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Module 13

Table of Contents

Instructions:

Click on any of the underlined titles in the table of contents to be directed to that section of the module. Click on the <back> symbol to return to the table of contents.

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Module 13 Summary

I. Nature and Characteristics of Corporations

A. The corporate form of business organization was introduced in the previous module. We explained at that time that large businesses in America are almost always organized as ***corporations***, and that corporations generate more business sales volume than any other business type. In this module we will look more closely at corporations and the entries that are made to record corporate transactions.

B. As we explained in the previous module, corporations in America have legal status as an "artificial being," or a ***separate legal entity*** in the eyes of the law. This creates major differences between corporations and the other legal forms of business organization (sole proprietorships, LLC's and partnerships).

1. The corporation begins its existence when the ***articles of incorporation*** are filed with the state. When the state approves the articles of incorporation (think of them as an application to form a corporation within the state), they then become a ***corporate charter*** (think of the charter as a license to operate as a corporation within the state).

2. The *charter* lists the business purpose, the corporation's organizational structure, the types of ***stock*** that may be issued, and the maximum number of *shares* of stock that the corporation is allowed to issue (referred to as the ***authorized shares***).

3. The ***stockholders*** write the corporation ***bylaws*** and elect members to the ***board of directors*** after the charter is received.

    a. The *bylaws* establish the rules that will be followed in the governance of the corporation. They specify the duties of the directors, the frequency of board meetings, the frequency of stockholder meetings, the types of stock that will be issued, and so on.

    b. The *Board of Directors* is responsible for major policy decisions and for creating the "big picture" goals and objectives of the corporation. Individual stockholders can

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only influence the board through their votes at the annual meeting.

b. The Board "***declares***" dividends (that is, determines their amounts and the payment dates) and authorizes their payment.

c. The Board hires the top corporate officer, the ***President*** (or ***CEO***). The President is responsible for the management of the company, and for seeing to it that the Board's "big picture" policies are carried out. The President often chooses the ***Vice-Presidents*** of Finance, Production, Personnel, etc., though the Board always has the final say regarding top-level staffing choices.

d. The Board also appoints a ***Corporate Secretary.*** This is often a Board member, and this person oversees the operation of the company to ensure that laws, regulations, and board policies are followed.

e. The ***Treasurer*** and ***Controller*** are officers who usually report to the ***Vice President of Finance*** (often called the *Chief Financial Officer*, or *CFO*).

   1. The *Controller* (also called the *Comptroller*) is the "head accountant." As such, the Controller oversees the accounting function, and is responsible for the preparation of the publicly reported financial statements and for meeting internal information needs.

   2. The *Treasurer* is concerned with "money management." This officer is responsible for managing the company's liquidity position and ensuring that adequate cash is available when needed. The Treasurer is involved in decisions regarding financing choices, stockholder and creditor relations, stock issuances, financial investments and hedging activities.

   3. The diagram below, illustrating the organizational structure of the corporation, was also presented in Module 12:

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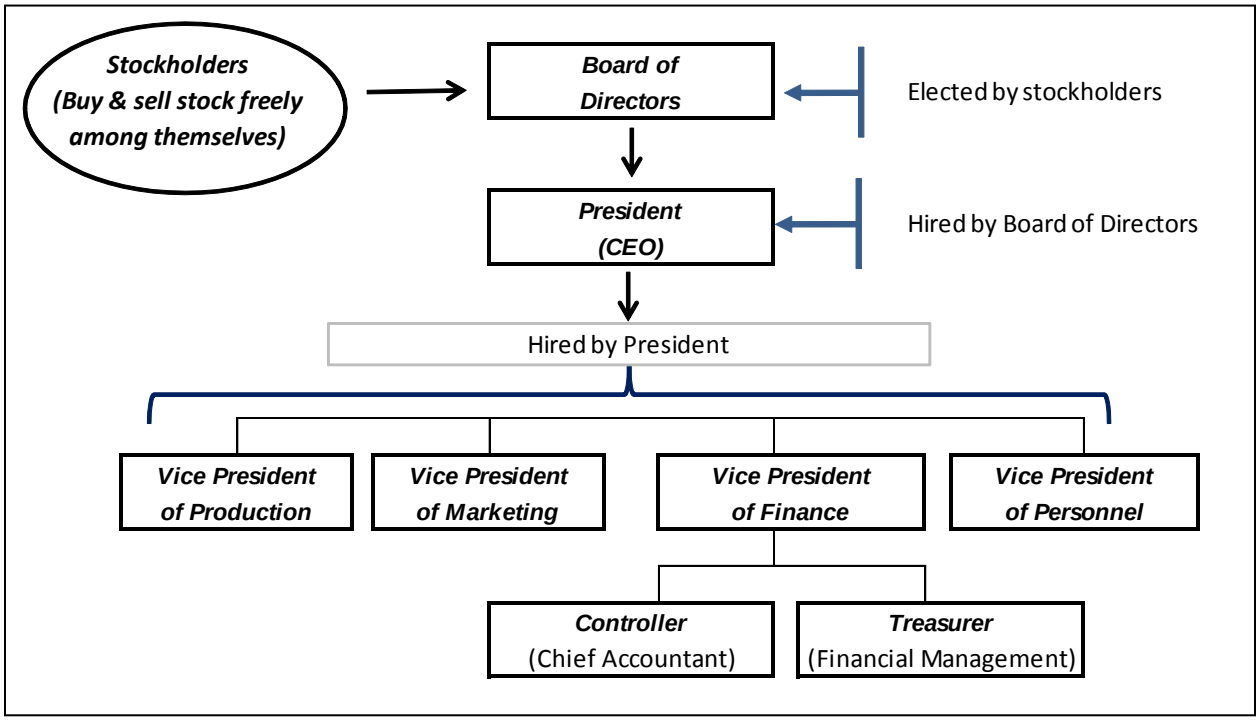

<back>

II. Types of Stock and their Characteristics

A. Ownership equity in corporations is represented by shares of corporation ***stock***. These are just certificates that represent legal ownership of a small portion of the company. It is common for large corporations to issue millions of shares of stock, so an individual holding a single share owns only a tiny fraction of the entire business. However, even a single share of stock gives the owner the same general rights that are provided to every other stockholder under the law:

1. Right to receive a proportionate share of any dividends distributed to the common stockholders. This just means that all stockholders will receive an equal amount per share held. For example, if there are 1,000,000 shares of stock outstanding and $1,000,000 of dividends are declared, each stockholder will receive $1 for every share of stock held (the dividend will be stated as "$1 per share").

2. Right to receive a proportionate share of the final liquidating dividends in the event of the failure of the business.

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3. Right to vote for the members of the Board of Directors and the right to vote on other important policy issues that the Board brings to the stockholders for a vote.

4. Right to maintain their percentage ownership of the corporation's stock by being offered that same percentage of any new issue of stock before it can be sold to anyone else (called the *preemptive right*).

B. The corporation issues stock to raise needed financing (capital). This is done through a group of banks and stockbrokers, called the *underwriters,* who help the company "place" its stock issue with investors.

1. A company's very first issuance of stock is called its *initial public offering* or *IPO*. When these new shares are first sold to investors the sales are said to have occurred in the *primary market*.

2. After the shares are issued, the stockholders may freely buy and sell the shares among themselves. These subsequent transactions often occur through *stockbrokers* and are transacted on the floors of the various stock *exchanges*. There several exchanges in the world. The New York Stock Exchange in New York City is presently the largest in the world.

3. The network of exchanges where stock is purchased and sold is called the *stock market*. Following the IPO, subsequent purchases and sales of the shares are referred to as *secondary market* transactions.

4. If you purchase stock through your broker, you will likely never see the stock certificates. Instead, your shares are held in the brokerage company's name, and the brokerage credits your account on their books for them. When dividends are paid to the brokerage (and it will receive them because the shares are held in the brokerage's name), the brokerage credits your account. You own the shares indirectly, in other words, but you still retain the right to the dividends and the right to vote your shares at the annual meeting.

C. When the articles of incorporation are approved by the state, the corporation will be authorized to issue up to a certain number of

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shares of stock. This maximum number is referred to as the ***authorized shares***.

D. Stock that has been issued by the corporation, or "sold" to individual stockholders in the primary market, is called ***issued stock***.

1. If the corporation purchases some of its own stock from stockholders (called ***treasury stock***) these shares are still considered to be issued shares, but they are no longer ***outstanding*** shares.

2. A corporation that has not issued all the shares it has been authorized and that has also purchased some treasury shares, would report a large number of shares as *authorized,* a smaller number of shares as *issued*, and a slightly smaller number as *outstanding*.

3. These are important distinctions, since *only outstanding shares receive dividends*.

Here's an Example!
A corporation is authorized to issue a million shares of stock. If it has issued 100,000 shares, and holds 10,000 treasury shares that were repurchased after issuance, then it would report one million shares of authorized stock, 100,000 shares of issued stock, with 90,000 shares outstanding. When dividends are declared, they will be distributed only to the owners of the 90,000 shares that are outstanding.

E Stocks may or may not have a ***par value***, depending on the laws in the state of incorporation.

1. In some states *par value* establishes ***legal capital*** (the amount of shareholder contributions that by law cannot be withdrawn from the corporation until all the corporate liabilities have been paid). Legal capital laws exist in order to protect creditors from excessive losses that would result if a failing corporation were to make massive distributions to stockholders prior to declaring bankruptcy.

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2. Other states, such as Illinois, define *legal capital* as anything paid in by shareholders, irregardless of the par value that might be printed on the shares. Since par value is irrelevant in establishing legal capital in these cases, some of these states allow (or require) the issuance of ***no-par*** stock.

3. Stock may have a ***stated value*** instead of par. *Stated value* stock is accounted for in the same way as par value stock.

Click the link below to play an audio presentation that discusses the concept of "legal capital."

Link to "Legal Capital" Presentation

F. There are two general types of stock, ***common stock*** and ***preferred stock***. They both represent owners' equity in the corporation, but they differ in regard to the legal rights the stockholders have regarding dividends and voting at the annual meeting.

1. ***Common stock*** is always issued, and will be reported on every corporation's balance sheet. While not a normal practice, it may be issued in different ***classes*** (for example, *class A common*, *class B common*, etc.). When it is, rights will differ for some classes of stock. For example, class B common stock may not have voting rights while class A common stock does.

2. ***Preferred stock*** is another type of stock. Not every corporation issues preferred stock, so it may or may not be present on an individual corporation's balance sheet.

   a. Preferred stock is NOT called "preferred" because it is somehow "better" than common. The word is used because the law gives the holders of preferred stock ***legal preference*** (also called *priority*) over common stockholders in regard to normal dividends from earnings as well as final liquidating dividends. *Preference* is a legal term, and in this case it means that preferred shareholders must be paid all of the dividends due to them before any dividends can be paid to common stockholders. In other words, they come "first" (which is where the term "priority" comes

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from), receiving "preference" over common stockholders when dividends are distributed.

b. In order to determine the amount that should be paid to preferred stockholders, the normal dividend for the year is usually stated as a *percentage of par value*. For example, 5% preferred stock with a $100 par value will pay $5 per share in dividends ($100 x 5% = $5). It is also possible for preferred to be no-par stock. In this case, the dividend amount is stated. For example, our stock, if it had no par value, would no longer be referred to as "5% preferred." Instead, it would be called "$5 preferred stock."

c Since interest rates are used to determine the preferred stock dividend, and since the preferred stockholders receive only that dividend amount no matter how much the corporation earns, preferred stock is similar to notes payable. However, there is a big difference between debt instruments and equity securities. Creditors can sue the corporation if the interest is not paid in full and on time. Stockholders cannot sue the corporation for dividends if the Board decides they should not be paid and refuses to declare them (this is called "passing" the dividend). Preferred stockholders cannot sue the corporation if their dividends are not paid, so preferred is clearly an equity security. However, because of the features it has in common with notes payable, it is sometimes referred to as a "hybrid security."

d. As explained above, preferred stockholders do not have a legal right to be paid the stated preferred stock dividend and so cannot sue the corporation if dividends are passed. However, the preferred stock may have been made ***cumulative*** preferred. If it is *cumulative* stock, then dividends not paid in the past *accumulate* and must be paid before any dividends can be distributed to common stockholders in the future. The amount of the ***dividends in arrears*** (the accumulation from prior years) will be disclosed in the financial statements, usually in a footnote. Remember, like the current year preferred stock dividends, they must be paid to the preferred

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stockholders before any dividends can be distributed to the common stockholders.

Here's an Example! ABC Corporation has 100,000 shares of common stock outstanding, along with 1,000 shares of 5% $100 par value preferred stock. Therefore, when dividends are distributed, preferred stockholders will receive $5 per share, or $5,000 in total, before any dividends can be paid to the common stockholders. The following table illustrates the effect of the cumulative feature. In the first set of columns, the preferred stock is assumed to be non-cumulative. In the second set the preferred stock is assumed to be cumulative.

			Preferred Stock is Non-Cumulative			Preferred Stock is Cumulative		
Year	Total Dividends Declared		Paid To Preferred	Paid To Common		Paid To Preferred	Paid To Common	Dividends in Arrears
1	$ 10,000		$ 5,000	$ 5,000		$ 5,000	$ 5,000	$ 0
2	$ 5,000		$ 5,000	$ 0		$ 5,000	$ 0	$ 0
3	$ 1,000		$ 1,000	$ 0		$ 1,000	$ 0	$ 4,000
4	$ 5,000		$ 5,000	$ 0		$ 5,000	$ 0	$ 4,000
5	$ 10,000		$ 5,000	$ 5,000		$ 9,000	$ 1,000	$ 0
6	$100,000		$ 5,000	$ 95,000		$ 5,000	$ 95,000	$ 0
Total	$131,000		$ 26,000	$ 105,000		$ 30,000	$101,000	

This example illustrates two things: (1) the differences between non-cumulative and cumulative preferred stocks, and (2) the more fundamental difference between common and preferred stocks. First, note that the cumulative feature protects preferred stock investors. While it cannot guarantee that they will receive their 5% return on their investment (corporations can always go bankrupt), it does ensure that the 5% dividend will eventually be received (if the corporation remains in business). The bigger picture here concerns the fundamental difference between preferred and common stock. While common's returns do fall to zero in the "bad years," the common stockholders overall returns are not limited to a percentage of par value in the "good years." When earnings and dividends soar, the common stockholders benefit tremendously. In this case, the total dividends paid to common stockholders over all six years are more than three times the amount paid to preferred! We should expect that the market value of the common stock, while being much more volatile, will also increase tremendously in year 6. The preferred stock's market value will probably not change much at all, even during year 6. After all, the preferred stock dividend will remain just $5 per share no matter how much profit the corporation earns..

Who should invest in common stock? The "gun-slinger" investors who can withstand a few years of poor returns in order to reap the large returns later on. Who should invest in preferred stock? Those who need the annual dividend for living expenses and who cannot accept the higher risks associated with common stock investments.

e. Preferred can also be ***convertible*** (shareholders may exchange their preferred shares for a preset number of common shares).

f. Preferred may also be ***callable*** (the corporation can force shareholders to surrender their shares at a preset price, called the ***call price***). If called, the preferred stockholder will receive the call price, any dividends in arrears, and a proportionate share of the current year's dividend.

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g. In liquidation, preferred stockholders are entitled to the par value of their shares, or the call price if one exists. They are also entitled to any dividends that might be *in arrears*.

h. Preferred stock generally does not have voting rights.

<back>

III. Earned Capital and Stock Issuances

A. Owners' equity (called ***stockholders' equity***) in corporations is divided into two categories: ***paid-in capital*** (received as an investment contribution from the stockholders) and ***earned capital*** (net income that has been retained in the business and was not distributed as dividends to the stockholders).

B. ***Retained Earnings*** is the name of the stockholder equity account that is used to record *earned capital*.

1. When the *Income Summary* account is closed at the end of the accounting period (see Modules 2 and 4 for a description of the closing process), the corporation's net income is transferred from *Income Summary* to the *Retained Earnings* account:

Income Summary	***$X***	
Retained Earnings		***$X***

2. Recall that the *legal capital laws* in many states in the US prevent the corporation from distributing paid-in capital to stockholders. This is why different accounts are used for the paid-in capital and the earned capital. If we can't distribute paid-in capital to the stockholders, we have to keep it separate from the earned capital!

a. Therefore, in order to pay a dividend, there must be a balance in *Retained Earnings* large enough to cover the dividend payment.

b. Any balance left in *Retained Earnings* represents earnings that have not been paid out to stockholders in the form of dividends. The Board may pay this amount out at a later date, or it may decide to retain these earnings permanently,

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using them to pay operating expenses or to finance the expansion of the business.

c. This means that an existing balance in *Retained Earnings* does *not* represent cash reserves, since the cash may have been used for other things or may still be tied up in receivables.

3. A debit balance in *Retained Earnings* (which could result from losses) is called a ***deficit.*** It is not a good sign, but it does not mean that the corporation is bankrupt. Cash may still be available to pay bills as they come due.

4. Other acceptable titles for the *Retained Earnings* account are *Retained Income*, *Accumulated Earnings* or *Earnings Retained for Use in the Business*. The term *Surplus* is antiquated and should not be used.

C. ***Paid-in Capital***. When common or preferred stock is issued to stockholders who have contributed assets to the corporation, an asset account (or accounts) is debited and *paid-in capital* accounts are credited.

1. The ***Common Stock*** or ***Preferred Stock*** account is always credited for the par value (or stated value) of the shares issued. ***Paid-In Capital in Excess of Par Value*** is credited for any excess over par or stated value:

Asset (Cash, Equipment, etc.)	***$X***	
Common (or Preferred) Stock		***$X***
Paid-in Capital in Excess of Par Value		***$X***

2. If the stock has a ***stated value*** instead of a *par* value, *Common Stock* is credited for the stated value of the shares issued, and a ***Paid-in Capital in Excess of Stated Value*** account is used for the excess over stated value. Otherwise the entry is the same as shown above:

Asset (Cash, Equipment, etc.)	***$X***	
Common (or Preferred) Stock		***$X***
Paid-in Capital in Excess of Stated Value		***$X***

3. If the stock is ***no-par stock***, a *Paid-in Capital in Excess* account is not used. Instead, the full amount of the cash received is entered in the *Common* (or *Preferred*) *Stock* account:

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Asset (Cash, Equipment, etc.)	***$X***	
Common (or Preferred) Stock		***$X***

4. When stock is issued for ***assets other than cash*** (equipment, land, buildings, etc.), the new assets should be recorded at either their estimated *fair market values* or the market value of the stock that is issued, depending on which is the better estimate.

   a. Theoretically, the assets' market values should be equal to the market value of the shares issued. However, because they are only estimates, the two values are likely to differ. When they do, the estimate that is deemed to be the better of the two is used to value the transaction. This is all in keeping with the *Cost Principle*.

   b. For example, suppose Corporation A issues 10,000 shares of $5 par value common stock in exchange for land that has a estimated fair market value of $100,000. The corporation's stock is actively traded, and it was trading at $9 per share in the stock market at the time of the exchange. This $9 per share value is known with certainty, and it should be used to "cost" the land at $90,000. After all, stock that was "worth" $90,000 was issued to acquire the land, so the *Cost Principle* would require us to value the land at this amount:

Land	*$90,000*	
Common Stock		*50,000*
Paid-in Capital in Excess of Par Value		*40,000*

   However, if the stock is not actively traded its market value on the date of issue will be uncertain. If the estimated fair value of the land is determined to be the more reliable estimate, then we would assume that the stock must have been worth $100,000 since it was exchanged for an asset that was worth $100,000. Now we will value the land at its estimated fair market value:

Land	*$100,000*	
Common Stock		*50,000*
Paid-in Capital in Excess of Par Value		*50,000*

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D. ***Paid-in Capital and Earned Capital on the Balance Sheet***

1. Paid-in capital accounts are separated from the earned capital accounts when the stockholder's equity section of the balance sheet is prepared. The format is as follows:

Preferred Stock, $X par value, X shares authorized and issued	$X	
Paid-In Capital In Excess of Par Value – Preferred Stock	$X	
Common Stock, $X par value, X shares authorized and issued	$X	
Paid-In Capital In Excess of Par Value – Common Stock	$X	
Total Paid-In Capital		$X
Retained Earnings		$X
Total Stockholders' Equity		$X

Here's a Comprehensive Example!

Part I. Paid-In Capital Accounts.

Tops Corporation is authorized to issue 100,000 shares of $2 par value common stock and 10,000 shares of $100 5% preferred stock. We will journalize several stockholder transactions, then prepare the corporation's balance sheet.

a. The corporation begins operations by issuing 5,000 shares of common stock at $3 per share, receiving $15,000:

Cash	***15,000***	
Common Stock		***10,000***
Paid-In Capital in Excess of Par Value - CS		***5,000***

b. The corporation issues 80 shares of preferred stock, receiving $12,000:

Cash	***12,000***	
Preferred Stock		***8,000***
Paid-In Capital in Excess of Par Value - PS		***4,000***

c. The corporation issues 1,000 shares of common stock in exchange for a machine valued at $3,000. The stock's market price is $3 per share:

Machine	***3,000***	
Common Stock		***2,000***
Paid-In Capital in Excess of Par Value - CS		***1,000***

Let's now prepare the Stockholders' Equity section of the corporate balance sheet:

Stockholders' Equity	
Preferred Stock, $100 par value, 10,000 shares authorized, 80 shares issued and outstanding	***$ 8,000***
Paid-In Capital In Excess of Par Value – Preferred Stock	***4,000***
Common Stock, $2 par value, 100,000 shares authorized, 6,000 issued and outstanding	***12,000***
Paid-In Capital In Excess of Par Value – Common Stock	***6,000***
Total Paid-in Capital	***30,000***
Retained Earnings	***0***
Total Stockholders' Equity	***30,000***

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IV. Treasury Stock

A. Corporations sometimes purchase shares of their own stock from existing stockholders, conducting the transaction in the open market. In the "old days," the stock certificates were held in the Treasurer's safe, and were referred to as shares of ***treasury stock***.

1. Purchases of Treasury Stock result in distributions of cash to shareholders. The only other way cash distributions to stockholders may occur is through the payment of dividends.

2. Like dividends, the purchase of *Treasury Stock* represents a distribution of earned capital and the amount that can be paid out is restricted by *legal capital* requirements.

3. *Treasury stock* is still considered to be *issued* stock, but it is no longer *outstanding*. It therefore does *not* receive dividends and *cannot* be voted at stockholder meetings.

4. The entry to record treasury stock purchases requires a debit to ***Treasury Stock*** and credit to *Cash* for the cost of the shares:

Treasury Stock	***$X***	
Cash		***$X***

5. *Treasury Stock* is a "negative" stockholder equity account (a stockholder equity account with a normal debit balance). It represents a distribution of earned capital, and it does reduce the amount of retained earnings that would otherwise be available for dividend payments.

a. To disclose this, the *Treasury Stock* account balance is subtracted from the *Retained Earnings* account balance at the bottom of the stockholder equity section of the balance sheet:

Common Stock, $X par value, X shares authorized and issued		$X
Paid-In Capital In Excess of Par Value – Common Stock		X
Total Paid-In Capital		$X
Retained Earnings	$X	
Less: Treasury Stock	(X)	X
Total Stockholders' Equity		$X

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a. You may wonder why the *Retained Earnings* account is not debited directly when the treasury shares are purchased. That is, if the purchase represents a distribution of earned capital to the stockholders, why not debit *Retained Earnings* in the entry above? Why do we want to have a *Treasury Stock* account to report on the balance sheet along with *Retained Earnings*?

b. Unlike dividends, treasury share purchases are only <u>temporary</u> distributions of earned capital to the stockholders. At some point, the treasury shares will be reissued (sold, that is, on the open market), and the amount that was distributed will be recovered. Therefore, we use the Treasury Stock account to "store" the amount that was distributed until the shares are reissued. At that time, we will reduce *Treasury Stock* and "return" the earned capital to the corporation. This process is illustrated below.

6. When treasury stock is reissued, *Cash* is debited for the amount received, and *Treasury Stock* is credited for the *original cost* of the shares. (After all, it is the original cost of the shares that is in the *Treasury Stock* account, so that original cost amount must be taken out of the account when the shares are reissued). Amounts received in excess of cost are credited to a contributed capital account, *Paid-in Capital from Sale of Treasury Stock*:

Cash	***$X***	
Treasury Stock		***$X***
Paid-in Capital from Sale of Treasury Stock		***$X***

Return of distributed capital + additional investment

Additional investment

Note that the sale of treasury stock "returns" the previously distributed earned capital to the corporation, making it available again for the payment of dividends. However, amounts received in excess of the original cost do *not* represent a return of earned capital. These excess amounts are new capital investments made by the buyers of the treasury shares. They represent paid-in capital that is not available for dividends.

7. Treasury stock is not always reissued for an amount that is greater than the amount of earned capital that was originally distributed. If treasury stock is reissued for less than original cost, the debit difference between cash received and original cost goes to *Paid-in Capital from Sale of Treasury Stock*:

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Cash	***$X***	
Paid-in Capital from Sale of Treasury Stock	***$X***	
Treasury Stock		***$X***

In essence, the Paid-in Capital from Sale of Treasury Stock account "keeps track" of the overall excess amount received upon the reissuance of the shares.

Here's a Brief Treasury Stock Example!

Suppose ABC Corporation purchases 100 treasury stock shares at $10 per share. The entry is:

Treasury Stock	*1,000*		
Cash		*1,000*	

Later, 20 shares are reissued for $12 per share. The entry is:

Cash	*240*		
Treasury Stock (20 x $10)		*200*	
Paid-in Capital from Sale of Treasury Stock		*40*	

Note that the excess amount received, $40, is equal to $2 per share. Suppose that another 20 shares are reissued later on, but this time for $9 per share. The entry is:

Cash	*180*		
Paid-in Capital from Sale of Treasury Stock	*20*		
Treasury Stock (20 x $10)		*200*	

Since the shares were issued for less than the amount that was originally distributed, a debit difference results in the entry. This $20 debit is recorded in the Paid-in Capital from Sale of Treasury Stock account, reducing its balance from $40 (credit) to $20 (credit).

Overall, 40 treasury shares have been reissued for a total of $420 ($240 + $180). The original cost of these shares was $400 (40 shares x $10 per share). Therefore, the $20 balance in the Paid-in Capital from Sale of Treasury Stock account is correct: overall, 40 shares of treasury stock were reissued, and $20 in excess of the original cost of the shares was received upon the reissuance of these 40 shares.

8. If the balance in *Paid-in Capital from Sale of Treasury Stock* is not sufficient to absorb all the debit difference, the remainder goes to *Retained Earnings*. This is appropriate, since it is obvious that less earned capital was recovered from the sale of the shares than was

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distributed when they were purchased. This means that a permanent distribution of assets to stockholders has occurred, and permanent distributions are recorded in the *Retained Earnings* account. The entry is:

Cash	***$X***	
Paid-in Capital from Sale of Treasury Stock	***$X***	
Retained Earnings	***$X***	
Treasury Stock		***$X***

Let's Continue Our Brief Example!
Suppose ABC Corporation reissues another 20 shares of the treasury stock, but this time receives only $6 per share. Remember, the existing balance in the Paid-in Capital from Sale of Treasury Stock account is only $20 (credit). The entry to record this reissuance is:

Cash	*120*		
Paid-in Capital from Sale of Treasury Stock	*20*		
Retained Earnings	*60*		
Treasury Stock (20 x $10)		*200*	

Since the shares were issued for less than the amount that was originally distributed, a debit difference results in the entry. This $20 debit is recorded in the Paid-in Capital from Sale of Treasury Stock account, reducing its balance from $40 (credit) to $20 (credit).

Now, a total of 60 treasury shares have been reissued for $540 ($240 + $180 + $120). The original cost of these shares was $600 (60 shares x $10 per share). Therefore, the $60 of the earned capital that was originally distributed has not been returned. Since the shares have been reissued, it can never be recovered. It is clear that $60 of earned capital has been permanently distributed to shareholders, and Retained Earnings should therefore be reduced accordingly.

9. The stockholder's equity section of the balance sheet, with treasury stock accounts included, is as follows:

Paid-In Capital In Excess of Par Value – Preferred Stock	$X	
Common Stock, $X par value, X shares authorized and issued	$X	
Paid-In Capital In Excess of Par Value – Common Stock	$X	
Paid-In Capital from Sale of Treasury Stock	$X	
Total Paid-In Capital		$X
Retained Earnings	$X	
Deduct Treasury Stock (X shares at cost)	(X)	$X
Total Stockholders' Equity		$X

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Comprehensive Example, Continued

Part II. Earned Capital Accounts

Tops Corporation's paid-in capital account transactions were presented earlier. We will now continue the example, adding transactions that involve *Retained Earnings* and *Treasury Stock*. Remember that Tops Corporation is authorized to issue 100,000 shares of $2 par value common stock and 10,000 shares of $100 5% preferred stock. In the transactions above, 6,000 shares of common stock and 80 shares of preferred were issued. We will now journalize several earned capital transactions, and then prepare the corporation's balance sheet.

Continued from previous example:

d. The corporation purchases 500 shares of its own common stock to hold as treasury shares, paying $4 per share:

Treasury Stock	***2,000***	
Cash		***2,000***

e. The corporation reissues 100 shares of the treasury stock, receiving $5 per share:

Cash	***500***	
Treasury Stock		***400***
Paid-In Capital from Sale of Treasury Stock		***100***

f. The corporation reissues 50 shares of the treasury stock, receiving $3 per share:

Cash	***150***	
Paid-In Capital from Sale of Treasury Stock	***50***	
Treasury Stock		***200***

g. The corporation completes the closing process, and transfers the $20,000 credit balance in Income Summary into the Retained Earnings account.

Income Summary	***20,000***	
Retained Earnings		***20,000***

h. The balance sheet is prepared. The Stockholders' Equity section is as follows:

Stockholders' Equity		
Preferred Stock, $100 par value, 10,000 shares authorized, 80 shares issued and outstanding		***$ 8,000***
Paid-In Capital In Excess of Par Value – Preferred Stock		***4,000***
Common Stock, $2 par value, 100,000 shares authorized, 6,000 issued, 5,650 outstanding		***12,000***
Paid-In Capital In Excess of Par Value – Common Stock		***6,000***
Paid-In Capital from Sale of Treasury Stock		***50***
Total Paid-In Capital		***30,050***
Retained Earnings	***$20,000***	
Deduct Treasury Stock (350 shares at $4 cost)	***(1,400)***	***18,600***
Total Stockholders' Equity		***$48,650***

Click the link below to play a video presentation that "walks you through" the example above.

Link to "Stock Issuances and Treasury Stock" Presentation

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V. Accounting for Dividends

A. ***Dividends*** are distributions of corporation assets to the corporation's shareholders. *Regular dividends* are almost always cash payments that represent distributions of earned capital (net income). They are usually paid quarterly. *Liquidating dividends* are distributed to stockholders at the end of the corporation's life. When the corporation is dissolved, its assets are liquidated (sold for cash) and the proceeds are used to pay the corporate liabilities. The remaining cash (or other assets) are then distributed to the stockholders. The distribution of a regular dividend or a liquidating dividend results in a permanent decrease in assets and a permanent decrease in the ***Retained Earnings*** account balance.

1. Dividends must be ***declared*** by the board of directors (this is usually done quarterly).

2. There are several important ***dates*** associated with dividends:

   a. ***Declaration date*** – the date the dividends are "declared" (announced) by board. This will be the date of the board meeting at which the dividends are approved. At this point the dividend payment becomes a legal liability. Following the declaration, stockholders can sue if the dividend is not paid.

   b. ***Date of record*** – the date by which the stockholders must be registered owners in the corporation's records (referred to as "owners of record") in order to receive the dividend. For example, the corporation might declare a dividend on July 1, payable to stockholders of record on July 31. In this case, July 1 is the declaration date, and July 31 is the date of record. Only stockholders who, according to the corporation's records, own the stock on July 31 will receive the dividend.

   c. ***Ex-dividend date*** -- the date on which a buyer of the stock is no longer entitled to the dividend. In the US, this date is two business days prior to the date of record. For example, if the date of record is Friday, July 31, the stock goes *ex-dividend* on Wednesday, July 29. Buyers of the stock on July 29 or later will not receive the dividend.

   d. ***Payment date*** – the date the dividends will actually be distributed.

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Why Do Ex-dividend Dates Exist?

It takes time for stock purchase and sale transactions to be processed. The corporation's stock ownership records have to be changed and the buyer's payment has to clear the bank before the ownership change becomes official. It often takes a day or two before this can occur and the transaction becomes *settled*. Prior to *settlement*, the seller of the stock is still the legal owner, and is entitled to receive dividends. After settlement, the buyer can claim the dividend.

Actual settlement times vary a good deal, depending on the circumstances of each transaction. Some might occur almost instantly, while others may take a few days.

Suppose it is Tuesday, January 11, and you want to buy the stock of Corporation X. The corporation has declared a dividend of $1 per share, payable to stockholders of record on Thursday, January 13. In order to determine the price you are willing to pay for the stock, you will have to know whether your transaction be settled in time for you to receive the dividend. If it is, you will be willing to pay $1 more for each share than you will be willing to pay if you don't get the dividend. If you do buy the stock on January 11, will the transaction be settled in time for you to receive the dividend?

If there were no rules regarding settlement and if an ex-dividend date did not exist, you would not be able to answer this question. You and every other stock market investor would not know how to price the stock, and trading would grind to a standstill every time a dividend record date was reached.

To prevent this, the US stock market exchanges have ruled that stock trades will be *settled* in three business days. This means that if you purchase a stock in the US on Monday, January 10, the transaction will settle on Thursday, January 13, no matter how long quickly or how long it actually takes for the paperwork to be completed. However, if you buy on Tuesday, January 11, the transaction will not settle until Friday, January 14.

Thanks to this rule, you now know with certainty that you will *not* be the registered owner of the stock on January 13 and you will *not* receive the dividend. The stock will begin to trade *ex-dividend* on the very day that you make the purchase.

B. Under legal capital requirements a balance at least equal to the amount of the dividend must exist in *Retained Earnings* (and any other stockholders' equity accounts that do not constitute legal capital, according to the state laws) before the dividend can be declared. Of course, cash must also be available in order to make the payment.

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C. ***Accounting for Cash Dividends***

1. ***On the declaration date*** the dividend payment becomes a legal liability and must be recorded. A *Dividends Payable* account is used to record the liability, and it will be reported as a current liability on the balance sheet. Dividends represent a permanent payout of earned capital, so *Retained Earnings* will be reduced directly (and permanently) as a result of the dividend payment. However, in order to provide a separate record of the current year's dividends a special *Dividends* account is usually debited when the dividend is declared, instead of Retained Earnings:

Cash Dividends	***$X***	
Dividends Payable		***$X***

The *Dividends* account is only used for "temporary storage," and it is closed into *Retained Earnings* at the end of the year (see below). This special, temporary account allows the corporation to keep track of the amount of dividends that have been declared during the current accounting period.

2. ***On the ex-dividend date*** no entry is made, since nothing affects the corporation's accounts when the stock goes ex-dividend.

2. ***On the payment date*** cash is distributed and the liability is paid down:

Dividends Payable	***$X***	
Cash		***$X***

3. When the ***closing entries*** are made, the *Cash Dividends* account is closed into *Retained Earnings*. The dividends have now made their way into the actual *Retained Earnings* account, permanently reducing the balance in the account:

Retained Earnings	***$X***	
Cash Dividends		***$X***

4. The net effect of these entries is to reduce cash assets and to reduce *Retained Earnings* by the amount of the dividends that were declared and distributed.

D. ***Stock Dividends***. If the business does not have enough cash to pay a cash dividend to the stockholders, ***stock dividends*** (newly issued shares of stock) may be declared instead. Stock dividends also decrease the

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Retained Earnings account, but because cash is not paid out there is no liability to record.

1. Because *stock dividends* do not result in a distribution of assets to shareholders, they are "costless" to the corporation and "valueless" to shareholders.

This is confusing! How can a dividend have no value?

Think of it this way. If you and I buy a pizza for $10 and cut it into two slices, each slice is "worth" $5. The value of your slice is $5, and the value of mine is $5. If we cut the pizza into four slices, we have done nothing that affects the value of the entire pizza. It is still a $10 pizza, but each of the 4 slices is now worth only $2.50. You have two slices that are worth $2.50 each (a total of $5), and I have two that are worth the same amount. We are no better off than we were before.

Let's pretend that you and I have formed a corporation, and that there are only two shares of stock that have been issued. You own one share and I own the other. The value of each share in the stock market is $10,000,000. Therefore, the entire corporation can be purchased for $20,000,000 (we'll assume that you and I are both willing to sell our stock). This $20,000,000 is referred to as the corporation's market value. The market value of the business is determined by the value of the assets it owns, and the value of the earnings and dividends it can produce.

Let's now say that because cash is not available, we decide to issue ourselves a stock dividend instead of a cash dividend. We declare a 100% stock dividend, which means that we issue one new share of stock to you and one new share to me. There are now 4 shares of stock outstanding, instead of two.

Assets and earnings have not gone up simply because we issued the new shares, so nothing has happened that will affect our corporation's market value. It was $20,000,000 before the stock dividend, and it will be $20,000,000 after the stock dividend. The value of each individual share of stock, though, has been affected. While there were previously two shares of stock that were worth a total of $20,000,000, there are now four that are worth $20,000,000. The value of each share has fallen from $10,000,000 to $5,000,000. You have two shares that are worth $5,000,000 each (a total of $10,000,000), and I have two that are worth the same amount. We are no better off after we receive the stock dividend than we were before.

The effect of issuing a stock dividend, whether it is large or small, is always the same. The overall market value of the company does not change, and so the stockholders wind up with more shares that have the same total value as the shares that were previously owned. Why issue a stock dividend then? Maybe the Board of Directors issues a stock dividend to appease unsophisticated investors who don't understand that they're not really getting anything?

2. When small stock dividends are declared (20% or less), the ***Stock Dividends*** account is debited for the *market value* of the shares that will be issued. *Stock Dividends*, along with the *Cash Dividends* account, is closed into *Retained Earnings* at the end of the period. Since new shares will be distributed on the payment date instead of

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cash, ***Common Stock Distributable*** is credited instead of *Dividends Payable*:

Stock Dividends	***$X***	
Common Stock Distributable		***$X***
Paid-in Capital in Excess of Par -- Common Stock		***$X***

a. You may wonder why we don't just credit Common Stock instead of the special *Common Stock Distributable* account. Remember, the balance in *Common Stock* is always the par or stated value of the shares that have been issued. Therefore, *Common Stock* cannot be credited because the shares have not yet been issued.

b. The par or stated value of the shares is "parked" temporarily in *Common Stock Distributable* until the shares are issued. At that time, it can be moved into *Common Stock*.

c. The regular *Paid-in Capital in Excess of Par Value* account is credited for any excess of market value over par or stated value. This account, along with *Common Stock Distributable*, is a paid-in capital account, not a liability account.

3. On the distribution date, the stock is issued. This means the balance in the *Common Stock Distributable* account can now be moved into the *Common Stock* account:

Common Stock Distributable	***$X***	
Common Stock		***$X***

4. When the closing entries are made, the *Stock Dividends* account is closed into *Retained Earnings*:

Retained Earnings	***$X***	
Stock Dividends		***$X***

5. The net effect of these entries is to transfer earned capital (*Retained Earnings*) into contributed capital accounts (*Common Stock* and *Paid-in Capital in Excess of Par Value*). This is referred to as a *capitalization* of retained earnings, and it reduces the corporation's legal capital. Since this could result in fewer cash dividends being paid to stockholders later on, not only does a stock dividend not help the stockholders, it can actually hurt them!

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Continuing the Example!

Tops Corporation's stock issuances and treasury stock transactions were recorded in the previous continuing examples. We will now illustrate transactions related to dividend declarations. Remember that Tops Corporation has issued 6,000 shares of $2 par value common stock and 80 shares of $100 par value 5% preferred stock. Also, the company holds 350 treasury stock shares, so there are only 5,650 shares of common stock outstanding. We will now journalize the following dividend transactions, and then prepare the corporation's balance sheet.

a. The corporation declares the annual dividend on the preferred stock and a $.10 per share dividend on the common stock. (Remember, only outstanding shares receive the dividend.)

Cash Dividends	***965***	
Preferred Stock Dividends Payable		***400***
Common Stock Dividends Payable		***565***

Preferred dividends = 5% x $100 par = $5 x 80 shares = $400
Common dividends = $.10 x 5,650 shares = $565.

b. The corporation pays the dividends:

Preferred Stock Dividends Payable	***400***	
Common Stock Dividends Payable	***565***	
Cash		***965***

c. The corporation declares a 10% stock dividend on the common stock:

Stock Dividends	***1,695***	
Common Stock Distributable		***1,130***
Paid-In Capital in Excess of Par Value - CS		***565***

10% x 5,650 shares = 565 new shares x $3 market price = $1,695 market value.
565 new shares x $2 par value = $1,130 par value.

d. The corporation issues the stock dividend shares:

Common Stock Distributable	***1,130***	
Common Stock		***1,130***

e. The corporation closes the "Cash Dividends" and "Stock Dividends" accounts into the "Retained Earnings" account:

Retained Earnings	***2,660***	
Cash Dividends		***965***
Stock Dividends		***1,695***

h. Prepare the Stockholders' Equity section of the corporate balance sheet.

Stockholders' Equity		
Preferred Stock, $100 par value, 10,000 shares authorized, 80 shares issued and outstanding		***$ 8,000***
Paid-In Capital In Excess of Par Value – Preferred Stock		***4,000***
Common Stock, $2 par value, 100,000 shares authorized, 6,565 issued, 6,215 outstanding		***13,130***
Paid-In Capital In Excess of Par Value – Common Stock		***6,565***
Paid-In Capital from Sale of Treasury Stock		***50***
Total Paid-In Capital		***31,745***
Retained Earnings	***17,340***	
Deduct Treasury Stock (350 shares at cost)	***(1,400)***	***15,940***
Total Stockholders' Equity		***$47,685***

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Click the link below to play a video presentation that walks you through the example above.

Link to "Dividend Declaration" Presentation

VI. Other Topics: Splits, Appropriations, Dividend Ratios

A. ***Stock Splits***. Stock prices can become quite large over time, and if they become too large trading in the shares can be stifled. One way to reduce the price per share without harming stockholders is the issuance of a large stock dividend (see above). This, though, results in a capitalization of retained earnings, reducing the corporation's legal capital. A better way to achieve the same effect would be to *split* the stock.

1. When the stock is ***split***, the old shares are called in and replaced with a greater number of new shares that carry a proportionately lower par or stated value.

2. For example, a 2-for-1 stock split means that two new shares will be issued for every current share. The new shares will carry a par or stated value that is ½ the par or stated value of the old shares. In the case of a 3-for-1 split, 3 new shares will be issued and each will carry a par or stated value that is 1/3 the previous amount.

3. With a 2-for-1 split, there will be twice as many shares outstanding after the split, but the par value will be half of what it used to be. With a 3-for-1 split, there will be three times as many shares after the split, and the par value will be one third as much as it was before. Therefore, when the stock is split, the total par value of the stock issued does not change. This means that the balance in *Common Stock* does not change.

4. Since the balance in the *Common Stock* account does not change when the stock is split, *a journal entry is not required to record the split*. However, the number of shares issued and outstanding and the par (or stated) value do change, and these new figures will be reported on the balance sheet. If Tops Corporation split its $2 par value stock 2-for-1, the balance sheet from the illustration above would now report the following:

Common Stock, $1 par value, 100,000 shares authorized, 13,130 issued, 12,430 outstanding	***13,130***

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5. It is necessary to amend the corporate charter in order to split the stock, which requires the approval of the state government.

B. ***Restrictions on Retained Earnings***

1. Retained earnings may be ***restricted*** (or ***appropriated***) by the Board. This means that some portion of the corporation's earned capital that would otherwise be available for the payment of dividends has been restricted for other internal uses.

2. Such restrictions must be disclosed, either through footnote disclosure or on the face of the balance sheet. Note that the total earned capital of the corporation is not reduced because of these restrictions, though the corporation's ability to pay dividends has been diminished.

C. **Retained Earnings Statement**

1. A *statement of retained earnings* is similar to the *statement of owner's equity* that was prepared in earlier modules for a sole proprietorship.

2. The Statement of Retained Earnings merely presents the beginning balance in the *Retained Earnings* account, and then lists all the transactions that either increased or decreased the account's balance during the accounting period. The end result will be equal to the ending balance in the *Retained Earnings* account.

3. For Tops Corporation, the statement will appear as follows:

Tops Corporation
Retained Earnings Statement

Retained earnings, beginning balance		$0
Net income	$20,000	
Less: Cash dividends	(965)	
Stock dividends	(1,695)	
Increase in retained earnings		17,340
Retained earnings, ending balance		$17,340

D. ***Prior period adjustments*** result from errors made in prior periods. Adjusting entries are necessary in the current period to correct the account balances that are now wrong because of these past errors. *Prior period*

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adjustments are not reported on the income statement. They are recorded by making a journal entry directly to *Retained Earnings* and are reported on the ***Retained Earnings Statement***.

E. Investors are interested in the *rate of return* they earn on their investments. The ***dividend yield ratio*** measures the percentage rate of return an investor earns from the dividend he or she receives from their stock investment. Dividend yields are usually rather meager, and are sometimes zero because some companies pay no dividends at all. Remember, though, that investors expect to sell their shares in the future at a profit. This gain is also instrumental in determining the rate of return the investor will earn on the stock investment.

$$\textbf{\textit{Dividend Yield}} = \frac{\textbf{\textit{Cash Dividend per Share}}}{\textbf{\textit{Market Price per Share}}}$$

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