Accounting Fundamentals Lesson 9

9.0 Stockholders' Equity

This lesson covers the accounting for stockholders' equity of a corporation.

Features of a corporation:

Corporations differ from proprietorships and partnerships in several ways.

1. First, a corporation is a separate legal entity that exists apart from its owners, the stockholders.

2. Corporations also have continuous lives regardless of changes in their ownership.

3. Stockholders have limited liability, which means they have no personal obligation for corporate liabilities.

4. Additionally, a separation of ownership exists, as stockholders own the corporation and the board of directors appoints officers to manage the business.

5. Corporations are taxed separately from their owners and are subject to double taxation on their income to the extent they are distributed to shareholders in the form of dividends.

6. Federal and state governments monitor corporations more closely than other types of business in that many corporations are required to disclose financial information.

Organizing a Corporation:

Incorporators organize a corporation by obtaining a charter from the state.

The charter includes the authorization for the corporation to issue a certain number of shares of stock.

A share of stock is the basic unit of ownership for a corporation.

The incorporator:

- Pays any necessary fees
- Signs the charter
- Files the applicable documents with the state
- Agrees to a set of bylaws, which is the constitution governing the company

When this is all done, the corporation then comes into existence.

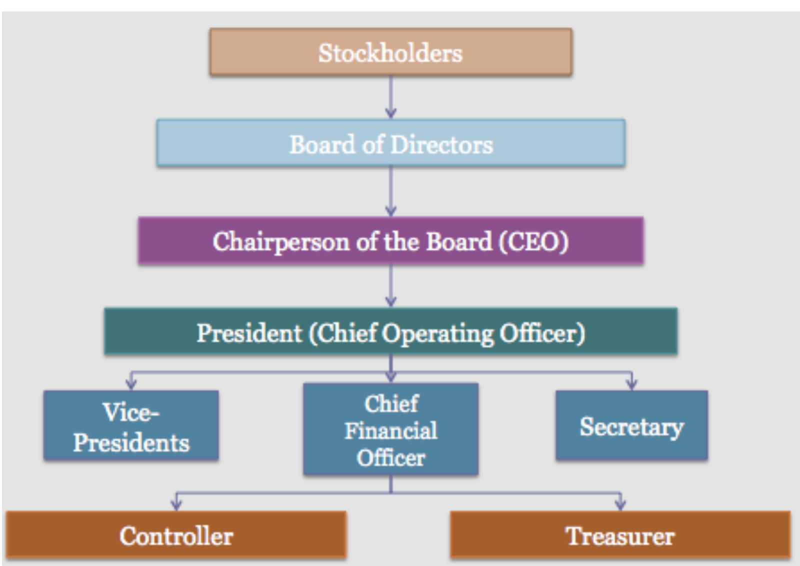
Ultimate Control of the corporation rests with the stockholders who elect a board of directors that sets company policy and appoints officers.

The Board elects a chairperson who usually is the most powerful person in the organization.

The chairperson of the board of directors has the title chief executive officer or CEO.

The board of directors also designates the president, who is the chief operating officer COO. The COO is in charge of day-to-day operations

Most corporations also have vice presidents in charge of sales, manufacturing, accounting, and finance like the CFO.



Stockholders Rights:

Ownership of stock generally entitles stockholders to four basic rights:

- To vote
- To receive dividends
- To receive a share of assets in liquidation
- To have a preemptive right of ownership.

Vote – The right to participate in management by voting on matters that come before the stockholders. This is the stockholder's sole voice in the management of the corporation. A stockholder gets one vote for each share of stock owned.

Dividends - The right to receive a proportionate part of any dividend. Each share of stock in a particular class receives an equal dividend.

Liquidation - The right to receive a proportionate share of any assets remaining after the corporation pays its liabilities in liquidation. Liquidation means to go out of business, sell the assets, pay all liabilities, and distribute any remaining cash to the owners.

Preemption - The right to maintain one's proportionate ownership in the corporation. Suppose you own 5% of a corporation's stock. If the corporation issues 100,000 new shares, it must offer you the opportunity to buy 5% (5,000) of the new shares.

Stockholders' equity represents the stockholders' ownership interest in the assets of a corporation.

Stockholders' equity is divided into two main parts:

- Paid-in-capital (the amount of equity the stockholders have contributed to the corporation)
- Retained earnings (the amount of equity the corporation has earned through profitable operations and has not used for dividends).

The owners' equity of a corporation is divided into shares of stock.

A corporation issues stock certificates to its owners when the company receives their investment in the business—usually cash.

The stock represents the corporation's capital so it is often called capital stock.

The basic unit of capital stock is a share. A corporation may issue a stock certificate for any number of shares—1, 100, or any other number—**but charter limits the total number of authorized shares.**

Classes of Stock:

Stock of a corporation may be:

- Common
- Preferred
- Par or no-par.

Common stock is the basic form of capital stock.

- Have the same basic rights of stock ownership

Preferred stock has advantages over common stock.

- Preferred stockholders receive dividends before the common stockholders
- Receive assets before the common stockholders if the corporation liquidates.

Par value refers to the arbitrary amount assigned by a company to a share of its stock. Par value is the nominal value of a security, which is determined by the issuing company to be its minimum price.

No-par stock does not have par value.

Most stock is issued above par value. Suppose a corporation issued its 50,000 shares of its $1 par stock for $300,000.

JOURNAL			
Date	Accounts and explanation	Debit	Credit
	Cash	300,000	
	Common Stock		50,000
	Paid-in Capital in Excess of Par - Common		250,000
	Issued stock above par value		

A company neither earns a profit nor incurs a loss when it sells it stock to, or buys stock from, its own shareholders.

- Amounts received in excess of amounts originally paid for treasury stock are recorded in paid-in capital from treasury stock transactions, thus bypassing the income statement.

- Amounts received from resale of treasury stock were less than amounts originally paid, are debited to paid-in capital to the extent of that balance, and after that, to retained earnings.

Stocks can be distinguished as:

- Authorized
- Issued
- Outstanding
- Treasury

Authorized stock - the maximum number of shares the company can issue under its charter. This is often set at a much higher number of shares than the company expects to issue to avoid having to go back to the state frequently for approval to issue more.

Issued stock - the number of shares the company has issued to its shareholders.

Outstanding stock – the number of shares that the stockholders own. Outstanding stock is issued stock minus treasury stock.

Treasury stock - is the company's own stock that it has issued and later reacquired.

Companies may purchase their own stock to:

- Give the stock to employees as part of a compensation plan
- Increase net assets by buying low and reselling higher later
- Avoid a takeover by an outside party
- Increase earnings per share
- Return excess cash to shareholders.

A corporation may purchase its own stock and retire it by canceling the stock certificates. Retired stock cannot be reissued.

A dividend is a distribution by a corporation to its stockholders and can take one of three forms

- Cash
- Stock
- Non-cash assets

Cash - Most dividends are cash dividends.

In order to pay a cash dividend, a company must have sufficient retained earnings to declare the dividend and enough cash to pay the dividend.

A corporation declares a dividend before paying it and only the board of directors has the authority to declare a dividend

This declaration date obligates the company to pay the dividend to shareholders on the date of record.

This date of record typically follows the declaration date by a few weeks. The payment date of the dividends usually follows the record date by a week or two.

Dividends may also be paid on preferred stock.

When a company has issued both preferred and common stock, the preferred shareholders receive their dividends first.

The common shareholders will receive dividends only if the total dividend is large enough to pay the preferred stockholders first.

Dividends on preferred stock are stated either as a percent of par value or as a dollar amount per share.

If preferred dividends are cumulative, owners of the cumulative preferred stock must receive all dividends in arrears (dividends that the corporation failed to pay in prior years) plus the current year's dividends before any dividends are paid to the common stockholders.

Stock – a stock dividend is a proportional distribution by a corporation of its own stock to its stockholders. Stock dividends increase the stock account and decrease Retained Earnings. Total equity is unchanged, and no asset or liability is affected.

- Stock dividends of 25% or less are considered as small
- Stock dividends above 25% are considered large

A corporation may choose to distribute stock dividends for these reasons:

1. To continue dividends but conserve cash. Stockholders pay no income tax on stock dividends.

2. To reduce the per-share market price of its stock. Distribution of a stock dividend usually causes the stock's market price to fall because of the increased number of outstanding shares that result from it. The objective is to make the stock less expensive and therefore attractive to more investors.

Stock Splits:

A stock split is an increase in the number of shares of stock authorized, issued, and outstanding with a corresponding proportionate reduction in the stock's par value.

For example:

If the company splits its stock 2 for 1, the number of outstanding shares is doubled and each share's par value is halved. A stock split, like a stock dividend, decreases the market price of the stock to make the stock more attractive in the market. No journal entry is prepared for a stock split. All account balances are the same after the stock split as before.

Stock values can be used for making decisions.

These values include:

- Market value
- Redemption value
- Liquidation value
- Book value

The market value - the stock's current selling price on the open market.

The redemption value - the price the company pays to purchase back its preferred stock.

Liquidation value - the amount that a company must pay a preferred shareholder in the event the company liquidates and closes.

The book value per share of common stock - the amount of owners' equity on the corporation's books for each share of stock.

To compare profitability of companies of different size, investors use profitability measures like return on assets and return on equity.

DuPont analysis provides a way to analyze various elements of profitability

The calculation for the return on assets (ROA) is:

$$\frac{\text{Net Income + Interest Expense}}{\text{Average Total Assets}}$$

The calculation for return on equity (ROE):

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