the transfer of an ownership interest in a partnership requires the consent of each owner. In contrast, the transfer of stock is entirely at the discretion of the stockholder. It does not require the approval of either the corporation or other stockholders.

The transfer of ownership rights between stockholders normally has no effect on the daily operating activities of the corporation. Nor does it affect the corporation's assets, liabilities, and total ownership equity. The transfer of these ownership rights is a transaction between individual owners. After it first issues the capital stock, the company does not participate in such transfers.

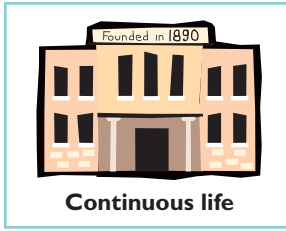


ABILITY TO ACQUIRE CAPITAL

It is relatively easy for a corporation to obtain capital through the issuance of stock. Investors buy stock in a corporation to earn money over time as the share price grows, and because a stockholder has limited liability and shares of stock are readily transferable. Also, individuals can become stockholders by investing relatively small amounts of money. In sum, the ability of a successful corporation to obtain capital is virtually unlimited.



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CONTINUOUS LIFE

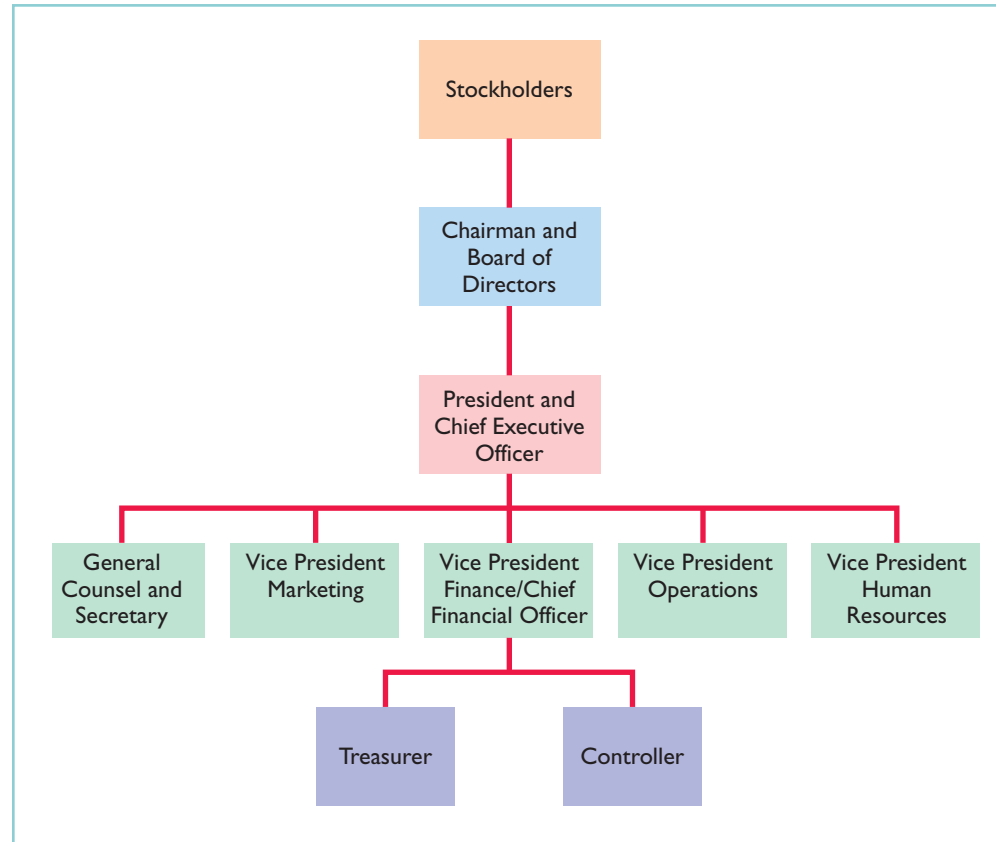
The life of a corporation is stated in its charter. The life may be perpetual, or it may be limited to a specific number of years. If it is limited, the company can extend the life through renewal of the charter. Since a corporation is a separate legal entity, its continuance as a going concern is not affected by the withdrawal, death, or incapacity of a stockholder, employee, or officer. As a result, a successful enterprise can have a continuous and perpetual life.

CORPORATION MANAGEMENT

As in **Ford Motor Company**, stockholders legally own the corporation. But they manage the corporation indirectly through a board of directors they elect. The board, in turn, formulates the operating policies for the company. The board also selects officers, such as a president and one or more vice presidents, to execute policy and to perform daily management functions.

Illustration 11-1 presents a typical organization chart showing the delegation of responsibility. The chief executive officer (CEO) has overall responsibility for managing the business. As the organization chart shows, the CEO delegates responsibility to other officers.

Illustration 11-1
Corporation organization chart



The chief accounting officer is the **controller**. The controller’s responsibilities include (1) maintaining the accounting records, (2) maintaining an adequate system of internal control, and (3) preparing financial statements, tax returns, and internal reports. The **treasurer** has custody of the corporation’s funds and is responsible for maintaining the company’s cash position.

ETHICS NOTE
Managers who are not owners are often compensated based on the performance of the firm. They thus may be tempted to exaggerate firm performance by inflating income figures.

The organizational structure of a corporation enables a company to hire professional managers to run the business. On the other hand, the separation of ownership and management prevents owners from having an active role in managing the company, which some owners like to have.

ETHICS INSIGHT



Directors Take on More Accountability

In the wake of Enron’s collapse, the members of Enron’s board of directors were questioned and scrutinized to determine what they knew, and when they knew it. A *Wall Street Journal* story reported that Enron’s board contends it was “kept in the dark” by management and by Arthur Andersen—Enron’s longtime auditors—and didn’t learn about the company’s troublesome accounting until October 2001. But, the *Wall Street Journal* reported that according to outside attorneys, “directors on at least two occasions waived Enron’s ethical code of conduct to approve partnerships between Enron and its chief financial officer. Those partnerships kept significant debt off of Enron’s books and masked actual company finances.”

Since Enron’s demise, passage of the Sarbanes-Oxley Act and proposals by the SEC and the stock exchanges have created a new corporate-governance climate: Stronger boards, with more independent directors, are now in favor.

Source: Carol Hymowitz, “Serving on a Board Now Means Less Talk, More Accountability,” *Wall Street Journal*, January 29, 2002.

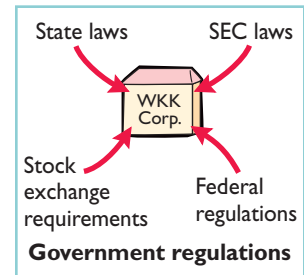


Was Enron’s board of directors fulfilling its role in a corporate organization when it waived Enron’s ethical code on two occasions?



GOVERNMENT REGULATIONS

A corporation is subject to numerous state and federal regulations. State laws usually prescribe the requirements for issuing stock, the distributions of earnings permitted to stockholders, and the effects of retiring stock. Federal securities laws govern the sale of capital stock to the general public. Also, most publicly held corporations are required to make extensive disclosure of their financial affairs to the Securities and Exchange Commission (SEC) through quarterly and annual reports. In addition, when a corporation lists its stock on organized securities exchanges, it must comply with the reporting requirements of these exchanges. Government regulations are designed to protect the owners of the corporation.



ADDITIONAL TAXES

Neither proprietorships nor partnerships pay income taxes separate from the owner’s share of earnings. Sole proprietors and partners report earnings on their personal income tax returns and pay taxes on this amount. Corporations, on the other hand, must pay federal and state income taxes as a separate legal entity. These taxes are substantial.

In addition, stockholders must pay taxes on cash dividends (pro rata distributions of net income). Thus, many argue that the government taxes corporate income twice (double taxation)—once at the corporate level, and again at the individual level.

In summary, we can identify the following advantages and disadvantages of a corporation compared to a proprietorship and a partnership.



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

Illustration 11-2 Advantages and disadvantages of a corporation

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Forming a Corporation

The initial step in forming a corporation is to file an application with the Secretary of State in the state in which incorporation is desired. The application contains such information as: (1) the name and purpose of the proposed corporation; (2) amounts, kinds, and number of shares of capital stock to be authorized; (3) the names of the incorporators; and (4) the shares of stock to which each has subscribed.

After the state approves the application, it grants a **charter**. The charter may be an approved copy of the application form, or it may be a separate document containing the same basic data. The issuance of the charter creates the corporation. Upon receipt of the charter, the corporation develops its by-laws. The **by-laws** establish the internal rules and procedures for conducting the affairs of the corporation. They also indicate the powers of the stockholders, directors, and officers of the enterprise.¹

ALTERNATIVE TERMINOLOGY

The charter is often referred to as the *articles of incorporation*.

Regardless of the number of states in which a corporation has operating divisions, it is incorporated in only one state. It is to the company's advantage to incorporate in a state whose laws are favorable to the corporate form of business organization. **General Motors**, for example, is incorporated in Delaware, whereas **Qualcomm** is a New Jersey corporation. Many corporations choose to incorporate in states with rules favorable to existing management. For example, **Gulf Oil** at one time changed its state of incorporation to Delaware to thwart possible unfriendly takeovers. There, state law allows boards of directors to approve certain defensive tactics against takeovers without a vote by shareholders.

Corporations engaged in interstate commerce must also obtain a license from each state in which they do business. The license subjects the corporation's operating activities to the corporation laws of the state.

Costs incurred in the formation of a corporation are called **organization costs**. These costs include legal and state fees, and promotional expenditures involved in the organization of the business. **Corporations expense organization costs as incurred.** To determine the amount and timing of future benefits is so difficult that it is standard procedure to take a conservative approach of expensing these costs immediately.

Ownership Rights of Stockholders

When chartered, the corporation may begin selling ownership rights in the form of shares of stock. When a corporation has only one class of stock, it is **common stock**. Each share of common stock gives the stockholder the ownership rights pictured in Illustration 11-3 (next page). A corporation's articles of incorporation or its by-laws state the ownership rights of a share of stock.

Proof of stock ownership is evidenced by a form known as a **stock certificate**. As Illustration 11-4 (next page) shows, the face of the certificate shows the name of the corporation, the stockholder's name, the class and special features of the stock, the number of shares owned, and the signatures of authorized corporate officials. Prenumbered certificates facilitate accountability. They may be issued for any quantity of shares.

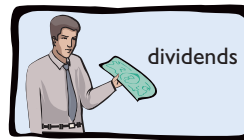
¹Following approval by two-thirds of the stockholders, the by-laws become binding upon all stockholders, directors, and officers. Legally, a corporation is regulated first by the laws of the state, second by its charter, and third by its by-laws. Corporations must take care to ensure that the provisions of the by-laws are not in conflict with either state laws or the charter.

Stockholders have the right to:

1. Vote in election of board of directors at annual meeting and vote on actions that require stockholder approval.



2. Share the corporate earnings through receipt of dividends.



3. Keep the same percentage ownership when new shares of stock are issued (**preemptive right**²).



4. Share in assets upon liquidation in proportion to their holdings. This is called a **residual claim**: owners are paid with assets that remain after all creditors' claims have been paid.

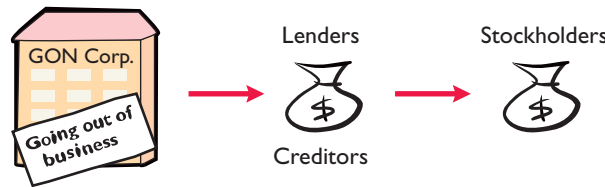


Illustration 11-3

Ownership rights of stockholders

Illustration 11-4

A stock certificate



² A number of companies have eliminated the preemptive right, because they believe it makes an unnecessary and cumbersome demand on management. For example, by stockholder approval, **IBM** has dropped its preemptive right for stockholders.

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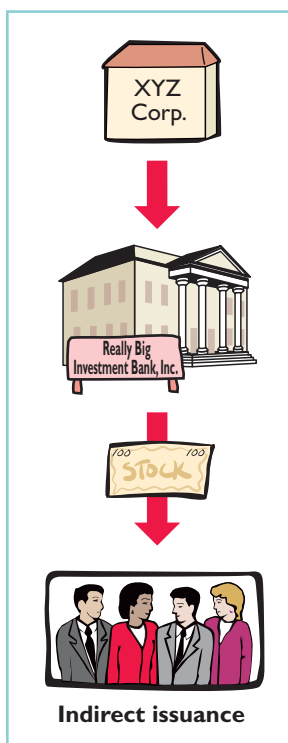
Stock Issue Considerations

In considering the issuance of stock, a corporation must resolve a number of basic questions: How many shares should it authorize for sale? How should it issue the stock? At what price should it issue the shares? What value should the corporation assign to the stock? These questions are addressed in the following sections.

AUTHORIZED STOCK

The charter indicates the amount of stock that a corporation is **authorized** to sell. The total amount of **authorized stock** at the time of incorporation normally anticipates both initial and subsequent capital needs. As a result, the number of shares authorized generally exceeds the number initially sold. If it sells all authorized stock, a corporation must obtain consent of the state to amend its charter before it can issue additional shares.

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. However, the number of authorized shares is often reported in the stockholders' equity section. It is then simple to determine the number of unissued shares that the corporation can issue without amending the charter: subtract the total shares issued from the total authorized. For example, if **Advanced Micro** was authorized to sell 100,000 shares of common stock and issued 80,000 shares, 20,000 shares would remain unissued.



ISSUANCE OF STOCK

A corporation can issue common stock **directly** to investors. Or it can issue the stock **indirectly** through an investment banking firm that specializes in bringing securities to market. 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. In this arrangement, the investment banker buys the stock from the corporation at a stipulated price and resells the shares to investors. The corporation thus avoids any risk of being unable to sell the shares. Also, it obtains immediate use of the cash received from the underwriter. The investment banking firm, in turn, assumes the risk of reselling the shares, in return for an underwriting fee.³ For example, **Google** (the world's number-one Internet search engine) used underwriters when it issued a highly successful initial public offering, raising \$1.67 billion. The underwriters charged a 3% underwriting fee (approximately \$50 million) on Google's stock offering.

How does a corporation set the price for a new issue of stock? Among the factors to be considered are: (1) the company's anticipated future earnings, (2) its expected dividend rate per share, (3) its current financial position, (4) the current state of the economy, and (5) the current state of the securities market. The calculation can be complex and is properly the subject of a finance course.

MARKET VALUE OF STOCK

The stock of publicly held companies is traded on organized exchanges. The interaction between buyers and sellers determines the prices per share. In general, the prices set by the marketplace tend to follow the trend of a company's earnings and dividends. But, factors beyond a company's control, such as an oil embargo, changes in interest rates, and the outcome of a presidential election, may cause day-to-day fluctuations in market prices.

³ Alternatively, the investment banking firm may agree only to enter into a **best-efforts** contract with the corporation. In such cases, the banker agrees to sell as many shares as possible at a specified price. The corporation bears the risk of unsold stock. Under a best-efforts arrangement, the banking firm is paid a fee or commission for its services.

The trading of capital stock on securities exchanges involves the transfer of **already issued shares** from an existing stockholder to another investor. These transactions have **no impact** on a corporation’s stockholders’ equity.


INVESTOR INSIGHT

How to Read Stock Quotes

The volume of trading on national and international exchanges is heavy. Shares in excess of a billion are often traded daily on the New York Stock Exchange (NYSE) alone. For each listed stock, the *Wall Street Journal* and other financial media report the total volume of stock traded for a given day, the high and low price for the day, the closing market price, and the net change for the day. A recent stock quote for **PepsiCo**, listed on the NYSE under the ticker symbol PEP, is shown below.

Stock	Volume	High	Low	Close	Net Change
PepsiCo	4,305,600	60.30	59.32	60.02	+0.41

These numbers indicate that PepsiCo’s trading volume was 4,305,600 shares. The high, low, and closing prices for that date were \$60.30, \$59.32, and \$60.02, respectively. The net change for the day was an increase of \$0.41 per share.

 For stocks traded on organized stock exchanges, how are the dollar prices per share established? What factors might influence the price of shares in the marketplace?



PAR AND NO-PAR-VALUE STOCKS

Par-value stock is capital stock to which the charter has assigned a value per share. Years ago, par value determined the **legal capital** per share that a company must retain in the business for the protection of corporate creditors; that amount was not available for withdrawal by stockholders. Thus, in the past, most states required the corporation to sell its shares at par or above.

However, par value was often immaterial relative to the value of the company’s stock—even at the time of issue. Thus, its usefulness as a protective device to creditors was questionable. For example, **Kellogg’s** par value is \$0.25 per share, yet a new issue in early 2009 would have sold at a **market value** in the \$38 per share range. Thus, par has no relationship with market value; in the vast majority of cases, it is an immaterial amount. As a consequence, today many states do not require a par value. Instead, they use other means to determine legal capital to protect creditors.

No-par-value stock is capital stock to which the charter has not assigned a value. No-par-value stock is quite common today. For example, **Nike**, **Procter & Gamble**, and **North American Van Lines** all have no-par stock. In many states the board of directors assigns a **stated value** to no-par shares.

before you go on...

Do it!

Indicate whether each of the following statements is true or false.

- 1. Similar to partners in a partnership, stockholders of a corporation have unlimited liability.
- 2. It is relatively easy for a corporation to obtain capital through the issuance of stock.
- 3. The separation of ownership and management is an advantage of the corporate form of business.

Corporate Organization

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Action Plan

- Review the characteristics of a corporation and understand which are advantages and which are disadvantages.
- Understand that corporations raise capital through the issuance of stock, which can be par or no-par.

- _____ 4. The journal entry to record the authorization of capital stock includes a credit to the appropriate capital stock account.
- _____ 5. Most states require a par value per share for capital stock.

Solution

1. False. The liability of stockholders is normally limited to their investment in the corporation.
2. True.
3. False. The separation of ownership and management is a disadvantage of the corporate form of business.
4. False. The authorization of capital stock does not result in a formal accounting entry.
5. False. Many states do not require a par value.

Related exercise material: **BE11-1, E11-1, E11-2,** and **Do it! 11-1.**



Corporate Capital

Owners' equity is identified by various names: **stockholders' equity, shareholders' equity, or corporate capital.** The stockholders' equity section of a corporation's balance sheet consists of two parts: (1) paid-in (contributed) capital and (2) retained earnings (earned capital).

The distinction between **paid-in capital** and **retained earnings** is important from both a legal and a financial point of view. Legally, corporations can make distributions of earnings (declare dividends) out of retained earnings in all states. However, in many states they cannot declare dividends out of paid-in capital. Management, stockholders, and others often look to retained earnings for the continued existence and growth of the corporation.

PAID-IN CAPITAL

Paid-in capital is the total amount of cash and other assets paid in to the corporation by stockholders in exchange for capital stock. As noted earlier, when a corporation has only one class of stock, it is **common stock.**

RETAINED EARNINGS

Retained earnings is net income that a corporation retains for future use. Net income is recorded in Retained Earnings by a closing entry that debits Income Summary and credits Retained Earnings. For example, assuming that net income for Delta Robotics in its first year of operations is \$130,000, the closing entry is:

A	=	L	+	SE
		-130,000 Inc		+130,000 RE
Cash Flows				
no effect				

Income Summary	130,000			
Retained Earnings				130,000
(To close Income Summary and transfer net income to retained earnings)				

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.

Illustration 11-5
Stockholders' equity section

DELTA ROBOTICS		
Balance Sheet (partial)		
Stockholders' equity		
Paid-in capital		
Common stock	\$800,000	
Retained earnings	130,000	
Total stockholders' equity		<u>\$930,000</u>

Illustration 11-6 compares the owners' equity (stockholders' equity) accounts reported on a balance sheet for a proprietorship and a corporation.

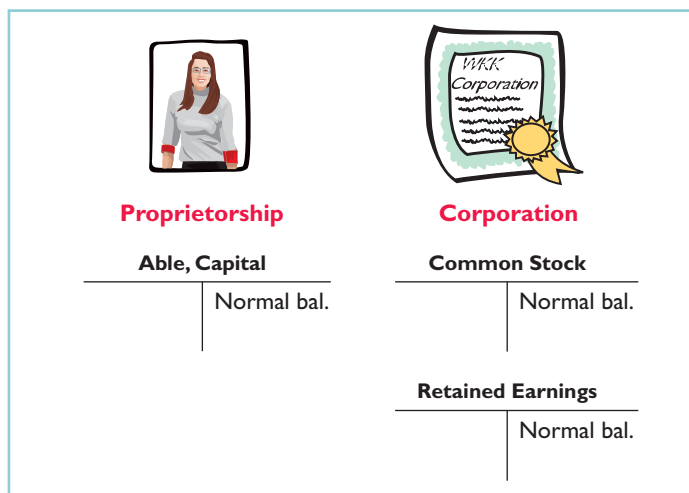


Illustration 11-6
Comparison of owners' equity accounts

Do it!

At the end of its first year of operation, Doral Corporation has \$750,000 of common stock and net income of \$122,000. Prepare (a) the closing entry for net income and (b) the stockholders' equity section at year-end.

Solution

(a) Income Summary	122,000			
Retained Earnings			122,000	
(To close Income Summary and transfer net income to retained earnings)				
(b) Stockholders' equity				
Paid-in capital				
Common stock	\$750,000			
Retained earnings	122,000			
Total stockholders' equity				\$872,000

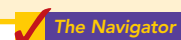
Related exercise material: **Do it!** 11-2.

before you go on...

Corporate Capital

Action Plan

- Record net income in Retained Earnings by a closing entry in which Income Summary is debited and Retained Earnings is credited.
- In the stockholders' equity section, show (1) paid-in capital and (2) retained earnings.



ACCOUNTING FOR COMMON STOCK ISSUES

Let's now look at how to account for issues of common stock. The primary objectives in accounting for the issuance of common stock are: (1) to identify the specific sources of paid-in capital, and (2) to maintain the distinction between paid-in capital and retained earnings. **The issuance of common stock affects only paid-in capital accounts.**

STUDY OBJECTIVE 2
Record the issuance of common stock.


Issuing Par-Value Common Stock for Cash

As discussed earlier, par value does not indicate a stock's market value. Therefore, the cash proceeds from issuing par-value stock may be equal to, greater than, or less than par value. When the company records issuance of common stock for cash,

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it credits to Common Stock the par value of the shares. It records in a separate paid-in capital account the portion of the proceeds that is above or below par value.

To illustrate, assume that Hydro-Slide, Inc. issues 1,000 shares of \$1 par-value common stock at par for cash. The entry to record this transaction is:

A	=	L	+	SE
+1,000				+1,000 CS
Cash Flows				
+1,000				

Cash	1,000	
Common Stock		1,000
(To record issuance of 1,000 shares of \$1 par common stock at par)		

If Hydro-Slide issues an additional 1,000 shares of the \$1 par-value common stock for cash at \$5 per share, the entry is:

A	=	L	+	SE
+5,000				+1,000 CS +4,000 CS
Cash Flows				
+5,000				

Cash	5,000	
Common Stock		1,000
Paid-in Capital in Excess of Par Value		4,000
(To record issuance of 1,000 shares of \$1 par common stock)		

The total paid-in capital from these two transactions is \$6,000, and the legal capital is \$2,000. Assuming Hydro-Slide, Inc. has retained earnings of \$27,000, Illustration 11-7 shows the company's stockholders' equity section.

Illustration 11-7
Stockholders' equity—paid-in capital in excess of par value

ALTERNATIVE TERMINOLOGY
Paid-in Capital in Excess of Par is also called *Premium on Stock*.

HYDRO-SLIDE, INC.	
Balance Sheet (partial)	
Stockholders' equity	
Paid-in capital	
Common stock	\$ 2,000
Paid-in capital in excess of par value	4,000
Total paid-in capital	6,000
Retained earnings	27,000
Total stockholders' equity	\$33,000

When a corporation issues stock for less than par value, it debits the account Paid-in Capital in Excess of Par Value, if a credit balance exists in this account. If a credit balance does not exist, then the corporation debits to Retained Earnings the amount less than par. This situation occurs only rarely: Most states do not permit the sale of common stock below par value, because stockholders may be held personally liable for the difference between the price paid upon original sale and par value.

Issuing No-Par Common Stock for Cash

When no-par common stock has a stated value, the entries are similar to those illustrated for par-value stock. The corporation credits the stated value to Common Stock. Also, when the selling price of no-par stock exceeds stated value, the corporation credits the excess to Paid-in Capital in Excess of Stated Value.

Accounting for Common Stock Issues 519

For example, 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:

Cash	40,000	
Common Stock		25,000
Paid-in Capital in Excess of Stated Value		15,000
(To record issue of 5,000 shares of \$5 stated value no-par stock)		

A	=	L	+	SE
+40,000				+25,000 CS +15,000 CS

Cash Flows
+40,000 

Hydro-Slide, Inc. reports Paid-in Capital in Excess of Stated Value as part of paid-in capital in the stockholders' equity section.

What happens when no-par stock does not have a stated value? In that case, the corporation credits the entire proceeds to Common Stock. Thus, if Hydro-Slide does not assign a stated value to its no-par stock, it would record the issuance of the 5,000 shares at \$8 per share for cash as follows.

Cash	40,000	
Common Stock		40,000
(To record issue of 5,000 shares of no-par stock)		

A	=	L	+	SE
+40,000				+40,000 CS

Cash Flows
+40,000 

Issuing Common Stock for Services or Noncash Assets

Corporations also may issue stock for services (compensation to attorneys or consultants) or for noncash assets (land, buildings, and equipment). In such cases, what cost should be recognized in the exchange transaction? To comply with the **cost principle**, in a noncash transaction **cost is the cash equivalent price**. Thus, **cost is either the fair market value of the consideration given up, or the fair market value of the consideration received**, whichever is more clearly determinable.

To illustrate, assume that attorneys have helped Jordan Company incorporate. They have billed the company \$5,000 for their services. They agree to accept 4,000 shares of \$1 par value common stock in payment of their bill. At the time of the exchange, there is no established market price for the stock. In this case, the market value of the consideration received, \$5,000, is more clearly evident. Accordingly, Jordan Company makes the following entry:

Organization Expense	5,000	
Common Stock		4,000
Paid-in Capital in Excess of Par Value		1,000
(To record issuance of 4,000 shares of \$1 par value stock to attorneys)		

A	=	L	+	SE
				-5,000 Exp +4,000 CS +1,000 CS

Cash Flows
no effect

As explained on page 512, organization costs are expensed as incurred.

In contrast, assume that Athletic Research Inc. is an existing publicly held corporation. Its \$5 par value stock 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 in this noncash transaction is the market price of the consideration given, \$80,000. The company records the transaction as follows.

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)		

A	=	L	+	SE
-80,000				+50,000 CS +30,000 CS

Cash Flows
no effect

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As illustrated in these examples, **the par value of the stock is never a factor in determining the cost of the assets received.** This is also true of the stated value of no-par stock.

before you go on...

Issuance of Stock

Action Plan

- In issuing shares for cash, credit Common Stock for par value per share.
- Credit any additional proceeds in excess of par value to a separate paid-in capital account.
- When stock is issued for services, use the cash equivalent price.
- For the cash equivalent price use either the fair market value of what is given up or the fair market value of what is received, whichever is more clearly determinable.

Do it!

Cayman Corporation begins operations on March 1 by issuing 100,000 shares of \$10 par value common stock for cash at \$12 per share. On March 15 it issues 5,000 shares of common stock to attorneys in settlement of their bill of \$50,000 for organization costs. Journalize the issuance of the shares, assuming the stock is not publicly traded.

Solution

Mar. 1	Cash	1,200,000	
	Common Stock		1,000,000
	Paid-in Capital in Excess of Par Value		200,000
	(To record issuance of 100,000 shares at \$12 per share)		
Mar. 15	Organization Expense	50,000	
	Common Stock		50,000
	(To record issuance of 5,000 shares for attorneys' fees)		

Related exercise material: **BE11-2, BE11-3, BE11-4, E11-3, E11-4,** and **Do it! 11-3.**



ACCOUNTING FOR TREASURY STOCK

STUDY OBJECTIVE 3

Explain the accounting for treasury stock.

Treasury stock is a corporation's own stock that it has issued and subsequently reacquired from shareholders, but not retired. A corporation may acquire treasury stock for various reasons:

HELPFUL HINT

Treasury shares do not have dividend rights or voting rights.

1. To reissue the shares to officers and employees under bonus and stock compensation plans.
2. To signal to the stock market that management believes the stock is underpriced, in the hope of enhancing its market value.
3. To have additional shares available for use in the acquisition 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, as illustrated in the **Ford Motor Company** Feature Story.

Many corporations have treasury stock. One survey of 600 U.S. companies found that approximately two-thirds have treasury stock.⁴ For example, **ExxonMobil Corp., Microsoft Corp., and Time Warner Inc.** purchased a combined \$14.37 billion of their shares in the first quarter of a recent year.

⁴Accounting Trends & Techniques 2007 (New York: American Institute of Certified Public Accountants).

Purchase of Treasury Stock

Companies generally account for treasury stock by **the cost method**. This method uses the cost of the shares purchased to value the treasury stock. Under the cost method, the company debits **Treasury Stock** for the **price paid to reacquire the shares**.

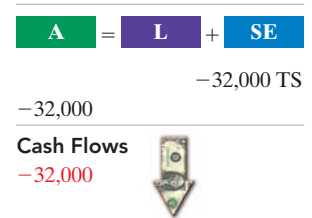
When the company disposes of the shares, it credits to Treasury Stock **the same amount** it paid to reacquire the shares. To illustrate, assume that on January 1, 2011, the stockholders' equity section of Mead, Inc. has 100,000 shares of \$5 par value common stock outstanding (all issued at par value) and Retained Earnings of \$200,000. The stockholders' equity section before purchase of treasury stock is as follows.

MEAD, INC.	
Balance Sheet (partial)	
Stockholders' equity	
Paid-in capital	
Common stock, \$5 par value, 100,000 shares issued and outstanding	\$500,000
Retained earnings	<u>200,000</u>
Total stockholders' equity	<u><u>\$700,000</u></u>

Illustration 11-8
Stockholders' equity with no treasury stock

On February 1, 2011, Mead acquires 4,000 shares of its stock at \$8 per share. The entry is:

Feb. 1	Treasury Stock Cash (To record purchase of 4,000 shares of treasury stock at \$8 per share)		32,000		32,000
--------	--	--	--------	--	--------



Note that Mead debits Treasury Stock for the cost of the shares purchased. Is the original paid-in capital account, Common Stock, affected? No, because the number of issued shares does not change. In the stockholders' equity section of the balance sheet, Mead deducts treasury stock from total paid-in capital and retained earnings. Treasury Stock is a **contra stockholders' equity account**. Thus, the acquisition of treasury stock reduces stockholders' equity.

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 value, 100,000 shares issued and 96,000 shares outstanding	\$500,000
Retained earnings	<u>200,000</u>
Total paid-in capital and retained earnings	700,000
Less: Treasury stock (4,000 shares)	<u>32,000</u>
Total stockholders' equity	<u><u>\$668,000</u></u>

Illustration 11-9
Stockholders' equity with treasury stock

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ETHICS NOTE
 The purchase of treasury stock reduces the cushion for creditors and preferred stockholders. A restriction for the cost of treasury stock purchased is often required. The restriction is usually applied to retained earnings.

In the balance sheet, Mead discloses both the number of shares issued (100,000) and the number in the treasury (4,000). The difference between these two amounts is the number of shares of stock outstanding (96,000). The term **outstanding stock** means the number of shares of issued stock that are being held by stockholders.

Some maintain that companies should report treasury stock as an asset because it can be sold for cash. Under this reasoning, companies should also show unissued stock as an asset, clearly an erroneous conclusion. Rather than being an asset, treasury stock reduces stockholder claims on corporate assets. This effect is correctly shown by reporting treasury stock as a deduction from total paid-in capital and retained earnings.

ACCOUNTING ACROSS THE ORGANIZATION



Why Did Reebok Buy Its Own Stock?

In a bold (and some would say risky) move, **Reebok** at one time bought back nearly a *third* of its shares. This repurchase of shares dramatically reduced Reebok's available cash. In fact, the company borrowed significant funds to accomplish the repurchase. In a press release, management stated that it was repurchasing the shares because it believed its stock was severely underpriced. The repurchase of so many shares was meant to signal management's belief in good future earnings.

Skeptics, however, suggested that Reebok's management was repurchasing shares to make it less likely that another company would acquire Reebok (in which case Reebok's top managers would likely lose their jobs). By depleting its cash, Reebok became a less likely acquisition target. Acquiring companies like to purchase companies with large cash balances so they can pay off debt used in the acquisition.



What signal might a large stock repurchase send to investors regarding management's belief about the company's growth opportunities?

HELPFUL HINT

Treasury stock transactions are classified as capital stock transactions. As in the case when stock is issued, the income statement is not involved.

A	=	L	+	SE
+10,000				
		+8,000 TS		
		+2,000 TS		
Cash Flows				
+10,000				

Disposal of Treasury Stock

Treasury stock is usually sold or retired. The accounting for its sale differs when treasury stock is sold above cost than when it is sold below cost.

SALE OF TREASURY STOCK ABOVE COST

If the selling price of the treasury shares is equal to their cost, the company records the sale of the shares by a debit to Cash and a credit to Treasury Stock. When the selling price of the shares is greater than their cost, the company credits the difference to Paid-in Capital from Treasury Stock.

To illustrate, assume that on July 1, Mead sells for \$10 per share the 1,000 shares of its treasury stock, previously acquired at \$8 per share. The entry is as follows.

July 1	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)		

Mead does not record a \$2,000 gain on sale of treasury stock for two reasons: (1) Gains on sales occur when **assets** are sold, and treasury stock is not an asset. (2) A corporation does not realize a gain or suffer a loss from stock transactions

with its own stockholders. Thus, companies should not include in net income any paid-in capital arising from the sale of treasury stock. Instead, they report Paid-in Capital from Treasury Stock separately on the balance sheet, as a part of paid-in capital.

SALE OF TREASURY STOCK BELOW COST

When a company sells treasury stock below its cost, it usually debits to Paid-in Capital from Treasury Stock the excess of cost over selling price. Thus, if Mead, Inc. sells an additional 800 shares of treasury stock on October 1 at \$7 per share, it makes the following entry.

Oct. 1	Cash Paid-in Capital from Treasury Stock Treasury Stock (To record sale of 800 shares of treasury stock below cost)	5,600 800 6,400	6,400
--------	--	---------------------------	-------

A	=	L	+	SE
+5,600				- 800 TS +6,400 TS
Cash Flows +5,600				

Observe the following from the two sales entries: (1) Mead credits Treasury Stock at cost in each entry. (2) Mead uses Paid-in Capital from Treasury Stock for the difference between cost and the resale price of the shares. (3) The original paid-in capital account, Common Stock, is not affected. **The sale of treasury stock increases both total assets and total stockholders' equity.**

After posting the foregoing entries, the treasury stock accounts will show the following balances on October 1.

Treasury Stock		Paid-in Capital from Treasury Stock	
Feb. 1	32,000	July 1	8,000
		Oct. 1	6,400
Oct. 1 Bal.	17,600	Oct. 1	800
		July 1	2,000
		Oct. 1 Bal.	1,200

Illustration 11-10
Treasury stock accounts

When a company fully depletes the credit balance in Paid-in Capital from Treasury Stock, it debits to Retained Earnings any additional excess of cost over selling price. To illustrate, assume that Mead, Inc. sells its remaining 2,200 shares at \$7 per share on December 1. The excess of cost over selling price is \$2,200 [2,200 × (\$8 – \$7)]. In this case, Mead debits \$1,200 of the excess to Paid-in Capital from Treasury Stock. It debits the remainder to Retained Earnings. The entry is:

Dec. 1	Cash Paid-in Capital from Treasury Stock Retained Earnings Treasury Stock (To record sale of 2,200 shares of treasury stock at \$7 per share)	15,400 1,200 1,000 17,600	17,600
--------	---	--	--------

A	=	L	+	SE
+15,400				- 1,200 TS - 1,000 RE +17,600 TS
Cash Flows +15,400				

before you go on...

Do it!

Santa Anita Inc. purchases 3,000 shares of its \$50 par value common stock for \$180,000 cash on July 1. It will hold the shares in the treasury until resold. On November 1, the corporation sells 1,000 shares of treasury stock for cash at \$70 per share. Journalize the treasury stock transactions.

Treasury Stock

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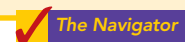
Action Plan

- Record the purchase of treasury stock at cost.
- When treasury stock is sold above its cost, credit the excess of the selling price over cost to Paid-in Capital from Treasury Stock.
- When treasury stock is sold below its cost, debit the excess of cost over selling price to Paid-in Capital from Treasury Stock.

Solution

July 1	Treasury Stock	180,000	
	Cash		180,000
	(To record the purchase of 3,000 shares at \$60 per share)		
Nov. 1	Cash	70,000	
	Treasury Stock		60,000
	Paid-in Capital from Treasury Stock		10,000
	(To record the sale of 1,000 shares at \$70 per share)		

Related exercise material: **BE11-5, E11-5, and Do it! 11-4.**



PREFERRED STOCK


STUDY OBJECTIVE 4

Differentiate preferred stock from common stock.

To appeal to more investors, a corporation may issue an additional class of stock, called preferred stock. **Preferred stock** has provisions that give it some preference or priority over common stock. Typically, preferred stockholders have a priority as to (1) distributions of earnings (dividends) and (2) assets in the event of liquidation. However, they generally do not have voting rights.

Like common stock, corporations may issue preferred stock for cash or for non-cash assets. The entries for these transactions are similar to the entries for common stock. When a corporation has more than one class of stock, each paid-in capital account title should identify the stock to which it relates. A company might have the following accounts: Preferred Stock, Common Stock, Paid-in Capital in Excess of Par Value—Preferred Stock, and Paid-in Capital in Excess of Par Value—Common Stock. For example, if Stine Corporation issues 10,000 shares of \$10 par value preferred stock for \$12 cash per share, the entry to record the issuance is:

A	=	L	+	SE
+120,000				+100,000 PS +20,000 PS
Cash Flows				
+120,000				




Cash	120,000	
Preferred Stock		100,000
Paid-in Capital in Excess of Par Value—Preferred Stock		20,000
(To record the issuance of 10,000 shares of \$10 par value preferred stock)		

Preferred stock may have either a par value or no-par value. In the stockholders' equity section of the balance sheet, companies list preferred stock first because of its dividend and liquidation preferences over common stock.

We discuss various features associated with the issuance of preferred stock on the following pages.

Dividend Preferences

As noted earlier, **preferred stockholders have the right to receive dividends before common stockholders.** For example, if the dividend rate on preferred stock is \$5 per share, common shareholders will not receive any dividends in the current year until preferred stockholders have received \$5 per share. The first claim to dividends does not, however, guarantee the payment of dividends. Dividends depend on many factors, such as adequate retained earnings and availability of cash. If a company does not pay dividends to preferred stockholders, it cannot of course pay dividends to common stockholders.



Preferred stockholders Common stockholders

Dividend Preference

The per share dividend amount is stated as a percentage of the preferred stock's par value or as a specified amount. For example, at one time **Crane Company** specified a 3¼% dividend on its \$100 par value preferred ($\$100 \times 3\frac{1}{4}\% = \3.75 per share). **PepsiCo** has a \$5.46 series of no-par preferred stock.

CUMULATIVE DIVIDEND

Preferred stock often contains a **cumulative dividend** feature. This means that preferred stockholders must be paid both current-year dividends and any unpaid prior-year dividends before common stockholders receive dividends. When preferred stock is cumulative, preferred dividends not declared in a given period are called **dividends in arrears**.

To illustrate, assume that Scientific Leasing has 5,000 shares of 7%, \$100 par value, cumulative preferred stock outstanding. The annual dividend is \$35,000 ($5,000 \times \7 per share), but dividends are two years in arrears. In this case, preferred stockholders are entitled to receive the following dividends in the current year.

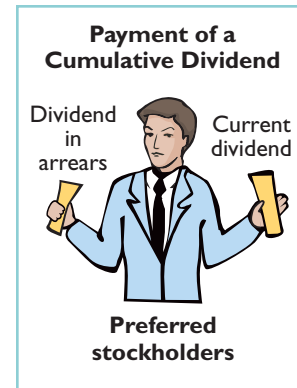
Dividends in arrears ($\$35,000 \times 2$)	\$ 70,000
Current-year dividends	35,000
Total preferred dividends	<u>\$105,000</u>

Illustration 11-11
Computation of total dividends to preferred stock

The company cannot pay dividends to common stockholders until it pays the entire preferred dividend. In other words, companies cannot pay dividends to common stockholders while any preferred stock is in arrears.

Are dividends in arrears considered a liability? **No—no payment obligation exists until the board of directors declares a dividend.** However, companies should disclose in the notes to the financial statements the amount of dividends in arrears. Doing so enables investors to assess the potential impact of this commitment on the corporation's financial position.

Companies that are unable to meet their dividend obligations are not looked upon favorably by the investment community. As a financial officer noted in discussing one company's failure to pay its cumulative preferred dividend for a period of time, "Not meeting your obligations on something like that is a major black mark on your record." The accounting entries for preferred stock dividends are explained later in the chapter.



Liquidation Preference

Most preferred stocks also have a preference on corporate assets if the corporation fails. This feature provides security for the preferred stockholder. The preference to assets may be for the par value of the shares or for a specified liquidating value. For example, **Commonwealth Edison** issued preferred stock that entitles its holders to receive \$31.80 per share, plus accrued and unpaid dividends, in the event of involuntary liquidation. The liquidation preference establishes the respective claims of creditors and preferred stockholders in litigation pertaining to bankruptcy lawsuits.

SECTION 2 Dividends

A **dividend** is a corporation's distribution of cash or stock to its stockholders on a **pro rata (proportional) basis**. Investors are very interested in a company's dividend policies and practices. Dividends can take four forms: cash, property, scrip (a promissory note to pay cash), or stock. Cash

STUDY OBJECTIVE 5
Prepare the entries for cash dividends and stock dividends.

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dividends predominate in practice. Also, companies declare stock dividends with some frequency. These two forms of dividends will be the focus of discussion in this chapter.

Dividends may be expressed in two ways: (1) as a percentage of the par or stated value of the stock, or (2) as a dollar amount per share. The financial press generally reports **dividends as a dollar amount per share**. For example, **Boeing Company's** dividend rate is \$1.45 a share, **Hershey Foods Corp.'s** is \$1.19, and **Nike's** is \$0.94.

CASH DIVIDENDS

A **cash dividend** is a pro rata distribution of cash to stockholders. For a corporation to pay a cash dividend, it must have:

1. **Retained earnings.** The legality of a cash dividend depends on the laws of the state in which the company is incorporated. Payment of cash dividends from retained earnings is legal in all states. In general, cash dividend distributions from only the balance in common stock (legal capital) are illegal.

A dividend declared out of paid-in capital is termed a **liquidating dividend**. Such a dividend reduces or “liquidates” the amount originally paid in by stockholders. Statutes vary considerably with respect to cash dividends based on paid-in capital in excess of par or stated value. Many states permit such dividends.

2. **Adequate cash.** The legality of a dividend and the ability to pay a dividend are two different things. For example, **Nike** recently had a retained earnings balance of approximately \$5 billion, could legally declare a dividend of this amount. But **Nike's** cash balance is only a little over \$2 billion.

Before declaring a cash dividend, a company's board of directors must carefully consider both current and future demands on the company's cash resources. In some cases, current liabilities may make a cash dividend inappropriate. In other cases, a major plant expansion program may warrant only a relatively small dividend.

3. **A declaration of dividends.** A company does not pay dividends unless its board of directors decides to do so, at which point the board “declares” the dividend. The board of directors has full authority to determine the amount of income to distribute in the form of a dividend and the amount to retain in the business. Dividends do not accrue like interest on a note payable, and they are not a liability until declared.

The amount and timing of a dividend are important issues. The payment of a large cash dividend could lead to liquidity problems for the company. On the other hand, a small dividend or a missed dividend may cause unhappiness among stockholders. Many stockholders expect to receive a reasonable cash payment from the company on a periodic basis. Many companies declare and pay cash dividends quarterly.

Entries for Cash Dividends

Three dates are important in connection with dividends: (1) the declaration date, (2) the record date, and (3) the payment date. Normally, there are two to four weeks between each date. Companies make accounting entries on two of the dates—the declaration date and the payment date.

On the **declaration date**, the board of directors formally declares (authorizes) the cash dividend and announces it to stockholders. Declaration of a cash dividend **commits the corporation to a legal obligation**. The obligation is binding and cannot

be rescinded. The company makes an entry to recognize the cash dividend (decrease in retained earnings) and the increase in the liability Dividends Payable.

To illustrate, assume that on December 1, 2011, the directors of Media General declare a 50¢ per share cash dividend on 100,000 shares of \$10 par value common stock. The dividend is \$50,000 (100,000 × 50¢). The entry to record the declaration is:

Declaration Date			
Dec. 1	Cash Dividends	50,000	
	Dividends Payable		50,000
	(To record declaration of cash dividend)		

A	=	L	+	SE
				-50,000 Div
				+50,000

Cash Flows
no effect

In Chapter 1, we used an account called Dividends to record a cash dividend. Here, we use the more specific title Cash Dividends to differentiate from other types of dividends, such as stock dividends. A company may have separate dividend accounts for each class of stock.

Dividends Payable is a current liability: It will normally be paid within the next several months. At the end of the year, the company transfers the balance of the dividends account to Retained Earnings by a closing entry.

At the **record date**, the company determines ownership of the outstanding shares for dividend purposes. The records maintained by the corporation supply this information. In the interval between the declaration date and the record date, the corporation updates its stock ownership records. For Media General, the record date is December 22. No entry is required on this date because the corporation's liability recognized on the declaration date is unchanged.

HELPFUL HINT
The purpose of the record date is to identify the persons or entities that will receive the dividend, not to determine the amount of the dividend liability.

Record Date			
Dec. 22			
	No entry necessary		

On the **payment date**, the company mails dividend checks to the stockholders and records the payment of the dividend. Assuming that the payment date is January 20 for Media General, the entry on that date is:

Payment Date			
Jan. 20	Dividends Payable	50,000	
	Cash		50,000
	(To record payment of cash dividend)		

A	=	L	+	SE
				-50,000
				-50,000

Cash Flows
-50,000



Note that payment of the dividend reduces both current assets and current liabilities. It has no effect on stockholders' equity. The **cumulative effect** of the **declaration and payment** of a cash dividend is to **decrease both stockholders' equity and total assets**. Illustration 11-12 (page 528) summarizes the three important dates associated with dividends for Media General.

Allocating Cash Dividends between Preferred and Common Stock

As explained earlier in the chapter, preferred stock has priority over common stock in regard to dividends. Holders of cumulative preferred stock must be paid any unpaid prior-year dividends before common stockholders receive dividends.

To illustrate, assume that at December 31, 2011, IBR Inc. has 1,000 shares of 8%, \$100 par value cumulative preferred stock. It also has 50,000 shares of \$10 par value common stock outstanding. The dividend per share for preferred stock is \$8 (\$100 par value × 8%). The required annual dividend for preferred stock is therefore

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Illustration 11-12
Key dividend dates

	December							January						
	S	M	Tu	W	Th	F	S	S	M	Tu	W	Th	F	S
Declaration date Board authorizes dividends		1	2	3	4	5	6					1	2	3
	7	8	9	10	11	12	13	4	5	6	7	8	9	10
	14	15	16	17	18	19	20	11	12	13	14	15	16	17
	21	22	23	24	25	26	27	18	19	20	21	22	23	24
	28	29	30	31				25	26	27	28	29	30	31
	Record date Registered shareholders are eligible for dividend							Payment date The company issues dividend checks						

\$8,000 (1,000 × \$8). At December 31, 2011, the directors declare a \$6,000 cash dividend. In this case, the entire dividend amount goes to preferred stockholders because of their dividend preference. The entry to record the declaration of the dividend is:

A	=	L	+	SE
		-6,000 Div		
		+6,000		
Cash Flows				
no effect				

Dec. 31	Cash Dividends	6,000	
	Dividends Payable		6,000
	(To record \$6 per share cash dividend to preferred stockholders)		

Because of the cumulative feature, dividends of \$2 per share are in arrears on preferred stock for 2011. The company must pay these dividends to preferred stockholders before it can pay any future dividends to common stockholders. IBR should disclose dividends in arrears in the financial statements.

At December 31, 2012, IBR declares a \$50,000 cash dividend. The allocation of the dividend to the two classes of stock is as follows.

Illustration 11-13
Allocating dividends to preferred and common stock

Total dividend		\$50,000
Allocated to preferred stock		
Dividends in arrears, 2011 (1,000 × \$2)	\$2,000	
2012 dividend (1,000 × \$8)	<u>8,000</u>	10,000
Remainder allocated to common stock		<u>\$40,000</u>

The entry to record the declaration of the dividend is:

A	=	L	+	SE
		-50,000 Div		
		+50,000		
Cash Flows				
no effect				

Dec. 31	Cash Dividends	50,000	
	Dividends Payable		50,000
	(To record declaration of cash dividends of \$10,000 to preferred stock and \$40,000 to common stock)		

What if IBR’s preferred stock were not cumulative? In that case preferred stockholders would have received only \$8,000 in dividends in 2012. Common stockholders would have received \$42,000.

ACCOUNTING ACROSS THE ORGANIZATION



What's Happening to Dividends?

The decision whether to pay a dividend, and how much to pay, is a very important management decision. In recent years, many companies have substantially increased their dividends, and total dividends paid by U.S. companies hit record levels.

One explanation for the increase is that Congress lowered, from 39% to 15%, the tax rate paid by investors on dividends received, making dividends more attractive to investors. Another driving force for the dividend increases was that companies were sitting on record amounts of cash. Because they did not see a lot of profitable investment opportunities, companies decided to return the cash to shareholders.

However, due to the prolonged recession, numerous companies cut their dividends in late 2008 and early 2009. Banks in particular reduced their dividends significantly. For example, **Wells Fargo** cut its dividend by 85%, and **U.S. Bancorp** cut its by 88%.

Source: Alan Levinsohn, "Divine Dividends," *Strategic Finance*, May 2005, pp. 59–60.



What factors must management consider in deciding how large a dividend to pay?



Do it!

MasterMind Corporation has 2,000 shares of 6%, \$100 par value preferred stock outstanding at December 31, 2011. At December 31, 2011, the company declared a \$60,000 cash dividend. Determine the dividend paid to preferred stockholders and common stockholders under each of the following scenarios.

1. The preferred stock is noncumulative, and the company has not missed any dividends in previous years.
2. The preferred stock is noncumulative, and the company did not pay a dividend in each of the two previous years.
3. The preferred stock is cumulative, and the company did not pay a dividend in each of the two previous years.

Solution

1. The company has not missed past dividends and the preferred stock is noncumulative; thus, the preferred stockholders are paid only this year's dividend. The dividend paid to preferred stockholders would be \$12,000 ($2,000 \times .06 \times \100). The dividend paid to common stockholders would be \$48,000 ($\$60,000 - \$12,000$).
2. The preferred stock is noncumulative; thus, past unpaid dividends do not have to be paid. The dividend paid to preferred stockholders would be \$12,000 ($2,000 \times .06 \times \100). The dividend paid to common stockholders would be \$48,000 ($\$60,000 - \$12,000$).
3. The preferred stock is cumulative; thus, dividends that have been missed (dividends in arrears) must be paid. The dividend paid to preferred stockholders would be \$36,000 ($3 \times 2,000 \times .06 \times \100). The dividend paid to common stockholders would be \$24,000 ($\$60,000 - \$36,000$).

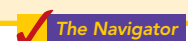
Related exercise material: **E11-6**, **E11-7**, and **Do it!** 11-5.

before you go on...

Dividends on Preferred and Common Stock

Action Plan

- Determine dividends on preferred shares by multiplying the dividend rate times the par value of the stock times the number of preferred shares.
- Understand the cumulative feature: If preferred stock is cumulative, then any missed dividends (dividends in arrears) and the current year's dividend must be paid to preferred stockholders before dividends are paid to common stockholders.

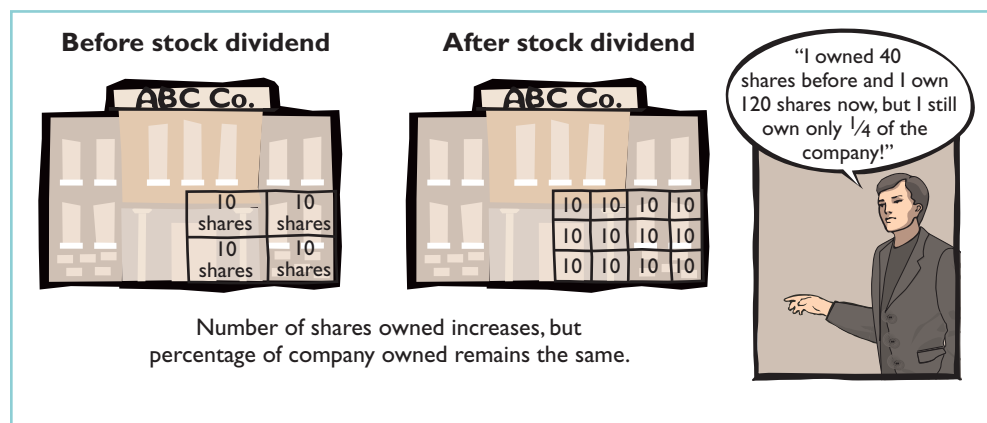


STOCK DIVIDENDS

A **stock dividend** is a pro rata distribution to stockholders of the corporation's own stock. Whereas a company pays cash in a cash dividend, a company issues shares of stock in a stock dividend. **A stock dividend results in a decrease in retained earnings and an increase in paid-in capital.** Unlike a cash dividend, a stock dividend does not decrease total stockholders' equity or total assets.

To illustrate, assume that you have a 2% ownership interest in Cetus Inc.; you own 20 of its 1,000 shares of common stock. If Cetus declares a 10% stock dividend, it would issue 100 shares ($1,000 \times 10\%$) of stock. You would receive two shares ($2\% \times 100$). Would your ownership interest change? No, it would remain at 2% ($22 \div 1,100$). **You now own more shares of stock, but your ownership interest has not changed.** Illustration 11-14 shows the effect of a stock dividend for stockholders.

Illustration 11-14
Effect of stock dividend for stockholders



The company has disbursed no cash, and has assumed no liabilities. What are the purposes and benefits of a stock dividend? Corporations issue stock dividends generally for one or more of the following reasons.

1. To satisfy stockholders' dividend expectations without spending cash.
2. To increase the marketability of the corporation's stock. When the number of shares outstanding increases, the market price per share decreases. Decreasing the market price of the stock makes it easier for smaller investors to purchase the shares.
3. To emphasize that a portion of stockholders' equity has been permanently reinvested in the business (and is unavailable for cash dividends).

When the dividend is declared, the board of directors determines the size of the stock dividend and the value assigned to each dividend. Generally, if the company issues a **small stock dividend** (less than 20–25% of the corporation's issued stock), the value assigned to the dividend is the fair market value per share. This treatment is based on the assumption that a small stock dividend will have little effect on the market price of the outstanding shares. Many stockholders consider small stock dividends to be distributions of earnings equal to the fair market value of the shares distributed. If a company issues a **large stock dividend** (greater than 20–25%), the value assigned to the dividend is the par or stated value. Small stock dividends predominate in practice. Thus, we will illustrate only entries for small stock dividends.

Entries for Stock Dividends

To illustrate the accounting for small stock dividends, assume that Medland Corporation has a balance of \$300,000 in retained earnings. It declares a 10% stock

Stock Dividends 531

dividend on its 50,000 shares of \$10 par value common stock. The current fair market value of its stock is \$15 per share. The number of shares to be issued is 5,000 (10% × 50,000). Therefore the total amount to be debited to Stock Dividends (decreases retained earnings) is \$75,000 (5,000 × \$15). The entry to record the declaration of the stock dividend is as follows.

Stock Dividends	75,000			
Common Stock Dividends Distributable			50,000	
Paid-in Capital in Excess of Par Value			25,000	
(To record declaration of 10% stock dividend)				

A		=		L		+		SE
								-75,000 Div
								+50,000 CS
								+25,000 CS

Cash Flows
no effect

At the declaration date, Medland increases (debits) Stock Dividends for the fair market value of the stock issued (\$15 × 5,000). It increases (credits) Common Stock Dividends Distributable for the par value of the dividend shares (\$10 × 5,000), and increases (credits) the excess over par (\$5 × 5,000) to an additional paid-in capital account.

Common Stock Dividends Distributable is a **stockholders' equity account**. It is not a liability because assets will not be used to pay the dividend. If the company prepares a balance sheet before it issues the dividend shares, it reports the distributable account under paid-in capital, as shown in Illustration 11-15.

Paid-in capital				
Common stock		\$500,000		
Common stock dividends distributable		<u>50,000</u>	\$550,000	

Illustration 11-15
Statement presentation of common stock dividends distributable

When Medland issues the dividend shares, it debits Common Stock Dividends Distributable, and credits Common Stock, as follows.

Common Stock Dividends Distributable	50,000			
Common Stock			50,000	
(To record issuance of 5,000 shares in a stock dividend)				

A		=		L		+		SE
								-50,000 CS
								+50,000 CS

Cash Flows
no effect

Effects of Stock Dividends

How do stock dividends affect stockholders' equity? They **change the composition of stockholders' equity**, because they transfer to paid-in capital a portion of retained earnings. However, **total stockholders' equity remains the same**. Stock dividends also have no effect on the par or stated value per share, but the number of shares outstanding increases. Illustration 11-16 shows these effects for Medland Corporation.

	<u>Before Dividend</u>		<u>After Dividend</u>
Stockholders' equity			
Paid-in capital			
Common stock, \$10 par	\$500,000		\$550,000
Paid-in capital in excess of par value	—		25,000
Total paid-in capital	500,000		575,000
Retained earnings	300,000		225,000
Total stockholders' equity	<u>\$800,000</u>		<u>\$800,000</u>
Outstanding shares	<u>50,000</u>		<u>55,000</u>

Illustration 11-16
Stock dividend effects

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In this example, total paid-in capital increases by \$75,000, and retained earnings decreases by the same amount. Note also that total stockholders' equity remains unchanged at \$800,000.

STOCK SPLITS

HELPFUL HINT

A stock split changes the par value per share but does not affect any balances in stockholders' equity.

A **stock split**, like a stock dividend, involves issuance of additional shares to stockholders according to their percentage ownership. **A stock split results in a reduction in the par or stated value per share.** The purpose of a stock split is to increase the marketability of the stock by lowering its market value per share.

The effect of a split on market value is generally *inversely proportional* to the size of the split. For example, after a recent 2-for-1 stock split, the market value of Nike's stock fell from \$111 to approximately \$55. The lower market value stimulated market activity, and within one year the stock was trading above \$100 again.

In a stock split, the number of shares increases in the same proportion that par or stated value per share decreases. For example, in a 2-for-1 split, one share of \$10 par value stock is exchanged for two shares of \$5 par value stock. **A stock split does not have any effect on total paid-in capital, retained earnings, or total stockholders' equity.** However, the number of shares outstanding increases. Illustration 11-17 shows these effects for Medland Corporation, assuming that it splits its 50,000 shares of common stock on a 2-for-1 basis.

Illustration 11-17
Stock split effects

	<u>Before Stock Split</u>	<u>After Stock Split</u>
Stockholders' equity		
Paid-in capital		
Common stock	\$500,000	\$500,000
Paid-in capital in excess of par value	-0-	-0-
Total paid-in capital	500,000	500,000
Retained earnings	300,000	300,000
Total stockholders' equity	<u>\$800,000</u>	<u>\$800,000</u>
Outstanding shares	<u>50,000</u>	<u>100,000</u>

A stock split does not affect the balances in any stockholders' equity accounts. Therefore **it is not necessary to journalize a stock split.**

Illustration 11-18 summarizes the significant differences between stock splits and stock dividends.

Illustration 11-18
Differences between the effects of stock splits and stock dividends

<u>Item</u>	<u>Stock Split</u>	<u>Stock Dividend</u>
Total paid-in capital	No change	Increase
Total retained earnings	No change	Decrease
Total par value (common stock)	No change	Increase
Par value per share	Decrease	No change

before you go on...

Do it!

Sing CD Company has had five years of record earnings. Due to this success, the market price of its 500,000 shares of \$2 par value common stock has tripled from \$15 per share to \$45. During this period, paid-in capital remained the same at \$2,000,000. Retained earnings increased from \$1,500,000 to \$10,000,000. CEO Joan Elbert is considering either (1) a 10% stock dividend or (2) a 2-for-1 stock split. She asks you to show the before-and-after effects of each option on (a) retained earnings, and (b) total stockholders' equity.

Solution

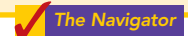
- (a) (1) The stock dividend amount is \$2,250,000 $[(500,000 \times 10\%) \times \$45]$. The new balance in retained earnings is \$7,750,000 $(\$10,000,000 - \$2,250,000)$.
- (2) The retained earnings balance after the stock split would be the same as it was before the split: \$10,000,000.
- (b) (1) Stock dividends change the composition of stockholders' equity because they transfer to paid-in capital a portion of retained earnings. However, total stockholders' equity remains the same.
- (2) In a stock split, the number of shares increases in the same proportion that par or stated value per share decreases. A stock split therefore does not have any effect on total paid-in capital, retained earnings, or total stockholders' equity.

Related exercise material: **BE11-8, BE11-9, E11-14, E11-15,** and **Do it! 11-6.**

Stock Dividends and Stock Splits

Action Plan

- Calculate the stock dividend's effect on retained earnings by multiplying the number of new shares times the market price of the stock (or par value for a large stock dividend).
- Recall that a stock dividend increases the number of shares without affecting total stockholders' equity.
- Recall that a stock split only increases the number of shares outstanding and decreases the par value per share.



SECTION 3 Retained Earnings

Retained earnings is net income that a company retains for use in the business. The balance in retained earnings is part of the stockholders' claim on the total assets of the corporation. It does not, however, represent a claim on any specific asset. Nor can the amount of retained earnings be associated with the balance of any asset account. For example, a \$100,000 balance in retained earnings does not mean that there should be \$100,000 in cash. The reason is that the company may have used the cash resulting from the excess of revenues over expenses to purchase buildings, equipment, and other assets. Illustration 11-19 shows recent amounts of retained earnings and cash in selected companies.

STUDY OBJECTIVE 6

Identify the items reported in a retained earnings statement.

Company	(in millions)	
	Retained Earnings	Cash
Disney Co.	\$28,413	\$3,001
Intel Corp.	26,537	3,305
Kellogg Co.	4,836	255
Amazon.com	(730)	2,769

Illustration 11-19
Retained earnings and cash balances

HELPFUL HINT

Remember that Retained Earnings is a stockholders' equity account, whose normal balance is a credit.

Remember that when a company has net income, it closes net income to retained earnings. The closing entry is a debit to Income Summary and a credit to Retained Earnings.

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When a company has a **net loss** (expenses exceed revenues), it also closes this amount to retained earnings. The closing entry in this case is a debit to Retained Earnings and a credit to Income Summary. This is done even if it results in a debit balance in Retained Earnings. **Companies do not debit net losses to paid-in capital accounts.** To do so would destroy the distinction between paid-in and earned capital. A debit balance in Retained Earnings is identified as a **deficit**. It is reported as a deduction in the stockholders' equity section, as shown below.

Illustration 11-20
Stockholders' equity with deficit

<u>Balance Sheet (partial)</u>	
Stockholders' equity	
Paid-in capital	
Common stock	\$800,000
Retained earnings (deficit)	(50,000)
Total stockholders' equity	<u>\$750,000</u>

RETAINED EARNINGS RESTRICTIONS

The balance in retained earnings is generally available for dividend declarations. Some companies state this fact. For example, **Lockheed Martin Corporation** states the following in the notes to its financial statements.

Illustration 11-21
Disclosure of unrestricted retained earnings



LOCKHEED MARTIN CORPORATION
Notes to the Financial Statements

At December 31, retained earnings were unrestricted and available for dividend payments.

In some cases, there may be **retained earnings restrictions**. These make a portion of the retained earnings balance currently unavailable for dividends. Restrictions result from one or more of the following causes.

- 1. Legal restrictions.** Many states require a corporation to restrict retained earnings for the cost of treasury stock purchased. The restriction keeps intact the corporation's legal capital that is being temporarily held as treasury stock. When the company sells the treasury stock, the restriction is lifted.
- 2. Contractual restrictions.** Long-term debt contracts may restrict retained earnings as a condition for the loan. The restriction limits the use of corporate assets for payment of dividends. Thus, it increases the likelihood that the corporation will be able to meet required loan payments.
- 3. Voluntary restrictions.** The board of directors may voluntarily create retained earnings restrictions for specific purposes. For example, the board may authorize a restriction for future plant expansion. By reducing the amount of retained earnings available for dividends, the company makes more cash available for the planned expansion.

Companies generally disclose **retained earnings restrictions** in the notes to the financial statements. For example, **Tektronix Inc.**, a manufacturer of electronic

measurement devices, had total retained earnings of \$774 million, but the unrestricted portion was only \$223.8 million.

TEKTRONIX INC.
Notes to the Financial Statements

Certain of the Company's debt agreements require compliance with debt covenants. Management believes that the Company is in compliance with such requirements. The Company had unrestricted retained earnings of \$223.8 million after meeting those requirements.

Illustration 11-22
Disclosure of restriction

PRIOR PERIOD ADJUSTMENTS

Suppose that a corporation has closed its books and issued financial statements. The corporation then discovers that it made a material error in reporting net income of a prior year. How should the company record this situation in the accounts and report it in the financial statements?

The correction of an error in previously issued financial statements is known as a **prior period adjustment**. The company makes the correction directly to Retained Earnings, because the effect of the error is now in this account. The net income for the prior period has been recorded in retained earnings through the journalizing and posting of closing entries.

To illustrate, assume that General Microwave discovers in 2011 that it understated depreciation expense in 2010 by \$300,000 due to computational errors. These errors overstated both net income for 2010 and the current balance in retained earnings. The entry for the prior period adjustment, ignoring all tax effects, is as follows.

Retained Earnings	300,000	300,000
Accumulated Depreciation		
(To adjust for understatement of depreciation in a prior period)		

A	=	L	+	SE	
					-300,000 RE
					-300,000
Cash Flows					
no effect					

A debit to an income statement account in 2011 is incorrect because the error pertains to a prior year.

Companies report prior period adjustments in the retained earnings statement. They add (or deduct, as the case may be) these adjustments from the beginning retained earnings balance. This results in an adjusted beginning balance. For example, assuming a beginning balance of \$800,000 in retained earnings, General Microwave reports the prior period adjustment as follows.

GENERAL MICROWAVE
Retained Earnings Statement (partial)

Balance, January 1, as reported	\$ 800,000
Correction for overstatement of net income in prior period (depreciation error)	(300,000)
Balance, January 1, as adjusted	\$ 500,000

Illustration 11-23
Statement presentation of prior period adjustments

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Again, reporting the correction in the current year’s income statement would be incorrect because it applies to a prior year’s income statement.

RETAINED EARNINGS STATEMENT

The **retained earnings statement** shows the changes in retained earnings during the year. The company prepares the statement from the Retained Earnings account. Illustration 11-24 shows (in account form) transactions that affect retained earnings.

Illustration 11-24
Debits and credits to retained earnings

Retained Earnings	
1. Net loss	1. Net income
2. Prior period adjustments for overstatement of net income	2. Prior period adjustments for understatement of net income
3. Cash dividends and stock dividends	
4. Some disposals of treasury stock	

As indicated, net income increases retained earnings, and a net loss decreases retained earnings. Prior period adjustments may either increase or decrease retained earnings. Both cash dividends and stock dividends decrease retained earnings. The circumstances under which treasury stock transactions decrease retained earnings are explained on page 523.

A complete retained earnings statement for Graber Inc., based on assumed data, is as follows.

Illustration 11-25
Retained earnings statement

GRABER INC. Retained Earnings Statement For the Year Ended December 31, 2011		
Balance, January 1, as reported		\$1,050,000
Correction for understatement of net income in prior period (inventory error)		<u>50,000</u>
Balance, January 1, as adjusted		1,100,000
Add: Net income		<u>360,000</u>
		1,460,000
Less: Cash dividends	\$100,000	
Stock dividends	<u>200,000</u>	<u>300,000</u>
Balance, December 31		<u>\$1,160,000</u>

before you go on...

Retained Earnings Statement

Do it!

Vega Corporation has retained earnings of \$5,130,000 on January 1, 2011. During the year, Vega earned \$2,000,000 of net income. It declared and paid a \$250,000 cash dividend. In 2011, Vega recorded an adjustment of \$180,000 due to the understatement (from a mathematical error) of 2010 depreciation expense. Prepare a retained earnings statement for 2011.

Solution

VEGA CORPORATION	
Retained Earnings Statement	
For the Year Ended December 31, 2011	
Balance, January 1, as reported	\$5,130,000
Correction for overstatement of net income in prior period (depreciation error)	(180,000)
Balance, January 1, as adjusted	4,950,000
Add: Net income	2,000,000
	6,950,000
Less: Cash dividends	250,000
Balance, December 31	\$6,700,000

Action Plan

- Recall that a retained earnings statement begins with retained earnings, as reported at the end of the previous year.
- Add or subtract any prior period adjustments to arrive at the adjusted beginning figure.
- Add net income and subtract dividends declared to arrive at the ending balance in retained earnings.

Related exercise material: **BE11-10, BE11-11, E11-17, E11-18**, and **Do it!** 11-7.



STATEMENT PRESENTATION AND ANALYSIS

In the stockholders' equity section of the balance sheet, paid-in capital and retained earnings are reported. The specific sources of paid-in capital are identified. Within paid-in capital, two classifications are recognized:

- 1. Capital stock.** This category consists of preferred and common stock. Preferred stock is shown before common stock because of its preferential rights. Par value, shares authorized, shares issued, and shares outstanding are reported for each class of stock.
- 2. Additional paid-in capital.** This includes the excess of amounts paid over par or stated value and paid-in capital from treasury stock.

STUDY OBJECTIVE 7

Prepare and analyze a comprehensive stockholders' equity section.

Presentation

The stockholders' equity section of Graber Inc.'s balance sheet is presented in Illustration 11-26 (page 538). Note the following: (1) "Common stock dividends distributable" is shown under "Capital stock," in "Paid-in capital." (2) A retained earnings restriction is disclosed in the notes.

The stockholders' equity section of Graber Inc. in Illustration 11-26 includes most of the accounts discussed in this chapter. The disclosures pertaining to Graber's common stock indicate that: 400,000 shares are issued; 100,000 shares are unissued (500,000 authorized less 400,000 issued); and 390,000 shares are outstanding (400,000 issued less 10,000 shares in treasury).

In published annual reports, the individual sources of additional paid-in capital are often combined and reported as a single amount, as shown in Illustration 11-27 (page 538). In addition, authorized shares are sometimes not reported.

In practice, the term "capital surplus" is sometimes used in place of additional paid-in capital and "earned surplus" in place of retained earnings. The use of the term "surplus" suggests that an excess amount of funds is available. Such is not necessarily the case. Therefore, **the term "surplus" should not be employed in accounting.** Unfortunately, a number of financial statements still do use it.

Instead of presenting a detailed stockholders' equity section in the balance sheet and a retained earnings statement, many companies prepare a **stockholders' equity statement**. This statement shows the changes in each stockholders' equity


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Illustration 11-26
Comprehensive stockholders' equity section

GRABER INC. Balance Sheet (partial)		
Stockholders' equity		
Paid-in capital		
Capital stock		
9% Preferred stock, \$100 par value, cumulative, callable at \$120, 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	
Common stock dividends distributable	50,000	<u>2,050,000</u>
Total capital stock		2,650,000
Additional paid-in capital		
In excess of par value—preferred stock	30,000	
In excess of stated value—common stock	<u>1,050,000</u>	
Total additional paid-in capital		<u>1,080,000</u>
Total paid-in capital		3,730,000
Retained earnings (see Note R)		<u>1,160,000</u>
Total paid-in capital and retained earnings		4,890,000
Less: Treasury stock—common (10,000 shares)		<u>80,000</u>
Total stockholders' equity		<u><u>\$4,810,000</u></u>

Note R: Retained earnings is restricted for the cost of treasury stock, \$80,000.

Illustration 11-27
Published stockholders' equity section

 KELLOGG COMPANY Balance Sheet (partial) (\$ in millions)		
Stockholders' equity		
Common stock, \$0.25 par value, 1,000,000,000 shares authorized		
Issued: 418,842,707 shares		\$ 105
Capital in excess of par value		438
Retained earnings		4,836
Treasury stock, at cost		
36,981,580 shares		(1,790)
Accumulated other comprehensive income		<u>(2,141)</u>
Total stockholders' equity		<u><u>\$1,448</u></u>

account and in total that have occurred during the year. An example of a stockholders' equity statement is illustrated in **PepsiCo's** financial statements in Appendix A and in an appendix to this chapter (Illustration 11-A1).

Analysis

Profitability from the viewpoint of the common stockholder can be measured by the **return on common stockholders' equity**. This ratio shows how many dollars of net income were earned for each dollar invested by the stockholders. It is computed by dividing net income available to common stockholders (which is net income minus preferred stock dividends) by average common stockholders' equity.

Statement Presentation and Analysis 539

To illustrate, Kellogg Company's beginning-of-the-year and end-of-the-year common stockholders' equity were \$2,526 and \$1,448 million, respectively. Its net income was \$1,148 million, and no preferred stock was outstanding. The return on common stockholders' equity ratio is computed as follows.

Net Income minus Preferred Dividends	÷	Average Common Stockholders' Equity	=	Return on Common Stockholders' Equity
(\$1,148 - \$0)	÷	$\frac{(\$2,526 + \$1,448)}{2}$	=	57.8%

Illustration 11-28
Return on common stockholders' equity ratio and computation

As shown in Illustration 11-28, if a company has preferred stock, the amount of preferred dividends is deducted from net income to compute income available to common stockholders. Also, the par value of preferred stock is deducted from total average stockholders' equity to arrive at the amount of common stockholders' equity.

before you go on...

Do it!

On January 1, 2011, Sienna Corporation purchased 2,000 shares of treasury stock. Other information regarding Sienna Corporation is provided below.

Stockholders' Equity

	2010	2011
Net income	\$110,000	\$110,000
Dividends on preferred stock	\$10,000	\$10,000
Dividends on common stock	\$2,000	\$1,600
Weighted-average number of shares outstanding	10,000	8,000*
Common stockholders' equity, beginning of year	\$500,000	\$400,000*
Common stockholders' equity, end of year	\$500,000	\$400,000

*Adjusted for purchase of treasury stock.

Compute (a) return on common stockholders' equity for each year and (b) discuss the changes.

Action Plan

- Determine return on common stockholders' equity by dividing net income available to common stockholders by the average common stockholders' equity.

Solution

(a)

$\text{Return on common stockholders' equity} = \frac{(\$110,000 - \$10,000)}{(\$500,000 + \$500,000)/2} = 20\%$	$\text{Return on common stockholders' equity} = \frac{(\$110,000 - \$10,000)}{(\$400,000 + \$400,000)/2} = 25\%$
--	--

(b) Between 2010 and 2011, return on common stockholders' equity improved from 20% to 25%. While this would appear to be good news for the company's common stockholders, this increase should be carefully evaluated. It is important to note that net income did not change during this period. The increase in the ratio was due to the purchase of treasury shares, which reduced the denominator. As the company repurchases its own shares, it becomes more reliant on debt and thus increases its risk.

Related exercise material: E11-22 and **Do it!** 11-8.



Be sure to read

all about YOU

Home-Equity Loans
on page 540 for information on how topics in this chapter apply to you.

all about YOU

Home-Equity Loans

In this chapter you learned that companies sometimes reduce their stockholders' equity by buying treasury stock or paying dividends. They do this for a variety of reasons—some good, and some not so good. Individuals who own homes sometimes engage in equity-reducing transactions by using home-equity loans. Home-equity loans use the equity existing in the home as collateral for borrowing additional monies.

Many people have chosen to use home-equity loans to finance vacations, new cars, improvements to the home, educational pursuits, and so on, or to consolidate debt. However, by taking out a home-equity loan, a homeowner is reducing the equity in that home.

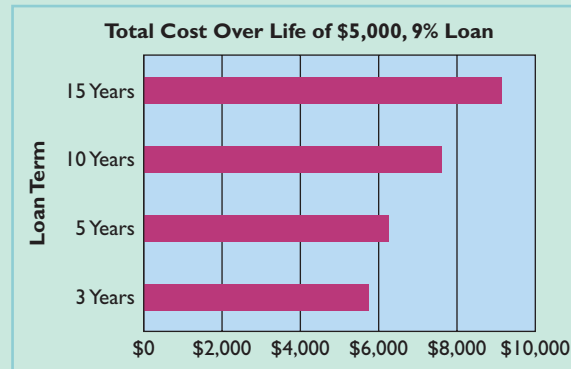
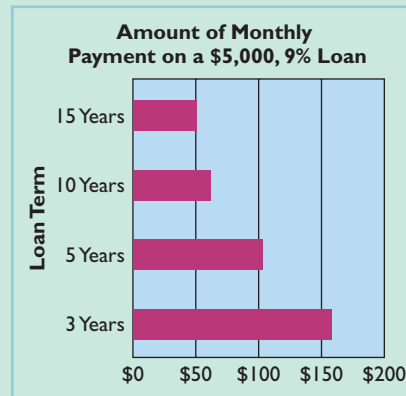
Now with the housing market in chaos, loans of this nature were \$14.7 billion delinquent through September 2008, and matters are getting worse, not better. Lenders even went so far as to provide credit for the down payment on homes.

Some Facts

- * Home-equity loans are now difficult to get. The reasons are that banks are not making the loans, and sinking home prices give homeowners less equity to borrow against.
- * Four major reasons why many individuals employ home-equity loans are: (1) to invest, (2) to get a tax deduction, (3) to defer other debt, or (4) to buy from a wish list.
- * While home-equity loans tend to have fixed rates, home-equity lines of credit, which allow the homeowner to borrow up to a certain amount whenever they want to, have variable rates. Rates on home-equity lines of credit averaged 8.33% in April 2006, versus about 14% for credit card debt.
- * Home-equity loan interest is tax-deductible (like home mortgage interest). Interest on car loans, most student loans, and credit cards is not.

About the Numbers

Home-equity loans can be very tempting. Suppose that you wanted to borrow \$5,000 to take a vacation. You could spread your payments over 15 years and you would have to pay only about \$50 per month. But look what your total payments would be over the life of the 15-year loan. Some vacation!



Source: Data from Marc Eisenson and Nancy Castleman, "When Mining Your Home for Money, Beware of Fool's Gold," Good Advice Press, www.goodadvicepress.com/omhomeequity.htm (accessed June 20, 2006).

What Do You Think?

Your home has increased in value by \$50,000 during the last five years. You have very little savings outside of the equity in your home. You desperately need a vacation, and you are considering taking out a \$5,000 home-equity loan to finance a two-week dream vacation in Europe. Is this a bad idea?

YES: This represents a significant portion of your savings. Home-equity loans should be used to finance investments of a lasting nature, not items of a fleeting nature like vacations.

NO: You need a vacation. If you use a little of the equity in your home now, you can make it up when your house increases in value in the future.

Source: Ruth Simon, "Lenders Push Home-Equity Deals," *Wall Street Journal*, April 27, 2006, p. D1; Marc Eisenson and Nancy Castleman, "When Mining Your Home for Money, Beware of Fool's Gold," Good Advice Press, www.goodadvicepress.com/omhomeequity.htm (accessed June 20, 2006).



Comprehensive **Do it!**

The Rolman Corporation is authorized to issue 1,000,000 shares of \$5 par value common stock. In its first year, the company has the following stock transactions.

- Jan. 10 Issued 400,000 shares of stock at \$8 per share.
- July 1 Issued 100,000 shares of stock for land. The land had an asking price of \$900,000. The stock is currently selling on a national exchange at \$8.25 per share.
- Sept. 1 Purchased 10,000 shares of common stock for the treasury at \$9 per share.
- Dec. 1 Sold 4,000 shares of the treasury stock at \$10 per share.

Instructions

- (a) Journalize the transactions.
- (b) Prepare the stockholders' equity section assuming the company had retained earnings of \$200,000 at December 31.

Solution to Comprehensive **Do it!**

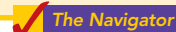
(a) Jan. 10	Cash	3,200,000	
	Common Stock		2,000,000
	Paid-in Capital in Excess of Par Value (To record issuance of 400,000 shares of \$5 par value stock)		1,200,000
July 1	Land	825,000	
	Common Stock		500,000
	Paid-in Capital in Excess of Par Value (To record issuance of 100,000 shares of \$5 par value stock for land)		325,000
Sept. 1	Treasury Stock	90,000	
	Cash (To record purchase of 10,000 shares of treasury stock at cost)		90,000
Dec. 1	Cash	40,000	
	Treasury Stock		36,000
	Paid-in Capital from Treasury Stock (To record sale of 4,000 shares of treasury stock above cost)		4,000

Action Plan

- When common stock has a par value, credit Common Stock for par value.
- Use fair market value in a noncash transaction.
- Debit and credit the Treasury Stock account at cost.
- Record differences between the cost and selling price of treasury stock in stockholders' equity accounts, not as gains or losses.

(b) **ROLMAN CORPORATION**
Balance Sheet (partial)

Stockholders' equity		
Paid-in capital		
Capital stock		
Common stock, \$5 par value, 1,000,000 shares authorized, 500,000 shares issued, 494,000 shares outstanding		\$2,500,000
Additional paid-in capital		
In excess of par value	\$1,525,000	
From treasury stock	4,000	
Total additional paid-in capital		1,529,000
Total paid-in capital		4,029,000
Retained earnings		200,000
Total paid-in capital and retained earnings		4,229,000
Less: Treasury stock (6,000 shares)		54,000
Total stockholders' equity		\$4,175,000

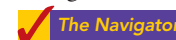


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SUMMARY OF STUDY OBJECTIVES



- 1 Identify the major characteristics of a corporation.** The major characteristics of a corporation are separate legal existence, limited liability of stockholders, transferable ownership rights, ability to acquire capital, continuous life, corporation management, government regulations, and additional taxes.
- 2 Record the issuance of common stock.** 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 that is above or below par value is recorded in a separate paid-in capital account. When no-par common stock has a stated value, the entries are similar to those for par value stock. When no-par stock does not have a stated value, the entire proceeds are credited to Common Stock.
- 3 Explain the accounting for treasury stock.** The cost method is generally used in accounting for treasury stock. Under this approach, Treasury Stock is debited at the price paid to reacquire the shares. The same amount is credited to Treasury Stock when the shares are sold. The difference between the sales price and cost is recorded in stockholders' equity accounts, not in income statement accounts.
- 4 Differentiate preferred stock from common stock.** Preferred stock has contractual provisions that give it priority over common stock in certain areas. Typically, preferred stockholders have a preference to (1) dividends and (2) assets in liquidation. They usually do not have voting rights.
- 5 Prepare the entries for cash dividends and stock dividends.** Entries for both cash and stock dividends are required on the declaration date and the payment date. At the declaration date the entries are: cash dividend—debit Cash Dividends, and credit Dividends Payable; small stock dividend—debit Stock Dividends, credit Paid-in Capital in Excess of Par (or Stated) Value, and credit Common Stock Dividends Distributable. On the payment date, the entries for cash and stock dividends are: cash dividend—debit Dividends Payable and credit Cash; small stock dividend—debit Common Stock Dividends Distributable and credit Common Stock.
- 6 Identify the items that are reported in a retained earnings statement.** Each of the individual debits and credits to retained earnings should be reported in the retained earnings statement. Additions consist of net income and prior period adjustments to correct understatements of prior years' net income. Deductions consist of net loss, adjustments to correct overstatements of prior years' net income, cash and stock dividends, and some disposals of treasury stock.
- 7 Prepare and analyze a comprehensive stockholders' equity section.** In the stockholders' equity section, paid-in capital and retained earnings are reported and specific sources of paid-in capital are identified. Within paid-in capital, two classifications are shown: capital stock and additional paid-in capital. If a corporation has treasury stock, the cost of treasury stock is deducted from total paid-in capital and retained earnings to obtain total stockholders' equity. One measure of profitability is the return on common stockholders' equity. It is calculated by dividing net income minus preferred stock dividends by average common stockholders' equity.



GLOSSARY



- Authorized stock** The amount of stock that a corporation is authorized to sell as indicated in its charter. (p. 514).
- By-laws** The internal rules and procedures for conducting the affairs of a corporation. (p. 512).
- Cash dividend** A pro rata distribution of cash to stockholders. (p. 526).
- Charter** A document that creates a corporation. (p. 512).
- Corporation** A business organized as a legal entity separate and distinct from its owners under state corporation law. (p. 508).
- Cumulative dividend** A feature of preferred stock entitling the stockholder to receive current and unpaid prior-year dividends before common stockholders receive any dividends. (p. 525).
- Declaration date** The date the board of directors formally declares the dividend and announces it to stockholders. (p. 526).
- Deficit** A debit balance in retained earnings. (p. 534).
- Dividend** A distribution by a corporation to its stockholders on a pro rata (proportional) basis. (p. 525).
- Liquidating dividend** A dividend declared out of paid-in capital. (p. 526).
- No-par-value stock** Capital stock that has not been assigned a value in the corporate charter. (p. 515).
- Organization costs** Costs incurred in the formation of a corporation. (p. 512).
- Outstanding stock** Capital stock that has been issued and is being held by stockholders. (p. 522).
- Paid-in capital** Total amount of cash and other assets paid in to the corporation by stockholders in exchange for capital stock. (p. 516).
- Par-value stock** Capital stock that has been assigned a value per share in the corporate charter. (p. 515).
- Payment date** The date dividend checks are mailed to stockholders. (p. 527).
- Preferred stock** Capital stock that has some contractual preferences over common stock. (p. 524).
- Prior period adjustment** The correction of an error in previously issued financial statements. (p. 535).

Appendix 11A Stockholders' Equity Statement 543

Privately held corporation A corporation that has only a few stockholders and whose stock is not available for sale to the general public. (p. 509).

Publicly held corporation A corporation that may have thousands of stockholders and whose stock is regularly traded on a national securities exchange. (p. 508).

Record date The date when ownership of outstanding shares is determined for dividend purposes. (p. 527).

Retained earnings Net income that a corporation retains for future use. (pp. 516, 533).

Retained earnings restrictions Circumstances that make a portion of retained earnings currently unavailable for dividends. (p. 534).

Retained earnings statement A financial statement that shows the changes in retained earnings during the year. (p. 536).

Return on common stockholders' equity ratio A ratio that measures profitability from the stockholders' point of

view. It is computed by dividing net income available to common stockholders by average common stockholders' equity. (p. 538).

Stated value The amount per share assigned by the board of directors to no-par stock that becomes legal capital per share. (p. 515).

Stock dividend A pro rata distribution of the corporation's own stock to stockholders. (p. 530).

Stock split The issuance of additional shares of stock to stockholders accompanied by a reduction in the par or stated value per share. (p. 532).

Stockholders' equity statement A statement that shows the changes in each stockholders' equity account and in total stockholders' equity during the year. (p. 537).

Treasury stock A corporation's own stock that the corporation has issued, fully paid for, and reacquired but not retired. (p. 520).

APPENDIX 11A Stockholders' Equity Statement

When balance sheets and income statements are presented by a corporation, changes in the separate accounts comprising stockholders' equity should also be disclosed. Disclosure of such changes is necessary to make the financial statements sufficiently informative for users. The disclosures may be made in an additional statement or in the notes to the financial statements.

STUDY OBJECTIVE 8

Describe the use and content of the stockholders' equity statement.

Many corporations make the disclosures in a **stockholders' equity statement**. The statement shows the changes in **each** stockholders' equity account and in **total** stockholders' equity during the year. As shown in Illustration 11A-1 the stockholders' equity statement is prepared in columnar form. It contains columns for each account and for total stockholders' equity. The transactions are then identified and their effects are shown in the appropriate columns.

Illustration 11A-1
Stockholders' equity statement

HAMPTON CORPORATION					
Stockholders' Equity Statement					
For the Year Ended December 31, 2011					
	Common Stock (\$5 Par)	Paid-in Capital in Excess of Par	Retained Earnings	Treasury Stock	Total
Balance January 1	\$300,000	\$200,000	\$650,000	\$(34,000)	\$1,116,000
Issued 5,000 shares of common stock at \$15	25,000	50,000			75,000
Declared a \$40,000 cash dividend			(40,000)		(40,000)
Purchased 2,000 shares for treasury at \$16				(32,000)	(32,000)
Net income for year			240,000		240,000
Balance December 31	<u>\$325,000</u>	<u>\$250,000</u>	<u>\$850,000</u>	<u>\$(66,000)</u>	<u>\$1,359,000</u>

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In practice, additional columns are usually provided to show the number of shares of issued stock and treasury stock. The stockholders' equity statement for **PepsiCo**, for a three-year period, is shown in Appendix A. **When a stockholders' equity statement is presented, a retained earnings statement is not necessary** because the retained earnings column explains the changes in this account.

SUMMARY OF STUDY OBJECTIVE FOR APPENDIX 11A



8 Describe the use and content of the stockholders' equity statement. Corporations must disclose changes in stockholders' equity accounts and may choose to do so by issuing a separate stockholders' equity statement. This

statement, prepared in columnar form, shows changes in each stockholders' equity account and in total stockholders' equity during the accounting period. When this statement is presented, a retained earnings statement is not necessary.

APPENDIX 11B Book Value—Another Per-Share Amount

Book Value per Share

STUDY OBJECTIVE 9

Compute book value per share.

You have learned about a number of per share amounts in this chapter. Another per-share amount of some importance is **book value per share**. It represents **the equity a common stockholder has in the net assets of the corporation** from owning one share of stock. Remember that the net assets (total assets minus total liabilities) of a corporation must be equal to total stockholders' equity. Therefore, the formula for computing book value per share when a company has only one class of stock outstanding is:

Illustration 11B-1
Book value per share formula

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

Thus, if Marlo Corporation has total stockholders' equity of \$1,500,000 (common stock \$1,000,000 and retained earnings \$500,000) and 50,000 shares of common stock outstanding, book value per share is \$30 (\$1,500,000 ÷ 50,000).

When a company has both preferred and common stock, the computation of book value is more complex. Since preferred stockholders have a prior claim on net assets over common stockholders, their equity must be deducted from total stockholders' equity. Then we can determine the stockholders' equity that applies to the common stock. The computation of book value per share involves the following steps.

- 1. Compute the preferred stock equity.** This equity is equal to the sum of the call price of preferred stock plus any cumulative dividends in arrears. If the preferred stock does not have a call price, the par value of the stock is used.
- 2. Determine the common stock equity.** Subtract the preferred stock equity from total stockholders' equity.
- 3. Determine book value per share.** Divide common stock equity by shares of common stock outstanding.

Appendix 11B Book Value—Another Per-Share Amount 545

EXAMPLE

We will use the stockholders' equity section of Graber Inc. shown in Illustration 11-26. Graber's preferred stock is callable at \$120 per share and is cumulative. Assume that dividends on Graber's preferred stock were in arrears for one year, \$54,000 (6,000 × \$9). The computation of preferred stock equity (Step 1 in the preceding list) is:

Call price (6,000 shares × \$120)	\$720,000
Dividends in arrears (6,000 shares × \$9)	54,000
Preferred stock equity	<u>\$774,000</u>

Illustration 11B-2
Computation of preferred stock equity—Step 1

The computation of book value (Steps 2 and 3) is as follows.

Total stockholders' equity	\$4,810,000
Less: Preferred stock equity	774,000
Common stock equity	<u>\$4,036,000</u>
Shares of common stock outstanding	<u>390,000</u>
Book value per share (\$4,036,000 ÷ 390,000)	<u>\$10.35</u>

Illustration 11B-3
Computation of book value per share with preferred stock—Steps 2 and 3

Note that we used the call price of \$120 instead of the par value of \$100. Note also that the paid-in capital in excess of par value of preferred stock, \$30,000, **is not assigned to the preferred stock equity**. Preferred stockholders ordinarily do not have a right to amounts paid-in in excess of par value. Therefore, such amounts are assigned to the common stock equity in computing book value.

Book Value versus Market Value

Be sure you understand that **book value per share may not equal market value per share**. Book value generally is based on recorded costs. Market value reflects the subjective judgments of thousands of stockholders and prospective investors about a company's potential for future earnings and dividends. Market value per share may exceed book value per share, but that fact does not necessarily mean that the stock is overpriced. 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 recent data.

<u>Company</u>	<u>Book Value (year-end)</u>	<u>Market Range (for the year)</u>
The Limited, Inc.	\$13.38	\$31.03–\$22.89
H. J. Heinz Company	\$ 7.48	\$40.61–\$34.53
Cisco Systems	\$ 3.66	\$21.24–\$17.01
Wal-Mart Stores	\$12.79	\$50.87–\$42.31

Illustration 11B-4
Book and market values compared

Book value per share **is useful** in determining the trend of a stockholder's per share equity in a corporation. It is also significant in many contracts and in court cases where the rights of individual parties are based on cost information.

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SUMMARY OF STUDY OBJECTIVE FOR APPENDIX 11B



9 Compute book value per share. Book value per share represents the equity a common stockholder has in the net assets of a corporation from owning one share of stock. When there

is only common stock outstanding, the formula for computing book value is: Total stockholders' equity ÷ Number of common shares outstanding = Book value per share.

GLOSSARY FOR APPENDIX 11B



Book value per share The equity a common stockholder has in the net assets of the corporation from owning one share of stock. (p. 544).

***Note:** All **asterisked** Questions, Exercises, and Problems relate to material in the appendices to the chapter.

SELF-STUDY QUESTIONS



Answers are at the end of the chapter.

- (SO 1) 1. Which of the following is *not* a major advantage of a corporation?
- Separate legal existence.
 - Continuous life.
 - Government regulations.
 - Transferable ownership rights.
- (SO 1) 2. A major disadvantage of a corporation is:
- limited liability of stockholders.
 - additional taxes.
 - transferable ownership rights.
 - none of the above.
- (SO 2) 3. Which of the following statements is *false*?
- Ownership of common stock gives the owner a voting right.
 - The stockholders' equity section begins with paid-in capital.
 - The authorization of capital stock does not result in a formal accounting entry.
 - The par value of a share of stock is equal to its market value.
- (SO 2) 4. ABC Corporation issues 1,000 shares of \$10 par value common stock at \$12 per share. In recording the transaction, credits are made to:
- Common Stock \$10,000 and Paid-in Capital in Excess of Stated Value \$2,000.
 - Common Stock \$12,000.
 - Common Stock \$10,000 and Paid-in Capital in Excess of Par Value \$2,000.
 - Common Stock \$10,000 and Retained Earnings \$2,000.
- (SO 3) 5. XYZ, Inc. sells 100 shares of \$5 par value treasury stock at \$13 per share. If the cost of acquiring the shares was \$10 per share, the entry for the sale should include credits to:
- Treasury Stock \$1,000 and Paid-in Capital from Treasury Stock \$300.
 - Treasury Stock \$500 and Paid-in Capital from Treasury Stock \$800.
 - Treasury Stock \$1,000 and Retained Earnings \$300.
 - Treasury Stock \$500 and Paid-in Capital in Excess of Par Value \$800.
6. In the stockholders' equity section, the cost of treasury stock is deducted from:
- total paid-in capital and retained earnings.
 - retained earnings.
 - total stockholders' equity.
 - common stock in paid-in capital.
7. Preferred stock may have priority over common stock *except* in:
- dividends.
 - assets in the event of liquidation.
 - cumulative dividend features.
 - voting.
8. M-Bot Corporation has 10,000 shares of 8%, \$100 par value, cumulative preferred stock outstanding at December 31, 2011. No dividends were declared in 2009 or 2010. If M-Bot wants to pay \$375,000 of dividends in 2011, common stockholders will receive:
- \$0.
 - \$295,000.
 - \$215,000.
 - \$135,000.
9. Entries for cash dividends are required on the:
- declaration date and the payment date.
 - record date and the payment date.
 - declaration date, record date, and payment date.
 - declaration date and the record date.
10. Which of the following statements about small stock dividends is true?
- A debit to Stock Dividends for the par value of the shares issued should be made.
 - A small stock dividend decreases total stockholders' equity.
 - Market value per share should be assigned to the dividend shares.
 - A small stock dividend decreases Stock Dividends Distributable.

Questions 547

- (SO 6) 11. All *but one* of the following is reported in a retained earnings statement. The exception is:
- cash and stock dividends.
 - net income and net loss.
 - some disposals of treasury stock below cost.
 - sales of treasury stock above cost.
- (SO 6) 12. A prior period adjustment is:
- reported in the income statement as a nontypical item.
 - a correction of an error that is made directly to retained earnings.
 - reported directly in the stockholders' equity section.
 - reported in the retained earnings statement as an adjustment of the ending balance of retained earnings.
- (SO 7) 13. In the stockholders' equity section of the balance sheet, common stock:
- is listed before preferred stock.
 - is added to total capital stock.
 - is part of paid-in capital.
 - is part of additional paid-in capital.
- (SO 7) 14. Which of the following is *not* reported under additional paid-in capital?
- Paid-in capital in excess of par value.
 - Common stock.
 - Paid-in capital in excess of stated value.
 - Paid-in capital from treasury stock.
- (SO 7) 15. Katie Inc. reported net income of \$186,000 during 2011 and paid dividends of \$26,000 on common stock. It also has 10,000 shares of 6%, \$100 par value, noncumulative preferred stock outstanding. Common stockholders' equity was \$1,200,000 on January 1, 2011, and \$1,600,000 on December 31, 2011. The company's return on common stockholders' equity for 2011 is:
- 10.0%.
 - 9.0%.
 - 7.1%.
 - 13.3%.
- *16. When a stockholders' equity statement is presented, it is (SO 8) not necessary to prepare a(an):
- retained earnings statement.
 - balance sheet.
 - income statement.
 - None of the above.
- *17. The ledger of JFK, Inc. shows common stock, common (SO 9) treasury stock, and no preferred stock. For this company, the formula for computing book value per share is:
- Total paid-in capital and retained earnings divided by the number of shares of common stock issued.
 - Common stock divided by the number of shares of common stock issued.
 - Total stockholders' equity divided by the number of shares of common stock outstanding.
 - Total stockholders' equity divided by the number of shares of common stock issued.

Go to the book's companion website,
www.wiley.com/college/veygandt,
 for Additional Self-Study Questions.



QUESTIONS

- Mike Horn, a student, asks your help in understanding the following characteristics of a corporation: (a) separate legal existence, (b) limited liability of stockholders, and (c) transferable ownership rights. Explain these characteristics to Mike.
- (a) Your friend Veena Gall cannot understand how the characteristic of corporation management is both an advantage and a disadvantage. Clarify this problem for Veena.
 (b) Identify and explain two other disadvantages of a corporation.
- Kari Jonas believes a corporation must be incorporated in the state in which its headquarters office is located. Is Kari correct? Explain.
- What are the basic ownership rights of common stockholders in the absence of restrictive provisions?
- A corporation has been defined as an entity separate and distinct from its owners. In what ways is a corporation a separate legal entity?
- (a) What are the two principal components of stockholders' equity?
 (b) What is paid-in capital? Give three examples.
- The corporate charter of Sokol Corporation allows the issuance of a maximum of 100,000 shares of common stock. During its first two years of operations, Sokol sold 80,000 shares to stockholders and reacquired 7,000 of these shares. After these transactions, how many shares are authorized, issued, and outstanding?
- Which is the better investment—common stock with a par value of \$5 per share, or common stock with a par value of \$20 per share? Why?
- What factors help determine the market value of stock?
- Why is common stock usually not issued at a price that is less than par value?
- Land appraised at \$80,000 is purchased by issuing 1,000 shares of \$20 par value common stock. The market price of the shares at the time of the exchange, based on active trading in the securities market, is \$90 per share. Should the land be recorded at \$20,000, \$80,000, or \$90,000? Explain.
- For what reasons might a company like IBM repurchase some of its stock (treasury stock)?
- Chen, Inc. purchases 1,000 shares of its own previously issued \$5 par common stock for \$12,000. Assuming the shares are held in the treasury, what effect does this transaction have on (a) net income, (b) total assets, (c) total paid-in capital, and (d) total stockholders' equity?

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14. The treasury stock purchased in question 13 is resold by Chen, Inc. for \$15,000. What effect does this transaction have on (a) net income, (b) total assets, (c) total paid-in capital, and (d) total stockholders' equity?
15. (a) What are the principal differences between common stock and preferred stock?
(b) Preferred stock may be cumulative. Discuss this feature.
(c) How are dividends in arrears presented in the financial statements?
16. Identify the events that result in credits and debits to retained earnings.
17. Indicate how each of the following accounts should be classified in the stockholders' equity section.
(a) Common Stock.
(b) Paid-in Capital in Excess of Par Value.
(c) Retained Earnings.
(d) Treasury Stock.
(e) Paid-in Capital from Treasury Stock.
(f) Paid-in Capital in Excess of Stated Value.
(g) Preferred Stock.
18. What three conditions must exist before a cash dividend is paid?
19. Three dates associated with Naperville Company's cash dividend are May 1, May 15, and May 31. Discuss the significance of each date and give the entry at each date.
20. Contrast the effects of a cash dividend and a stock dividend on a corporation's balance sheet.
21. Mark Federia asks, "Since stock dividends don't change anything, why declare them?" What is your answer to Mark?
22. Fields Corporation has 20,000 shares of \$10 par value common stock outstanding when it announces a 2-for-1 stock split. Before the split, the stock had a market price of \$120 per share. After the split, how many shares of stock will be outstanding? What will be the approximate market price per share?
23. The board of directors is considering either a stock split or a stock dividend. They understand that total stockholders' equity will remain the same under either action. However, they are not sure of the different effects of the two types of actions on other aspects of stockholders' equity. Explain the differences to the directors.
24. What is a prior period adjustment, and how is it reported in the financial statements?
25. What is the purpose of a retained earnings restriction? Identify the possible causes of retained earnings restrictions.
- *26. What is the formula for computing book value per share when a corporation has only common stock?
- *27. Alou Inc.'s common stock has a par value of \$1, a book value of \$29, and a current market value of \$15. Explain why these amounts are all different.

BRIEF EXERCISES

List the advantages and disadvantages of a corporation.

(SO 1)

Prepare entry for issuance of par value common stock.

(SO 2)

Prepare entry for issuance of no-par value common stock.

(SO 2)

Prepare entry for issuance of stock in a noncash transaction.

(SO 2)

Prepare entries for treasury stock transactions.

(SO 3)

Prepare entry for issuance of preferred stock.

(SO 4)

Prepare entries for a cash dividend.

(SO 5)

BE11-1 Ron Child is studying for his accounting midterm examination. Identify for Ron the advantages and disadvantages of the corporate form of business organization.

BE11-2 On May 10, Romano Corporation issues 1,000 shares of \$10 par value common stock for cash at \$18 per share. Journalize the issuance of the stock.

BE11-3 On June 1, Herrera Inc. issues 3,000 shares of no-par common stock at a cash price of \$7 per share. Journalize the issuance of the shares assuming the stock has a stated value of \$1 per share.

BE11-4 Tara Inc.'s \$10 par value common stock is actively traded at a market value of \$16 per share. Tara issues 5,000 shares to purchase land advertised for sale at \$85,000. Journalize the issuance of the stock in acquiring the land.

BE11-5 On July 1, Fritz Corporation purchases 500 shares of its \$5 par value common stock for the treasury at a cash price of \$9 per share. On September 1, it sells 300 shares of the treasury stock for cash at \$11 per share. Journalize the two treasury stock transactions.

BE11-6 Ervay Inc. issues 5,000 shares of \$100 par value preferred stock for cash at \$120 per share. Journalize the issuance of the preferred stock.

BE11-7 Chavez Corporation has 50,000 shares of common stock outstanding. It declares a \$1 per share cash dividend on November 1 to stockholders of record on December 1. The dividend is paid on December 31. Prepare the entries on the appropriate dates to record the declaration and payment of the cash dividend.

Do it! Review 549

BE11-8 Walters Corporation has 60,000 shares of \$10 par value common stock outstanding. It declares a 10% stock dividend on December 1 when the market value per share is \$16. The dividend shares are issued on December 31. Prepare the entries for the declaration and distribution of the stock dividend.

Prepare entries for a stock dividend.
(SO 5)

BE11-9 The stockholders' equity section of Martin Corporation consists of common stock (\$10 par) \$2,000,000 and retained earnings \$300,000. A 10% stock dividend (20,000 shares) is declared when the market value per share is \$14. Show the before-and-after effects of the dividend on the following.

Show before-and-after effects of a stock dividend.
(SO 5)

- (a) The components of stockholders' equity.
(b) Shares outstanding.

BE11-10 For the year ending December 31, 2011, Mount Inc. reports net income \$120,000 and dividends \$85,000. Prepare the retained earnings statement for the year assuming the balance in retained earnings on January 1, 2011, was \$220,000.

Prepare a retained earnings statement.
(SO 6)

BE11-11 The balance in retained earnings on January 1, 2011, for Ola Smith Inc. was \$800,000. During the year, the corporation paid cash dividends of \$90,000 and distributed a stock dividend of \$8,000. In addition, the company determined that it had understated its depreciation expense in prior years by \$50,000. Net income for 2011 was \$150,000. Prepare the retained earnings statement for 2011.

Prepare a retained earnings statement.
(SO 6)

BE11-12 Ingram Corporation has the following accounts at December 31: Common Stock, \$10 par, 5,000 shares issued, \$50,000; Paid-in Capital in Excess of Par Value \$10,000; Retained Earnings \$45,000; and Treasury Stock—Common, 500 shares, \$11,000. Prepare the stockholders' equity section of the balance sheet.

Prepare stockholders' equity section.
(SO 7)

***BE11-13** The balance sheet for Jimenez Inc. shows the following: total paid-in capital and retained earnings \$870,000, total stockholders' equity \$810,000, common stock issued 44,000 shares, and common stock outstanding 40,000 shares. Compute the book value per share.

Compute book value per share.
(SO 9)

Do it! Review

Do it! 11-1 Indicate whether each of the following statements is true or false.

- ____ 1. The corporation is an entity separate and distinct from its owners.
____ 2. The liability of stockholders is normally limited to their investment in the corporation.
____ 3. The relative lack of government regulation is an advantage of the corporate form of business.
____ 4. There is no journal entry to record the authorization of capital stock.
____ 5. No-par value stock is quite rare today.

Analyze statements about corporate organization.
(SO 1)

Do it! 11-2 At the end of its first year of operation, Dade Corporation has \$1,000,000 of common stock and net income of \$216,000. Prepare (a) the closing entry for net income and (b) the stockholders' equity section at year-end.

Close net income and prepare stockholders' equity section.
(SO 1)

Do it! 11-3 Caribbean Corporation began operations on April 1 by issuing 60,000 shares of \$5 par value common stock for cash at \$13 per share. On April 19, it issued 2,000 shares of common stock to attorneys in settlement of their bill of \$27,500 for organization costs. Journalize both issuances, assuming the stock is not publicly traded.

Journalize issuance of stock.
(SO 2)

Do it! 11-4 Chiapas Corporation purchased 2,000 shares of its \$10 par value common stock for \$120,000 on August 1. It will hold these shares in the treasury until resold. On December 1, the corporation sold 1,200 shares of treasury stock for cash at \$72 per share. Journalize the treasury stock transactions.

Journalize treasury stock transactions.
(SO 3)

Do it! 11-5 Mensa Corporation has 3,000 shares of 7%, \$100 par value preferred stock outstanding at December 31, 2011. At December 31, 2011, the company declared a \$105,000 cash dividend. Determine the dividend paid to preferred stockholders and common stockholders under each of the scenarios on page 550.

Determine dividends paid to preferred and common stockholders.
(SO 5)

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1. The preferred stock is noncumulative, and the company has not missed any dividends in previous years.
2. The preferred stock is noncumulative, and the company did not pay a dividend in each of the two previous years.
3. The preferred stock is cumulative, and the company did not pay a dividend in each of the two previous years.

Determine effects of stock dividend and stock split.

(SO 5)

Do it! 11-6 Riff CD Company has had 4 years of retained earnings. Due to this success, the market price of its 400,000 shares of \$3 par value common stock has increased from \$12 per share to \$51. During this period, paid-in capital remained the same at \$2,400,000. Retained earnings increased from \$1,800,000 to \$12,000,000. CEO Josh Borke is considering either (1) a 15% stock dividend or (2) a 2-for-1 stock split. He asks you to show the before-and-after effects of each option on (a) retained earnings and (b) total stockholders' equity.

Prepare a retained earnings statement.

(SO 6)

Do it! 11-7 Alpha Centuri Corporation has retained earnings of \$3,100,000 on January 1, 2011. During the year, Alpha Centuri earned \$1,200,000 of net income. It declared and paid a \$150,000 cash dividend. In 2011, Alpha Centuri recorded an adjustment of \$110,000 due to the overstatement (from mathematical error) of 2010 depreciation expense. Prepare a retained earnings statement for 2011.

Compute return on stockholders' equity and discuss changes.

(SO 7)

Do it! 11-8 On January 1, 2011, Tuscany Corporation purchased 1,000 shares of treasury stock. Other information regarding Tuscany Corporation is provided below.

	2010	2011
Net income	\$200,000	\$210,000
Dividends on preferred stock	\$ 30,000	\$ 30,000
Dividends on common stock	\$ 20,000	\$ 25,000
Weighted-average number of common shares outstanding	10,000	9,000
Common stockholders' equity beginning of year	\$600,000	\$750,000
Common stockholders' equity end of year	\$750,000	\$830,000

Compute (a) return on common stockholders' equity for each year and (b) discuss the changes.

EXERCISES



Identify characteristics of a corporation.

(SO 1)

E11-1 Jeff Lynne has prepared the following list of statements about corporations.

1. A corporation is an entity separate and distinct from its owners.
2. As a legal entity, a corporation has most of the rights and privileges of a person.
3. Most of the largest U.S. corporations are privately held corporations.
4. Corporations may buy, own, and sell property; borrow money; enter into legally binding contracts; and sue and be sued.
5. The net income of a corporation is not taxed as a separate entity.
6. Creditors have a legal claim on the personal assets of the owners of a corporation if the corporation does not pay its debts.
7. The transfer of stock from one owner to another requires the approval of either the corporation or other stockholders.
8. The board of directors of a corporation legally owns the corporation.
9. The chief accounting officer of a corporation is the controller.
10. Corporations are subject to less state and federal regulations than partnerships or proprietorships.

Instructions

Identify each statement as true or false. If false, indicate how to correct the statement.

Identify characteristics of a corporation.

(SO 1, 2)

E11-2 Jeff Lynne (see E11-1) has studied the information you gave him in that exercise and has come to you with more statements about corporation.

1. Corporation management is both an advantage and a disadvantage of a corporation compared to a proprietorship or a partnership.

Exercises 551

2. Limited liability of stockholders, government regulations, and additional taxes are the major disadvantages of a corporation.
3. When a corporation is formed, organization costs are recorded as an asset.
4. Each share of common stock gives the stockholder the ownership rights to vote at stockholder meetings, share in corporate earnings, keep the same percentage ownership when new shares of stock are issued, and share in assets upon liquidation.
5. The number of issued shares is always greater than or equal to the number of authorized shares.
6. A journal entry is required for the authorization of capital stock.
7. Publicly held corporations usually issue stock directly to investors.
8. The trading of capital stock on a securities exchange involves the transfer of already issued shares from an existing stockholder to another investor.
9. The market value of common stock is usually the same as its par value.
10. Retained earnings is the total amount of cash and other assets paid in to the corporation by stockholders in exchange for capital stock.

Instructions

Identify each statement as true or false. If false, indicate how to correct the statement.

E11-3 During its first year of operations, Klumpe Corporation had the following transactions pertaining to its common stock.

- Jan. 10 Issued 70,000 shares for cash at \$5 per share.
 July 1 Issued 40,000 shares for cash at \$8 per share.

Journalize issuance of common stock.

(SO 2)

Instructions

- (a) Journalize the transactions, assuming that the common stock has a par value of \$5 per share.
- (b) Journalize the transactions, assuming that the common stock is no-par with a stated value of \$1 per share.

E11-4 Grossman Corporation issued 1,000 shares of stock.

Journalize issuance of common stock.

(SO 2)

Instructions

Prepare the entry for the issuance under the following assumptions.

- (a) The stock had a par value of \$5 per share and was issued for a total of \$52,000.
- (b) The stock had a stated value of \$5 per share and was issued for a total of \$52,000.
- (c) The stock had no par or stated value and was issued for a total of \$52,000.
- (d) The stock had a par value of \$5 per share and was issued to attorneys for services during incorporation valued at \$52,000.
- (e) The stock had a par value of \$5 per share and was issued for land worth \$52,000.

E11-5 Mad City Corporation purchased from its stockholders 5,000 shares of its own previously issued stock for \$250,000. It later resold 2,000 shares for \$54 per share, then 2,000 more shares for \$49 per share, and finally 1,000 shares for \$40 per share.

Journalize treasury stock transactions.

(SO 3)

Instructions

Prepare journal entries for the purchase of the treasury stock and the three sales of treasury stock.

E11-6 AI Corporation issued 100,000 shares of \$20 par value, cumulative, 8% preferred stock on January 1, 2009, for \$2,100,000. In December 2011, AI declared its first dividend of \$500,000.

Differentiate between preferred and common stock.

(SO 4)

Instructions

- (a) Prepare AI's journal entry to record the issuance of the preferred stock.
- (b) If the preferred stock is *not* cumulative, how much of the \$500,000 would be paid to **common** stockholders?
- (c) If the preferred stock is cumulative, how much of the \$500,000 would be paid to **common** stockholders?

E11-7 Garza Co. had the following transactions during the current period.

- Mar. 2 Issued 5,000 shares of \$1 par value common stock to attorneys in payment of a bill for \$30,000 for services provided in helping the company to incorporate.
 June 12 Issued 60,000 shares of \$1 par value common stock for cash of \$375,000.
 July 11 Issued 1,000 shares of \$100 par value preferred stock for cash at \$110 per share.
 Nov. 28 Purchased 2,000 shares of treasury stock for \$80,000.

Journalize issuance of common and preferred stock and purchase of treasury stock.

(SO 2, 3, 4)



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Instructions

Journalize the transactions shown on the preceding page.

Journalize noncash common stock transactions.

(SO 2)

E11-8 As an auditor for the CPA firm of Agler and Carl, you encounter the following situations in auditing different clients.

1. Desi Corporation is a closely held corporation whose stock is not publicly traded. On December 5, the corporation acquired land by issuing 5,000 shares of its \$20 par value common stock. The owners' asking price for the land was \$120,000, and the fair market value of the land was \$110,000.
2. Lucille Corporation is a publicly held corporation whose common stock is traded on the securities markets. On June 1, it acquired land by issuing 20,000 shares of its \$10 par value stock. At the time of the exchange, the land was advertised for sale at \$250,000. The stock was selling at \$11 per share.

Instructions

Prepare the journal entries for each of the situations above.

Journalize treasury stock transactions.

(SO 3)

E11-9 On January 1, 2011, the stockholders' equity section of Rowen Corporation shows: common stock (\$5 par value) \$1,500,000; paid-in capital in excess of par value \$1,000,000; and retained earnings \$1,200,000. During the year, the following treasury stock transactions occurred.

- Mar. 1 Purchased 50,000 shares for cash at \$16 per share.
 July 1 Sold 10,000 treasury shares for cash at \$17 per share.
 Sept. 1 Sold 8,000 treasury shares for cash at \$15 per share.

Instructions

- (a) Journalize the treasury stock transactions.
- (b) Restate the entry for September 1, assuming the treasury shares were sold at \$13 per share.

Journalize preferred stock transactions and indicate statement presentation.

(SO 4, 7)

E11-10 Tinker Corporation is authorized to issue both preferred and common stock. The par value of the preferred is \$50. During the first year of operations, the company had the following events and transactions pertaining to its preferred stock.

- Feb. 1 Issued 20,000 shares for cash at \$51 per share.
 July 1 Issued 10,000 shares for cash at \$57 per share.

Instructions

- (a) Journalize the transactions.
- (b) Post to the stockholders' equity accounts.
- (c) Indicate the financial statement presentation of the related accounts.

Answer questions about stockholders' equity section.

(SO 2, 3, 4, 7)

E11-11 The stockholders' equity section of Lumley Corporation at December 31 is as follows.

LUMLEY CORPORATION
Balance Sheet (partial)

Paid-in capital	
Preferred stock, cumulative, 10,000 shares authorized, 6,000 shares issued and outstanding	\$ 600,000
Common stock, no par, 750,000 shares authorized, 600,000 shares issued	1,200,000
Total paid-in capital	1,800,000
Retained earnings	1,858,000
Total paid-in capital and retained earnings	3,658,000
Less: Treasury stock (12,000 common shares)	64,000
Total stockholders' equity	\$3,594,000

Instructions

From a review of the stockholders' equity section, as chief accountant, write a memo to the president of the company answering the following questions.

- (a) How many shares of common stock are outstanding?
- (b) Assuming there is a stated value, what is the stated value of the common stock?
- (c) What is the par value of the preferred stock?
- (d) If the annual dividend on preferred stock is \$30,000, what is the dividend rate on preferred stock?
- (e) If dividends of \$60,000 were in arrears on preferred stock, what would be the balance in Retained Earnings?

Exercises 553

E11-12 Flores Corporation recently hired a new accountant with extensive experience in accounting for partnerships. Because of the pressure of the new job, the accountant was unable to review his textbooks on the topic of corporation accounting. During the first month, the accountant made the following entries for the corporation's capital stock.

Prepare correct entries for capital stock transactions.

(SO 2, 3, 4)



May 2	Cash	120,000	
	Capital Stock		120,000
	(Issued 10,000 shares of \$10 par value common stock at \$12 per share)		
10	Cash	600,000	
	Capital Stock		600,000
	(Issued 10,000 shares of \$50 par value preferred stock at \$60 per share)		
15	Capital Stock	14,000	
	Cash		14,000
	(Purchased 1,000 shares of common stock for the treasury at \$14 per share)		
31	Cash	8,000	
	Capital Stock		5,000
	Gain on Sale of Stock		3,000
	(Sold 500 shares of treasury stock at \$16 per share)		

Instructions

On the basis of the explanation for each entry, prepare the entry that should have been made for the capital stock transactions.

E11-13 On January 1, Armada Corporation had 95,000 shares of no-par common stock issued and outstanding. The stock has a stated value of \$5 per share. During the year, the following occurred.

Journalize cash dividends; indicate statement presentation.

(SO 5)

- Apr. 1 Issued 15,000 additional shares of common stock for \$17 per share.
- June 15 Declared a cash dividend of \$1 per share to stockholders of record on June 30.
- July 10 Paid the \$1 cash dividend.
- Dec. 1 Issued 2,000 additional shares of common stock for \$19 per share.
- 15 Declared a cash dividend on outstanding shares of \$1.20 per share to stockholders of record on December 31.

Instructions

- (a) Prepare the entries, if any, on each of the three dividend dates.
- (b) How are dividends and dividends payable reported in the financial statements prepared at December 31?

E11-14 On January 1, 2011, Abdella Corporation had \$1,000,000 of common stock outstanding that was issued at par. It also had retained earnings of \$750,000. The company issued 60,000 shares of common stock at par on July 1 and earned net income of \$400,000 for the year.

Journalize stock dividends.

(SO 5)

Instructions

Journalize the declaration of a 15% stock dividend on December 10, 2011, for the following independent assumptions.

- 1. Par value is \$10, and market value is \$18.
- 2. Par value is \$5, and market value is \$20.

E11-15 On October 31, the stockholders' equity section of Omar Company consists of common stock \$600,000 and retained earnings \$900,000. Omar is considering the following two courses of action: (1) declaring a 5% stock dividend on the 60,000, \$10 par value shares outstanding, or (2) effecting a 2-for-1 stock split that will reduce par value to \$5 per share. The current market price is \$14 per share.

Compare effects of a stock dividend and a stock split.

(SO 5)

Instructions

Prepare a tabular summary of the effects of the alternative actions on the components of stockholders' equity and outstanding shares. Use the following column headings: Before Action, After Stock Dividend, and After Stock Split.

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Prepare correcting entries for dividends and a stock split.

(SO 5)

E11-16 Before preparing financial statements for the current year, the chief accountant for Springer Company discovered the following errors in the accounts.

1. The declaration and payment of \$50,000 cash dividend was recorded as a debit to Interest Expense \$50,000 and a credit to Cash \$50,000.
2. A 10% stock dividend (1,000 shares) was declared on the \$10 par value stock when the market value per share was \$16. The only entry made was: Retained Earnings (Dr.) \$10,000 and Dividends Payable (Cr.) \$10,000. The shares have not been issued.
3. A 4-for-1 stock split involving the issue of 400,000 shares of \$5 par value common stock for 100,000 shares of \$20 par value common stock was recorded as a debit to Retained Earnings \$2,000,000 and a credit to Common Stock \$2,000,000.

Instructions

Prepare the correcting entries at December 31.

Prepare a retained earnings statement.

(SO 6)

E11-17 On January 1, 2011, Castle Corporation had retained earnings of \$550,000. During the year, Castle had the following selected transactions.

1. Declared cash dividends of \$120,000.
2. Corrected overstatement of 2010 net income because of depreciation error \$30,000.
3. Earned net income of \$350,000.
4. Declared stock dividends of \$80,000.

Instructions

Prepare a retained earnings statement for the year.

Prepare a retained earnings statement.

(SO 6)

E11-18 Sasha Company reported retained earnings at December 31, 2010, of \$310,000. Sasha had 200,000 shares of common stock outstanding throughout 2011.

The following transactions occurred during 2011.

1. An error was discovered: in 2009, depreciation expense was recorded at \$70,000, but the correct amount was \$50,000.
2. A cash dividend of \$0.50 per share was declared and paid.
3. A 5% stock dividend was declared and distributed when the market price per share was \$15 per share.
4. Net income was \$285,000.

Instructions

Prepare a retained earnings statement for 2011.

Classify stockholders' equity accounts.

(SO 7)

E11-19 The ledger of O'Dell Corporation contains the following accounts: Common Stock, Preferred Stock, Treasury Stock—Common, Paid-in Capital in Excess of Par Value—Preferred Stock, Paid-in Capital in Excess of Stated Value—Common Stock, Paid-in Capital from Treasury Stock, and Retained Earnings.

Instructions

Classify each account using the following table headings.

	Paid-in Capital			
Account	Capital Stock	Additional	Retained Earnings	Other

Prepare a stockholders' equity section.

(SO 7)

E11-20 The following accounts appear in the ledger of Tiger Inc. after the books are closed at December 31.

Common Stock, no par, \$1 stated value, 400,000 shares authorized; 300,000 shares issued	\$ 300,000
Common Stock Dividends Distributable	60,000
Paid-in Capital in Excess of Stated Value—Common Stock	1,200,000
Preferred Stock, \$5 par value, 8%, 40,000 shares authorized; 30,000 shares issued	150,000
Retained Earnings	700,000
Treasury Stock (10,000 common shares)	74,000
Paid-in Capital in Excess of Par Value—Preferred Stock	344,000

Instructions

Prepare the stockholders' equity section at December 31, assuming retained earnings is restricted for plant expansion in the amount of \$100,000.

E11-21 Kelly Groucutt Company reported the following balances at December 31, 2010: common stock \$400,000; paid-in capital in excess of par value \$100,000; retained earnings \$250,000. During 2011, the following transactions affected stockholder's equity.

1. Issued preferred stock with a par value of \$125,000 for \$200,000.
2. Purchased treasury stock (common) for \$40,000.
3. Earned net income of \$140,000.
4. Declared and paid cash dividends of \$56,000.

Prepare stockholders' equity section.
(SO 7)

Instructions

Prepare the stockholders' equity section of Kelly Groucutt Company's December 31, 2011, balance sheet.

E11-22 In 2011, Mike Singletary Corporation had net sales of \$600,000 and cost of goods sold of \$360,000. Operating expenses were \$153,000, and interest expense was \$7,500. The corporation's tax rate is 30%. The corporation declared preferred dividends of \$15,000 in 2011, and its average common stockholders' equity during the year was \$200,000.

Prepare an income statement and compute return on stockholders' equity.
(SO 7)

Instructions

- (a) Prepare an income statement for Mike Singletary Corporation.
- (b) Compute Mike Singletary Corporation's return on common stockholders' equity for 2011.

***E11-23** In a recent year, the stockholders' equity section of **Aluminum Company of America (Alcoa)** showed the following (in alphabetical order): additional paid-in capital \$6,101, common stock \$925, preferred stock \$56, retained earnings \$7,428, and treasury stock \$2,828. All dollar data are in millions.

Prepare a stockholders' equity section.
(SO 7, 9)

The preferred stock has 557,740 shares authorized, with a par value of \$100 and an annual \$3.75 per share cumulative dividend preference. At December 31, 557,649 shares of preferred are issued and 546,024 shares are outstanding. There are 1.8 billion shares of \$1 par value common stock authorized, of which 924.6 million are issued and 844.8 million are outstanding at December 31.

Instructions

- (a) Prepare the stockholders' equity section, including disclosure of all relevant data.
- (b) Compute the book value per share of common stock, assuming there are no preferred dividends in arrears. (Round to two decimals.)

***E11-24** At December 31, Missouri Corporation has total stockholders' equity of \$3,000,000. Included in this total are preferred stock \$500,000 and paid-in capital in excess of par value—preferred stock \$50,000. There are 10,000 shares of \$50 par value 10% cumulative preferred stock outstanding. At year-end, 200,000 shares of common stock are outstanding.

Compute book value per share with preferred stock.
(SO 4, 9)

Instructions

Compute the book value per share of common stock, under each of the following assumptions.

- (a) There are no preferred dividends in arrears, and the preferred stock does not have a call price.
- (b) Preferred dividends are one year in arrears, and the preferred stock has a call price of \$60 per share.

***E11-25** On October 1, Chile Corporation's stockholders' equity is as follows.

Common stock, \$5 par value	\$200,000
Paid-in capital in excess of par value	25,000
Retained earnings	75,000
Total stockholders' equity	\$300,000

Compute book value per share; indicate account balances after a stock dividend.
(SO 5, 7, 9)

On October 1, Chile declares and distributes a 10% stock dividend when the market value of the stock is \$15 per share.

Instructions

- (a) Compute the book value per share (1) before the stock dividend and (2) after the stock dividend. (Round to two decimals.)
- (b) Indicate the balances in the three stockholders' equity accounts after the stock dividend shares have been distributed.

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EXERCISES: SET B AND CHALLENGE EXERCISES



Visit the book's companion website at www.wiley.com/college/veygandt, and choose the Student Companion site, to access Exercise Set B and a set of Challenge Exercises.

PROBLEMS: SET A



Journalize stock transactions, post, and prepare paid-in capital section.

(SO 2, 4, 7)

P11-1A Hayslett Corporation was organized on January 1, 2011. It is authorized to issue 20,000 shares of 6%, \$50 par value preferred stock, and 500,000 shares of no-par common stock with a stated value of \$2 per share. The following stock transactions were completed during the first year.

- Jan. 10 Issued 100,000 shares of common stock for cash at \$3 per share.
- Mar. 1 Issued 10,000 shares of preferred stock for cash at \$55 per share.
- Apr. 1 Issued 25,000 shares of common stock for land. The asking price of the land was \$90,000. The company's estimate of the fair market value of the land was \$85,000.
- May 1 Issued 75,000 shares of common stock for cash at \$4 per share.
- Aug. 1 Issued 10,000 shares of common stock to attorneys in payment of their bill for \$50,000 for services provided in helping the company organize.
- Sept. 1 Issued 5,000 shares of common stock for cash at \$6 per share.
- Nov. 1 Issued 2,000 shares of preferred stock for cash at \$58 per share.

Instructions

- (a) Journalize the transactions.
- (b) Post to the stockholders' equity accounts. (Use J1 as the posting reference.)
- (c) Prepare the paid-in capital section of stockholders' equity at December 31, 2011.

(c) Total paid-in capital
\$1,431,000

Journalize and post treasury stock transactions, and prepare stockholders' equity section.

(SO 3, 7)



P11-2A Greeve Corporation had the following stockholders' equity accounts on January 1, 2011: Common Stock (\$1 par) \$400,000, Paid-in Capital in Excess of Par Value \$500,000, and Retained Earnings \$100,000. In 2011, the company had the following treasury stock transactions.

- Mar. 1 Purchased 5,000 shares at \$7 per share.
- June 1 Sold 1,000 shares at \$10 per share.
- Sept. 1 Sold 2,000 shares at \$9 per share.
- Dec. 1 Sold 1,000 shares at \$5 per share.

Greeve Corporation uses the cost method of accounting for treasury stock. In 2011, the company reported net income of \$60,000.

Instructions

- (a) Journalize the treasury stock transactions, and prepare the closing entry at December 31, 2011, for net income.
- (b) Open accounts for (1) Paid-in Capital from Treasury Stock, (2) Treasury Stock, and (3) Retained Earnings. Post to these accounts using J12 as the posting reference.
- (c) Prepare the stockholders' equity section for Greeve Corporation at December 31, 2011.

(b) Treasury Stock \$7,000
(c) Total stockholders' equity
\$1,058,000

Journalize and post transactions, prepare stockholders' equity section.

(SO 2, 3, 4, 7, 9)

P11-3A The stockholders' equity accounts of Jajoo Corporation on January 1, 2011, were as follows.

Preferred Stock (10%, \$100 par noncumulative, 5,000 shares authorized)	\$ 300,000
Common Stock (\$5 stated value, 300,000 shares authorized)	1,000,000
Paid-in Capital in Excess of Par Value—Preferred Stock	20,000
Paid-in Capital in Excess of Stated Value—Common Stock	425,000
Retained Earnings	488,000
Treasury Stock—Common (5,000 shares)	40,000

During 2011, the corporation had the following transactions and events pertaining to its stockholders' equity.

- Feb. 1 Issued 3,000 shares of common stock for \$25,000.
- Mar. 20 Purchased 1,500 additional shares of common treasury stock at \$8 per share.
- June 14 Sold 4,000 shares of treasury stock—common for \$36,000.
- Sept. 3 Issued 2,000 shares of common stock for a patent valued at \$17,000.
- Dec. 31 Determined that net income for the year was \$340,000.

Instructions

- (a) Journalize the transactions and the closing entry for net income.
- (b) Enter the beginning balances in the accounts and post the journal entries to the stockholders' equity accounts. (Use J1 as the posting reference.)
- (c) Prepare a stockholders' equity section at December 31, 2011.

(c) Total stockholders' equity
\$2,599,000

P11-4A On January 1, 2011, Galactica Corporation had the following stockholders' equity accounts.

Prepare dividend entries and stockholders' equity section.
(SO 5, 7)

Common Stock (\$20 par value, 60,000 shares issued and outstanding)	\$1,200,000
Paid-in Capital in Excess of Par Value	200,000
Retained Earnings	500,000

During the year, the following transactions occurred.

- Feb. 1 Declared a \$1 cash dividend per share to stockholders of record on February 15, payable March 1.
- Mar. 1 Paid the dividend declared in February.
- Apr. 1 Announced a 5-for-1 stock split. Prior to the split, the market price per share was \$35.
- July 1 Declared a 5% stock dividend to stockholders of record on July 15, distributable July 31. On July 1, the market price of the stock was \$7 per share.
- July 31 Issued the shares for the stock dividend.
- Dec. 1 Declared a \$0.50 per share dividend to stockholders of record on December 15, payable January 5, 2012.
- 31 Determined that net income for the year was \$380,000.

Instructions

- (a) Journalize the transactions and closing entries.
- (b) Enter the beginning balances and post the entries to the stockholders' equity accounts. (Note: Open additional stockholders' equity accounts as needed.)
- (c) Prepare a stockholders' equity section at December 31.

(c) Total stockholders' equity
\$2,062,500

P11-5A The ledger of Nakona Corporation at December 31, 2011, after the books have been closed, contains the following stockholders' equity accounts.

Prepare retained earnings statement and stockholders' equity section, and compute earnings per share.
(SO 5, 6, 7)

Preferred Stock (10,000 shares issued)	\$1,000,000
Common Stock (400,000 shares issued)	2,000,000
Paid-in Capital in Excess of Par Value—Preferred	200,000
Paid-in Capital in Excess of Stated Value—Common	1,100,000
Common Stock Dividends Distributable	200,000
Retained Earnings	2,365,000

A review of the accounting records reveals the following.

1. No errors have been made in recording 2011 transactions or in preparing the closing entry for net income.
2. Preferred stock is 8%, \$100 par value, noncumulative, and callable at \$125. Since January 1, 2010, 10,000 shares have been outstanding; 20,000 shares are authorized.
3. Common stock is no-par with a stated value of \$5 per share; 600,000 shares are authorized.
4. The January 1 balance in Retained Earnings was \$2,450,000.
5. On October 1, 100,000 shares of common stock were sold for cash at \$8 per share.
6. A cash dividend of \$600,000 was declared and properly allocated to preferred and common stock on November 1. No dividends were paid to preferred stockholders in 2010.
7. On December 31, a 10% common stock dividend was declared out of retained earnings on common stock when the market price per share was \$7.

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- 8. Net income for the year was \$795,000.
- 9. On December 31, 2011, the directors authorized disclosure of a \$100,000 restriction of retained earnings for plant expansion. (Use Note A.)

- (b) Retained earnings
\$2,365,000
- (c) Total stockholders' equity
\$6,865,000

Prepare entries for stock transactions and stockholders' equity section.

(SO 2, 3, 4, 7)



Instructions

- (a) Reproduce the Retained Earnings account (T account) for the year.
- (b) Prepare a retained earnings statement for the year.
- (c) Prepare a stockholders' equity section at December 31.
- (d) Compute the earnings per share of common stock using 325,000 as the weighted-average shares outstanding for the year.
- (e) Compute the allocation of the cash dividend to preferred and common stock.

P11-6A Arnold Corporation has been authorized to issue 40,000 shares of \$100 par value, 8%, noncumulative preferred stock and 2,000,000 shares of no-par common stock. The corporation assigned a \$5 stated value to the common stock. At December 31, 2011, the ledger contained the following balances pertaining to stockholders' equity.

Preferred Stock	\$ 240,000
Paid-in Capital in Excess of Par Value—Preferred	56,000
Common Stock	2,000,000
Paid-in Capital in Excess of Stated Value—Common	5,700,000
Treasury Stock—Common (1,000 shares)	22,000
Paid-in Capital from Treasury Stock	3,000
Retained Earnings	560,000

The preferred stock was issued for land having a fair market value of \$296,000. All common stock issued was for cash. In November, 1,500 shares of common stock were purchased for the treasury at a per share cost of \$22. In December, 500 shares of treasury stock were sold for \$28 per share. No dividends were declared in 2011.

Instructions

- (a) Prepare the journal entries for the:
 - (1) Issuance of preferred stock for land.
 - (2) Issuance of common stock for cash.
 - (3) Purchase of common treasury stock for cash.
 - (4) Sale of treasury stock for cash.
- (b) Prepare the stockholders' equity section at December 31, 2011.

- (b) Total stockholders' equity
\$8,537,000

Prepare dividend entries and stockholders' equity section.

(SO 5, 7)

P11-7A On January 1, 2011, Snider Corporation had the following stockholders' equity accounts.

Common Stock (\$10 par value, 90,000 shares issued and outstanding)	\$900,000
Paid-in Capital in Excess of Par Value	200,000
Retained Earnings	540,000

During the year, the following transactions occurred.

- Jan. 15 Declared a \$1 cash dividend per share to stockholders of record on January 31, payable February 15.
- Feb. 15 Paid the dividend declared in January.
- Apr. 15 Declared a 10% stock dividend to stockholders of record on April 30, distributable May 15. On April 15, the market price of the stock was \$15 per share.
- May 15 Issued the shares for the stock dividend.
- July 1 Announced a 2-for-1 stock split. The market price per share prior to the announcement was \$17. (The new par value is \$5.)
- Dec. 1 Declared a \$0.50 per share cash dividend to stockholders of record on December 15, payable January 10, 2012.
- 31 Determined that net income for the year was \$250,000.

Instructions

- (a) Journalize the transactions and the closing entries for net income and dividends.
- (b) Enter the beginning balances, and post the entries to the stockholders' equity accounts. (Note: Open additional stockholders' equity accounts as needed.)
- (c) Prepare a stockholders' equity section at December 31.

- (c) Total stockholders' equity
\$1,701,000

Problems: Set B 559

***P11-8A** The following stockholders' equity accounts arranged alphabetically are in the ledger of McGrath Corporation at December 31, 2011.

Common Stock (\$10 stated value)	\$1,500,000
Paid-in Capital from Treasury Stock	6,000
Paid-in Capital in Excess of Stated Value—Common Stock	690,000
Paid-in Capital in Excess of Par Value—Preferred Stock	288,400
Preferred Stock (8%, \$100 par, noncumulative)	400,000
Retained Earnings	776,000
Treasury Stock—Common (8,000 shares)	88,000

Prepare stockholders' equity section; compute book value per share.

(SO 7, 9)

Instructions

- (a) Prepare a stockholders' equity section at December 31, 2011.
- (b) Compute the book value per share of the common stock, assuming the preferred stock has a call price of \$110 per share.

Total stockholders' equity
\$3,572,400

***P11-9A** On January 1, 2011, Hamblin Inc. had the following stockholders' equity balances.

Common Stock (500,000 shares issued)	\$1,000,000
Paid-in Capital in Excess of Par Value	500,000
Common Stock Dividends Distributable	100,000
Retained Earnings	600,000

Prepare stockholders' equity statement.

(SO 8)

During 2011, the following transactions and events occurred.

1. Issued 50,000 shares of \$2 par value common stock as a result of 10% stock dividend declared on December 15, 2010.
2. Issued 30,000 shares of common stock for cash at \$5 per share.
3. Purchased 25,000 shares of common stock for the treasury at \$6 per share.
4. Declared and paid a cash dividend of \$111,000.
5. Sold 8,000 shares of treasury stock for cash at \$6 per share.
6. Earned net income of \$360,000.

Instructions

Prepare a stockholders' equity statement for the year.

Total stockholders' equity
\$2,497,000

PROBLEMS: SET B

P11-1B Keeler Corporation was organized on January 1, 2011. It is authorized to issue 10,000 shares of 8%, \$100 par value preferred stock, and 500,000 shares of no-par common stock with a stated value of \$3 per share. The following stock transactions were completed during the first year.

Journalize stock transactions, post, and prepare paid-in capital section.

(SO 2, 4, 7)

- Jan. 10 Issued 80,000 shares of common stock for cash at \$4 per share.
- Mar. 1 Issued 5,000 shares of preferred stock for cash at \$105 per share.
- Apr. 1 Issued 24,000 shares of common stock for land. The asking price of the land was \$90,000. The fair market value of the land was \$85,000.
- May 1 Issued 80,000 shares of common stock for cash at \$4.50 per share.
- Aug. 1 Issued 10,000 shares of common stock to attorneys in payment of their bill of \$40,000 for services provided in helping the company organize.
- Sept. 1 Issued 10,000 shares of common stock for cash at \$5 per share.
- Nov. 1 Issued 1,000 shares of preferred stock for cash at \$109 per share.

Instructions

- (a) Journalize the transactions.
- (b) Post to the stockholders' equity accounts. (Use J5 as the posting reference.)
- (c) Prepare the paid-in capital section of stockholders' equity at December 31, 2011.

(c) Total paid-in capital
\$1,489,000

P11-2B Goldberg Corporation had the following stockholders' equity accounts on January 1, 2011: Common Stock (\$5 par) \$500,000, Paid-in Capital in Excess of Par Value \$200,000, and Retained Earnings \$100,000. In 2011, the company had the following treasury stock transactions.

Journalize and post treasury stock transactions, and prepare stockholders' equity section.

(SO 3, 7)

- Mar. 1 Purchased 5,000 shares at \$8 per share.
- June 1 Sold 1,000 shares at \$12 per share.
- Sept. 1 Sold 2,000 shares at \$10 per share.
- Dec. 1 Sold 1,000 shares at \$6 per share.

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Goldberg Corporation uses the cost method of accounting for treasury stock. In 2011, the company reported net income of \$40,000.

Instructions

- (a) Journalize the treasury stock transactions, and prepare the closing entry at December 31, 2011, for net income.
- (b) Open accounts for (1) Paid-in Capital from Treasury Stock, (2) Treasury Stock, and (3) Retained Earnings. Post to these accounts using J10 as the posting reference.
- (c) Prepare the stockholders' equity section for Goldberg Corporation at December 31, 2011.

(b) Treasury Stock \$8,000
(c) Total stockholders' equity \$838,000

Journalize and post transactions, prepare stockholders' equity section.

(SO 2, 3, 4, 7, 9)

P11-3B The stockholders' equity accounts of Port Corporation on January 1, 2011, were as follows.

Preferred Stock (8%, \$50 par cumulative, 10,000 shares authorized)	\$ 400,000
Common Stock (\$1 stated value, 2,000,000 shares authorized)	1,000,000
Paid-in Capital in Excess of Par Value—Preferred Stock	100,000
Paid-in Capital in Excess of Stated Value—Common Stock	1,450,000
Retained Earnings	1,816,000
Treasury Stock—Common (10,000 shares)	40,000

During 2011, the corporation had the following transactions and events pertaining to its stockholders' equity.

- Feb. 1 Issued 25,000 shares of common stock for \$100,000.
- Apr. 14 Sold 6,000 shares of treasury stock—common for \$33,000.
- Sept. 3 Issued 5,000 shares of common stock for a patent valued at \$30,000.
- Nov. 10 Purchased 1,000 shares of common stock for the treasury at a cost of \$6,000.
- Dec. 31 Determined that net income for the year was \$452,000.

No dividends were declared during the year.

Instructions

- (a) Journalize the transactions and the closing entry for net income.
- (b) Enter the beginning balances in the accounts, and post the journal entries to the stockholders' equity accounts. (Use J5 for the posting reference.)
- (c) Prepare a stockholders' equity section at December 31, 2011, including the disclosure of the preferred dividends in arrears.

(c) Total stockholders' equity \$5,335,000

Prepare dividend entries and stockholders' equity section.

(SO 5, 7)

P11-4B On January 1, 2011, Argentina Corporation had the following stockholders' equity accounts.

Common Stock (\$20 par value, 75,000 shares issued and outstanding)	\$1,500,000
Paid-in Capital in Excess of Par Value	200,000
Retained Earnings	600,000

During the year, the following transactions occurred.

- Feb. 1 Declared a \$1 cash dividend per share to stockholders of record on February 15, payable March 1.
- Mar. 1 Paid the dividend declared in February.
- Apr. 1 Announced a 2-for-1 stock split. Prior to the split, the market price per share was \$36.
- July 1 Declared a 10% stock dividend to stockholders of record on July 15, distributable July 31. On July 1, the market price of the stock was \$13 per share.
- 31 Issued the shares for the stock dividend.
- Dec. 1 Declared a \$0.50 per share dividend to stockholders of record on December 15, payable January 5, 2012.
- 31 Determined that net income for the year was \$350,000.

Instructions

- (a) Journalize the transactions and the closing entries for net income and dividends.
- (b) Enter the beginning balances, and post the entries to the stockholders' equity accounts. (Note: Open additional stockholders' equity accounts as needed.)
- (c) Prepare a stockholders' equity section at December 31.

(c) Total stockholders' equity \$2,492,500

Problems: Set B 561

P11-5B On December 31, 2010, Bradstrom Company had 1,500,000 shares of \$10 par common stock issued and outstanding. The stockholders' equity accounts at December 31, 2010, had the following balances.

Common Stock	\$15,000,000
Additional Paid-in Capital	1,500,000
Retained Earnings	900,000

Prepare retained earnings statement and stockholders' equity section.

(SO 6, 7)

Transactions during 2011 and other information related to stockholders' equity accounts were as follows.

- On January 10, 2011, Bradstrom issued at \$105 per share 100,000 shares of \$100 par value, 7% cumulative preferred stock.
- On February 8, 2011, Bradstrom reacquired 15,000 shares of its common stock for \$16 per share.
- On June 8, 2011, Bradstrom declared a cash dividend of \$1 per share on the common stock outstanding, payable on July 10, 2011, to stockholders of record on July 1, 2011.
- On December 15, 2011, Bradstrom declared the yearly cash dividend on preferred stock, payable January 10, 2012, to stockholders of record on December 15, 2011.
- Net income for the year is \$3,600,000.
- It was discovered that depreciation expense had been overstated in 2010 by \$80,000.

Instructions

- Prepare a retained earnings statement for the year ended December 31, 2011.
- Prepare the stockholders' equity section of Bradstrom's balance sheet at December 31, 2011.

(b) Total stockholders' equity
\$29,155,000

P11-6B The post-closing trial balance of Chen Corporation at December 31, 2011, contains the following stockholders' equity accounts.

Preferred Stock (15,000 shares issued)	\$ 750,000
Common Stock (250,000 shares issued)	2,500,000
Paid-in Capital in Excess of Par Value—Preferred	250,000
Paid-in Capital in Excess of Par Value—Common	400,000
Common Stock Dividends Distributable	250,000
Retained Earnings	902,000

Prepare retained earnings statement and stockholders' equity section, and compute earnings per share.

(SO 5, 6, 7)

A review of the accounting records reveals the following.

- No errors have been made in recording 2011 transactions or in preparing the closing entry for net income.
- Preferred stock is \$50 par, 8%, and cumulative; 15,000 shares have been outstanding since January 1, 2010.
- Authorized stock is 20,000 shares of preferred, 500,000 shares of common with a \$10 par value.
- The January 1 balance in Retained Earnings was \$1,170,000.
- On July 1, 20,000 shares of common stock were sold for cash at \$16 per share.
- On September 1, the company discovered an understatement error of \$90,000 in computing depreciation in 2010. The net of tax effect of \$63,000 was properly debited directly to Retained Earnings.
- A cash dividend of \$250,000 was declared and properly allocated to preferred and common stock on October 1. No dividends were paid to preferred stockholders in 2010.
- On December 31, a 10% common stock dividend was declared out of retained earnings on common stock when the market price per share was \$18.
- Net income for the year was \$495,000.
- On December 31, 2011, the directors authorized disclosure of a \$200,000 restriction of retained earnings for plant expansion. (Use Note X.)

Instructions

- Reproduce the Retained Earnings account for the year.
- Prepare a retained earnings statement for the year.
- Prepare a stockholders' equity section at December 31.
- Compute the earnings per share of common stock using 240,000 as the weighted-average shares outstanding for the year.
- Compute the allocation of the cash dividend to preferred and common stock.

(b) Retained earnings
\$902,000

(c) Total stockholders' equity
\$5,052,000

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Prepare stockholders' equity section; compute book value per share.

(SO 7, 9)

Total stockholders' equity
\$6,907,000

***P11-7B** The following stockholders' equity accounts arranged alphabetically are in the ledger of Rizzo Corporation at December 31, 2011.

Common Stock (\$5 stated value)	\$2,500,000
Paid-in Capital from Treasury Stock	10,000
Paid-in Capital in Excess of Stated Value—Common Stock	1,600,000
Paid-in Capital in Excess of Par Value—Preferred Stock	679,000
Preferred Stock (8%, \$50 par, noncumulative)	800,000
Retained Earnings	1,448,000
Treasury Stock—Common (10,000 shares)	130,000

Instructions

- (a) Prepare a stockholders' equity section at December 31, 2011.
- (b) Compute the book value per share of the common stock, assuming the preferred stock has a call price of \$60 per share.

PROBLEMS: SET C



Visit the book's companion website at www.wiley.com/college/veygandt, and choose the Student Companion site, to access Problem Set C.

COMPREHENSIVE PROBLEM

CP11-1 Hiatt Corporation's balance sheet at December 31, 2010, is presented below.

HIATT CORPORATION

Balance Sheet
December 31, 2010

Cash	\$ 24,600	Accounts payable	\$ 25,600
Accounts receivable	45,500	Common stock (\$10 par)	80,000
Allowance for doubtful accounts	(1,500)	Retained earnings	127,400
Supplies	4,400		<u>\$233,000</u>
Land	40,000		
Building	142,000		
Accumulated depreciation-building	(22,000)		
	<u>\$233,000</u>		

During 2011, the following transactions occurred.

1. On January 1, 2011, Hiatt issued 1,500 shares of \$20 par, 7% preferred stock for \$33,000.
2. On January 1, 2011, Hiatt also issued 900 shares of the \$10 par value common stock for \$21,000.
3. Hiatt performed services for \$280,000 on account.
4. On April 1, 2011, Hiatt collected fees of \$36,000 in advance for services to be performed from April 1, 2011, to March 31, 2012.
5. Hiatt collected \$267,000 from customers on account.
6. Hiatt bought \$35,100 of supplies on account.
7. Hiatt paid \$32,200 on accounts payable.
8. Hiatt reacquired 400 shares of its common stock on June 1, 2011, for \$38 per share.
9. Paid other operating expenses of \$188,200.
10. On December 31, 2011, Hiatt declared the annual preferred stock dividend and a \$1.20 per share dividend on the outstanding common stock, all payable on January 15, 2012.
11. An account receivable of \$1,300 which originated in 2010 is written off as uncollectible.

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Adjustment data:

1. A count of supplies indicates that \$5,900 of supplies remain unused at year-end.
2. Recorded revenue earned from item 4 above.
3. The allowance for doubtful accounts should have a balance of \$3,500 at year end.
4. Depreciation is recorded on the building on a straight-line basis based on a 30-year life and a salvage value of \$10,000.
5. The income tax rate is 30%. (*Hint:* Prepare the income statement up to income before taxes and multiply by 30% to compute the amount.)

Instructions

(You may want to set up T accounts to determine ending balances.)

- (a) Prepare journal entries for the transactions listed above and adjusting entries.
- (b) Prepare an adjusted trial balance at December 31, 2011.
- (c) Prepare an income statement and a retained earnings statement for the year ending December 31, 2011, and a classified balance sheet as of December 31, 2011.

(b) Totals \$671,350
(c) Net income \$54,250
Tot. assets \$361,200

CONTINUING COOKIE CHRONICLE

(*Note:* This is a continuation of the Cookie Chronicle from Chapters 1 through 10.)

CCC11 Natalie and her friend Curtis Lesperance decide that they can benefit from joining Cookie Creations and Curtis's coffee shop. In the first part of this problem, they come to you with questions about setting up a corporation for their new business. In the second part of the problem, they want your help in preparing financial information following the first year of operations of their new business, Cookie & Coffee Creations.



Go to the book's companion website,
www.wiley.com/college/veygandt,
to see the completion of this problem.

BROADENING YOUR PERSPECTIVE

FINANCIAL REPORTING AND ANALYSIS

Financial Reporting Problem: PepsiCo, Inc.

BYP11-1 The stockholders' equity section for **PepsiCo, Inc.** is shown in Appendix A. You will also find data relative to this problem on other pages of the appendix.



Instructions

- (a) What is the par or stated value per share of PepsiCo's common stock?
- (b) What percentage of PepsiCo's authorized common stock was issued at December 27, 2008?
- (c) How many shares of common stock were outstanding at December 27, 2008, and at December 29, 2007?
- ***(d)** What was the book value per share at December 27, 2008, and at December 29, 2007?
- (e) What were the high and low market price per share in the fourth quarter of fiscal 2008, as reported under Selected Financial Data?

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Comparative Analysis Problem: PepsiCo, Inc. vs. The Coca-Cola Company



***BYP11-2** PepsiCo's financial statements are presented in Appendix A. Coca-Cola's financial statements are presented in Appendix B.

Instructions

- Based on the information contained in these financial statements, compute the 2008 book value per share for each company. (*Hint:* Use the value reported for "common shareholders' equity" as the numerator for PepsiCo.)
- Compare the market value per share for each company to the book value per share at year-end 2008. Assume that the market value of Coca-Cola's stock was \$45.27 at year-end 2008.
- Why are book value and market value per share different?
- Compute earnings per share and return on common stockholders' equity for both companies for the year ending in January 2008. Assume PepsiCo's weighted-average shares were 1,575 million and Coca-Cola's weighted-average shares were 2,462 million. Can these measures be used to compare the profitability of the two companies? Why or why not?
- What was the total amount of dividends paid by each company in 2008?



Exploring the Web

BYP11-3 Use the stockholders' equity section of an annual report and identify the major components.

Address: www.reportgallery.com, or go to www.wiley.com/college/weygandt

Steps

- From Report Gallery Homepage, choose **Search by Alphabet**, and choose a letter.
- Select a particular company.
- Choose Annual Report.
- Follow instructions below.

Instructions

Answer the following questions.

- What is the company's name?
- What classes of capital stock has the company issued?
- For each class of stock:
 - How many shares are authorized, issued, and/or outstanding?
 - What is the par value?
- What are the company's retained earnings?
- Has the company acquired treasury stock? How many shares?

CRITICAL THINKING



Decision Making Across the Organization

BYP11-4 The stockholders' meeting for Harris Corporation has been in progress for some time. The chief financial officer for Harris is presently reviewing the company's financial statements and is explaining the items that comprise the stockholders' equity section of the balance sheet for the current year. The stockholders' equity section of Harris Corporation at December 31, 2011, is shown on page 565.

HARRIS CORPORATION

Balance Sheet (partial)
December 31, 2011

Paid in capital		
Capital stock		
Preferred stock, authorized 1,000,000 shares cumulative, \$100 par value, \$8 per share, 6,000 shares issued and outstanding		\$ 600,000
Common stock, authorized 5,000,000 shares, \$1 par value, 3,000,000 shares issued, and 2,700,000 outstanding		<u>3,000,000</u>
Total capital stock		3,600,000
Additional paid-in capital		
In excess of par value—preferred stock	\$ 50,000	
In excess of par value—common stock	<u>25,000,000</u>	
Total additional paid-in capital		<u>25,050,000</u>
Total paid-in capital		28,650,000
Retained earnings		<u>900,000</u>
Total paid-in capital and retained earnings		29,550,000
Less: Common treasury stock (300,000 shares)		<u>9,300,000</u>
Total stockholders' equity		<u>\$20,250,000</u>

At the meeting, stockholders have raised a number of questions regarding the stockholders' equity section.

Instructions

With the class divided into groups, answer the following questions as if you were the chief financial officer for Harris Corporation.

- (a) "What does the cumulative provision related to the preferred stock mean?"
- (b) "I thought the common stock was presently selling at \$29.75, but the company has the stock stated at \$1 per share. How can that be?"
- (c) "Why is the company buying back its common stock? Furthermore, the treasury stock has a debit balance because it is subtracted from stockholders' equity. Why is treasury stock not reported as an asset if it has a debit balance?"
- (d) "Why is it necessary to show additional paid-in capital? Why not just show common stock at the total amount paid in?"

Communication Activity

BYP11-5 Sal Greco, your uncle, is an inventor who has decided to incorporate. Uncle Sal knows that you are an accounting major at U.N.O. In a recent letter to you, he ends with the question, "I'm filling out a state incorporation application. Can you tell me the difference in the following terms: (1) authorized stock, (2) issued stock, (3) outstanding stock, (4) preferred stock?"

Instructions

In a brief note, differentiate for Uncle Sal among the four different stock terms. Write the letter to be friendly, yet professional.

Ethics Case

BYP11-6 The R&D division of Healy Chemical Corp. has just developed a chemical for sterilizing the vicious Brazilian "killer bees" which are invading Mexico and the southern states of the United States. The president of Healy is anxious to get the chemical on the market to boost Healy's profits. He believes his job is in jeopardy because of decreasing sales and profits. Healy has an opportunity to sell this chemical in Central American countries, where the laws are much more relaxed than in the United States.

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The director of Healy's R&D division strongly recommends further testing in the laboratory for side-effects of this chemical on other insects, birds, animals, plants, and even humans. He cautions the president, "We could be sued from all sides if the chemical has tragic side-effects that we didn't even test for in the labs." The president answers, "We can't wait an additional year for your lab tests. We can avoid losses from such lawsuits by establishing a separate wholly owned corporation to shield Healy Corp. from such lawsuits. We can't lose any more than our investment in the new corporation, and we'll invest just the patent covering this chemical. We'll reap the benefits if the chemical works and is safe, and avoid the losses from lawsuits if it's a disaster." The following week Healy creates a new wholly owned corporation called Dryden Inc., sells the chemical patent to it for \$10, and watches the spraying begin.

Instructions

- (a) Who are the stakeholders in this situation?
- (b) Are the president's motives and actions ethical?
- (c) Can Healy shield itself against losses of Dryden Inc.?



"All About You" Activity

BYP11-7 A high percentage of Americans own stock in corporations. As a shareholder in a corporation, you will receive an annual report. One of the goals of this course is for you to learn how to navigate your way around an annual report.

Instructions

Use the annual report provided in Appendix A to answer the following questions.

- (a) What CPA firm performed the audit of PepsiCo's financial statements?
- (b) What was the amount of PepsiCo's basic earnings per share in 2008?
- (c) What were net sales in 2008?
- (d) How many shares of treasury stock did the company have at the end of 2008?
- (e) How much cash did PepsiCo spend on capital expenditures in 2008?
- (f) Over what life does the company depreciate its buildings?
- (g) What was the total amount of dividends paid in 2008?

FASB Codification Activity

BYP11-8 Access the FASB Codification at <http://asc.fasb.org> to prepare responses to the following.

- (a) What is a stock dividend?
- (b) What is a stock split?
- (c) At what percentage point does the issuance of additional shares qualify as a stock dividend, as opposed to a stock split?



Answers to Insight and Accounting Across the Organization Questions

p. 511 Directors Take on More Accountability

Q: Was Enron's board of directors fulfilling its role in a corporate organization when it waived Enron's ethical code on two occasions?

A: *The board of directors is elected by the owners (stockholders) of the corporation to manage the corporation. One of its roles is to formulate the ethical and operating policies for the company and to assume an oversight responsibility on behalf of the stockholders and other third parties. It was the responsibility of the board of directors to enforce the corporation's ethical code, not to waive it.*

p. 515 How to Read Stock Quotes

Q: For stocks traded on organized stock exchanges, how are the dollar prices per share established?

A: *The dollar prices per share are established by the interaction between buyers and sellers of the shares.*

Q: What factors might influence the price of shares in the marketplace?

A: *The price of shares is influenced by a company's earnings and dividends as well as by factors beyond a company's control, such as changes in interest rates, labor strikes, scarcity of supplies*

or resources, and politics. The number of willing buyers and sellers (demand and supply) also plays a part in the price of shares.

p. 522 Why Did Reebok Buy Its Own Stock?

Q: What signal might a large stock repurchase send to investors regarding management's belief about the company's growth opportunities?

A: *When a company has many growth opportunities it will normally conserve its cash in order to be better able to fund expansion. A large use of cash to buy back stock (and essentially shrink the company) would suggest that management was not optimistic about its growth opportunities.*

p. 529 What's Happening to Dividends?

Q: What factors must management consider in deciding how large a dividend to pay?

A: *Management must consider the size of its retained earnings balance, the amount of available cash, its expected near-term cash needs, its growth opportunities, and what level of dividend it will be able to sustain based upon its expected future earnings.*

**Authors' Comments on All About You:
Home-Equity Loans, p. 540**



The reasons why people reduce the equity in their homes with home-equity loans are as varied as the reasons why companies reduce their stockholders' equity by buying treasury stock or paying dividends. There are good and bad reasons to buy treasury stock and pay dividends, and there are good and bad reasons to use a home-equity loan.


Suppose you are considering putting an addition on your house, which would increase its value. That may be a good use of a home-equity loan, since it increases the value of your investment. Or suppose that you need to buy a new car. Financing the purchase with a home-equity loan can make good financial sense, since the interest on a home-equity loan is tax-deductible, while the interest on a car loan is not. But you should be sure you repay the home-equity loan over the same time period that you would have repaid the car loan. As the graphs in the box show, if you spread the loan over a long period, you could end up owing more money than the car is worth when it comes time to sell it.

Borrowing against the equity in your home to go on a vacation is not a financially prudent thing to do. If you want to go on a vacation, you should set up a separate travel fund as part of your personal budget, and go on the vacation only when you can actually afford it.

The bottom line is this: Reducing equity, either corporate or personal, increases reliance on debt and therefore increases risk. It is a decision that should be carefully considered.

Answers to Self-Study Questions

1. c 2. b 3. d 4. c 5. a 6. a 7. d 8. d 9. a 10. c 11. d 12. b 13. c 14. b 15. b
*16. a *17. c

 Remember to go back to the Navigator box on the chapter-opening page and check off your completed work.