

## **CHAPTER 11: REPORTING AND INTERPRETING OWNERS' EQUITY**

### CHAPTER SUMMARY

This chapter discusses accounting for owners' equity for corporations. Each specific source of owners' equity should be accounted for separately. The two basic sources of owners' equity for a corporation are contributed capital (capital stock) and earned capital (retained earnings). Separate accounts are kept for each element of capital stock.

A corporation may purchase its own stock in the marketplace. Stock previously issued by the corporation and subsequently reacquired is known as treasury stock as long as the issuing corporation holds it. The purchase of treasury stock reduces corporate capital, and the subsequent resale of the treasury stock increases corporate capital.

The earnings of a corporation that are not retained for business expansion are distributed to the stockholders by means of dividends. Dividends are paid only after the board of directors of the corporation declares dividends. A cash dividend results in a decrease in assets (cash) and a commensurate decrease in stockholders' equity (retained earnings). In contrast, a stock dividend does not change assets, liabilities, or total stockholders' equity. A stock dividend results in a transfer of retained earnings to the permanent or contributed capital of the corporation. Therefore, a stock dividend affects only certain account balances within stockholders' equity. A stock split affects only the par value of the stock and the number of shares outstanding; the individual equity account balances are not changed.

Sole proprietorships and partnerships are discussed in Chapter Supplement A. Except for owners' equity items and details, accounting is basically unaffected by the type of business organization.

### CHAPTER OBJECTIVES

LO1 Explain the role of stock in the capital structure of a corporation.

LO2 Analyze the earnings per share ratio.

LO3 Describe the characteristics of common stock and analyze transactions affecting common stock.

LO4 Discuss dividends and analyze transactions.

LO5 Analyze the dividend yield ratio.

LO6 Discuss the purpose of stock dividends, stock splits, and report transactions.

LO7 Describe the characteristics of preferred stock and analyze transactions affecting preferred stock.

LO8 Discuss the impact of capital stock transactions on cash flows.

## CHAPTER OUTLINE

### I. UNDERSTANDING THE BUSINESS

1. Corporations are the dominant form of business organization in the terms of volume of operations.
2. Participation in corporate ownership commences by purchasing stock.
3. Advantages of the corporate form of business:
  - a. Ease of Transfer: Stock ownership can be transferred (sold) easily through established markets (stock exchanges).
  - b. Limited liability for owners: The maximum a stockholder stands to lose is the investment in the stock.
  - c. Since a corporation is a separate legal entity, it enjoys continuity of life (separate from its owners).
  - d. Corporations have the ability to raise substantial amounts of capital through debt and equity issues.
  - e. Corporations offer the ability for owners to earn high returns on their investments. However, this is not without risk and can result in losses to owners.
4. There are two primary sources of stockholders' equity.
  - a. Contributed capital constitutes amounts received from shareholders in exchange for stock ownership. Components are:
    1. Par value derived from the sale of stock.
    2. Additional contributed capital (additional paid-in capital) in excess of par value.
  - b. Earned Capital – known as Retained Earnings – is the cumulative amount of net income since the organization of the corporation less the cumulative amount of dividends declared by the corporation since inception. (If the retained earnings account has a debit balance due to accumulated losses, it is called a retained deficit.)

### II. LO1 EXPLAIN THE ROLE OF STOCK IN THE CAPITAL STRUCTURE OF A CORPORATION.

#### A. Introduction

1. The corporation is the only form of business recognized as a separate *legal* entity.
2. Creation and governance of corporations are highly regulated by law.
3. Corporations are created under state (not federal) laws. Each state has different laws for incorporation.

#### B. Benefits of Stock Ownership

1. The ownership of common stock conveys several rights:
  - a. A voice in management: Owners are granted the right to vote at stockholders' meetings on major issues concerning the management of the corporation including the election of the board of directors. In lieu of attending a meeting, a vote by proxy (absentee ballot) gives the stockholders' voting rights to a designated party.
  - b. Dividends: Owners may receive dividends (distributions of corporate profits).
  - c. Residual claim: Owners may receive distributions from the corporation upon liquidation.

#### C. Authorized, Issued, and Outstanding Shares

1. Authorized number of shares is the *maximum* number of shares that can be issued by a corporation as specified in its charter. This should be a larger number than a corporation plans to issue initially to provide for the option of selling stock in the future.
2. Issued number of shares is the total *cumulative* number of authorized shares that have been *sold to date* by the corporation. Unissued number of shares is the number of authorized shares that have not yet been sold to date.
3. Outstanding number of shares is the number of shares currently owned by stockholders ("out" there).

$$\text{Outstanding shares} = \text{Issued shares} - \text{Treasury stock shares}$$

4. Treasury stock is the number of shares that have been sold to investors and then reacquired by the corporation. If there is no treasury stock, the number of issued shares will equal the number of outstanding shares.

**III. LO2 ANALYZE THE EARNINGS PER SHARE RATIO.**

1. EPS is a measure of profitability.
2. Facilitates comparing companies of different sizes.

$$\text{Earnings Per Share} = \frac{\text{Net Income}^*}{\text{Average Number of Shares of Common Stock Outstanding during the Period}}$$

\* If there are Preferred dividends, the amount is subtracted from the Net Income in the numerator.

**IV. LO3 DESCRIBE THE CHARACTERISTICS OF COMMON STOCK AND ANALYZE TRANSACTIONS AFFECTING COMMON STOCK.**

**A. General**

1. There are two types of stock issues.
2. All corporations must issue common stock, but every corporation does not issue preferred stock.

**B. Common Stock Transactions**

1. Common stock is the residual equity (the "leftovers") of a corporation.
  - a. It ranks after preferred stock for dividends and liquidation distributions.
  - b. Common stockholders are the "risk takers" and, therefore, they are voting owners of a corporation.
2. Common stockholders receive dividends after the preferred stockholders receive their dividends. The board of directors, usually based on the company's profitability for common stockholders, determines dividend rates.
3. A corporation may issue two types of common shares: par value and no-par value.
  - a. Par value is an arbitrary, nominal, value established in the corporate charter.
    1. It has no relationship to the market value of the stock.
    2. The concept of par value was established as a protection for creditors by specifying a permanent amount of capital (legal capital) to be maintained by the corporation (not available for withdrawal by the owners). Though the definition of legal capital varies among states, it is usually considered to be the par value of stock outstanding.
  - b. No-par value stock does not have an amount per share specified in the charter.
    1. Some states require no-par stock.
    2. Legal capital is established by law. In the case of no-par value stock, legal capital is either the amount for which stock is originally sold or a stated value.

**C. Initial Sale of Stock**

1. When a corporation sells stock to the public, the transaction must be recorded in the accounts of the corporation. When stock sales are made for cash, Cash is debited and Common Stock is credited for par value.

Cash	xxx	
Common Stock		xxx

2. Any additional amount in excess of par is credited to Capital in Excess of Par Value.

Cash	xxx	
Common Stock		xxx
Capital in Excess of Par Value		xxx

3. In the case of no-par common stock that has no stated value, the total proceeds received at the issue are debited to Cash and credited to No-Par Common Stock. The capital in excess of par value account is not used under these circumstances.
4. There are two types of initial stock offerings to the public.
  - a. An initial public offering (IPO) involves the very first sale of a company's stock to the public (when a company first goes public).
  - b. A seasoned new issue is a subsequent sale of new stock (not previously issued) to the public after an IPO.

- E. Sale of Stock in Secondary Markets**
1. After the issue of stock by a corporation, shares may be exchanged (traded) in secondary markets such as the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), and the NASDAQ market.
  2. These subsequent sales *only affect the books of the investors involved*.
    - a. No transactions are recorded on the corporation's books.
    - b. However, corporate management is very alert to stock trading prices in the secondary market.
- F. Stock Issued for Employee Compensation**
1. Executive compensation packages are often developed to reward managers for meeting goals that are important to shareholders.
    - a. Stock options are often part of these compensation packages.
    - b. Stock options permit the holders to buy stock at a fixed price (grant price).
      1. If the stock prices decline below the grant price, holders will not exercise the option.
      2. If the stock price increases over the grant price, holders can exercise the options at a "low" price and hold the stock or sell it for a gain.
    - c. Stock option plans have increased substantially over the past few years. These plans provide a very popular way to reward managers.
- G. Repurchase of Stock**
1. Treasury stock is previously issued stock that is reacquired by the issuing corporation. Treasury stock is:
    - a. Held by the corporation.
    - b. Have no ownership rights.
    - c. It is not outstanding stock so it has no right to vote or to receive dividends.
    - d. It is not an asset to the corporation.
    - e. Treasury stock is a contra equity account (it reduces total stockholders' equity).
  2. The cost method records treasury stock at its cost:
 

Treasury Stock	xxx	
Cash		xxx

    - a. This transaction *reduces* assets and *reduces* stockholders' equity.
  3. Balance Sheet effects:
    - a. If a company has treasury stock on its balance sheet date, the amount of treasury stock is *subtracted* in the stockholders' equity section.
    - b. A disclosure note if required.
    - c. A restriction is placed on retained earnings to the extent of the treasury stock cost to preclude dividend declarations of that amount.
  4. Resale of Treasury Stock
    - a. When treasury stock shares are resold, Cash is debited and treasury stock is credited (reduced by the cost of the proportional number of shares resold).
    - b. If treasury stock is acquired and resold for the same amount, that is the extent of the journal entry.
    - c. If the acquisition and resale amounts differ, additional elements appear in the journal entry.
      1. Treasury stock is resold for *more* than its cost (an economic gain):
        - a. Capital in Excess of Par is *credited* for the difference.
        - b. A gain results in an overall *increase* in stockholders' equity.
      2. Treasury stock is resold for *less* than its cost (an economic loss):
        - a. Capital in Excess of Par is *debited* for the difference.
        - b. If that account balance is not adequate to absorb this difference, Retained Earnings is reduced to the extent needed.
        - c. A loss results in an overall *decrease* in stockholders' equity.
  5. Neither the purchase nor the sale of treasury stock affects the *issued* or *unissued* number of shares. Treasury stock only affects the number of shares *outstanding*.

**V. LO4 DISCUSS DIVIDENDS AND ANALYZE TRANSACTIONS.**

- A.** Investors buy stock to receive a return on their investment in the form of stock price appreciation and/or dividends.
1. Dividends are created when the board of directors of a corporation declares them. There is no legal obligation of a corporation to pay dividends until they are declared.
  2. Types of dividends:
    - a. Cash dividends. (Without a qualifier, the term dividend means a “cash” dividend.)
    - b. Property dividends (noncash assets).
    - c. Stock dividends (the company's own capital stock).
- B.** There are two requirements to be met for cash dividends to be declared and paid.
1. Sufficient retained earnings are needed. State laws often limit cash dividends to the amount of retained earnings (less any amount of treasury stock).
  2. Sufficient cash is needed.
    - a. Retained earnings do *not* equal cash.
    - b. Cash is needed for continuing operations and for operational asset acquisitions. There must be adequate cash after these commitments are met in order to pay dividends.
- C.** Three important dates for dividends:
1. Date of declaration:
    - a. The date that the board of directors *officially* approves the dividend.
    - b. For a cash dividend, a liability is credited at that time (Dividends Payable).
    - c. The debit may be made to a Dividends Declared or simply “Dividend” account or directly to the Retained Earnings account.
    - d. Dividends Declared is a *contra equity* account that is closed to Retained Earnings.
  2. Date of record:
    - a. The date on which the corporation prepares a list of current stockholders based on stockholder ownership records. This list indicates to whom dividend checks will be sent.
    - b. No journal entry is required on this date.
  3. Date of payment:
    - a. The date that dividend checks are disbursed.
    - b. The liability account is debited (reduced), and the Cash account is credited (reduced).
    - c. This is the date on which the dividend liability is *liquidated*.

**VI. LO5 ANALYZE THE DIVIDEND YIELD RATIO.**

1. A measure of profitability.
2. Measures the dividend return on the current price of stock.
3. Must be considered in conjunction with stability and increase in the price of common stock.

$$\text{Dividend Yield} = \frac{\text{Dividends per Share}}{\text{Market Price per Share}}$$

**VII. LO6 DISCUSS THE PURPOSE OF STOCK DIVIDENDS, STOCK SPLITS, AND REPORT TRANSACTIONS.**

- A.** Stock Dividends
1. A stock dividend is a distribution of *additional* shares of a corporation's own capital stock on a prorata basis (to maintain the same percentage of shares previously held) to its stockholders at no cost.
    - a. Usually consist of common stock issued to holders of common stock.
    - b. Common for rapidly expanding companies that want to retain their assets to finance expansion.
  2. Balance Sheet effects:
    - a. Does not create a liability when it is declared.
    - b. Does not reduce assets when it is distributed.
    - c. Total stockholders' equity does not change.
      1. A portion of retained earnings is changed into contributed capital. This is called capitalizing earnings.
      2. When retained earnings are reclassified to contributed capital, it *reduces* the amount available for future dividends.

3. Stock dividends are classified based on their size. The size of the stock dividend dictates the accounting treatment.
  - a. A large stock dividend involves the distribution of additional shares that is more than 20-25% of the currently outstanding shares. This is the most common.
    1. *Par value* is used to record large stock dividends.
    2. Retained Earnings is debited and common stock is credited for the par value.
    3. Large stock dividends have a greater market price reaction than small stock dividends.
  - b. A small stock dividend involves the distribution of additional shares that is less than 20-25% of the currently outstanding shares.
    1. *Market value* is used to record small stock dividends.
    2. Retained Earnings is debited for the market value of the shares, common stock is credited for the par value, and the difference is credited to Capital in Excess of Par Value.

**B. Stock Splits**

1. Stock splits are *not* dividends, but stock splits and stock dividends have similar effects on the stockholder but are quite different in terms of their impact on the stockholders' equity accounts.
  - a. Each stockholder will own additional shares of stock.
  - b. The effects on the issuing company are quite different.
2. A stock split does not require a journal entry by the corporation.
  - a. Instead, the old shares are returned to the corporation and new shares are issued.
  - b. The stock split is accomplished by *reducing* the par value per share and *increasing* the number of shares issued.
  - c. Retained Earnings is unaffected.
  - d. A disclosure note is required.

**VIII. LO7 DESCRIBE THE CHARACTERISTICS OF PREFERRED STOCK AND ANALYZE TRANSACTIONS AFFECTING PREFERRED STOCK.**

**A. Preferred Stock**

1. Combines some of the features of bonds and common stock.
  - a. Typically lacks the control feature of common stock in that it usually does not have voting rights.
  - b. Often used to raise corporate capital without diluting common stockholders' control.
2. Generally, preferred stock is less risky than common stock because of its preference to receive dividends and asset distributions (upon liquidation) before common stockholders.
3. Most preferred stock has a fixed dividend rate such as a specified percent of par or a specified amount per share.

**B. Dividends on Preferred Stock**

1. Investors in preferred stock give up some rights (voting) compared to common stock.
2. Preferred Stock enjoys a *preference* in dividends.
3. Dividends must be allocated between *preferred shareholders* and *common shareholders*. Two dividend preferences are:
  - a. *Current Dividend Preference*
    1. Preferred stock always has a right to be paid dividends before any dividends can be paid on common stock.
    2. Once this current preference is met, dividends may be paid to common stock.
  - b. *Cumulative Dividend Preference*
    3. Some preferred stock carries the additional feature of *accumulating* any dividend amounts not paid or declared in a previous year.
    4. Dividends In Arrears are these "unsatisfied" accumulations.
    5. Stock with this feature is called Cumulative Preferred Stock.

4. Impact of Dividends in Arrears
  - a. Dividends in arrears are not liabilities.
    1. Dividends must be declared to become a liability.
    2. Any preferred stock arrearage must be disclosed in the notes to the financial statements.
      - a. When preferred stock is cumulative, the arrearages and the current preference must be allocated to preferred stock before any dividends are available to common stock.
      - b. If preferred stock is noncumulative, no dividend arrearage can exist.
5. Restrictions on Retained Earnings
  - a. Restrictions on retained earnings require full-disclosure on the financial statements or in the notes.
  - b. Items that can place restrictions on retained earnings include debt covenants and preferred dividends in arrears. These restrictions place a limit on the ability of a company to pay dividends to its owners.
  - c. Analysts are particularly interested in retained earnings restrictions because of the impact on a company's dividend policy.

**IX. LO8 DISCUSS THE IMPACT OF CAPITAL STOCK TRANSACTIONS ON CASH FLOWS.**

	Effect on Cash Flows from Financing Activities
Issuance of Capital Stock	Increase
Purchase of Treasury Stock	Decrease
Sale of Treasury Stock	Increase
Payment of Cash Dividends	Decrease

**X. CHAPTER SUPPLEMENT A: ACCOUNTING FOR OWNERS' EQUITY FOR SOLE PROPRIETORSHIPS AND PARTNERSHIPS.**

- A. Owner's Equity for a Sole Proprietorship
  1. The proprietor (the only owner) has a *capital* account and a *drawing* (withdrawals) account.
    - a. *Owner's capital account*
      1. Used to record owner investments in the business.
      2. Also used to accumulate income and losses of the business.
      3. The net of revenues, expenses, gains and losses are closed to the capital account at the end of the accounting period.
      4. The capital account reflects the cumulative total of all owner investments and earnings less withdrawals to date.
    - b. *Owner's withdrawal account*
      1. Used to record asset withdrawals by the owner during the year.
      2. Used to record the owner's "salary" since this is not considered to be an expense of the business.
  2. A sole proprietorship is not a taxable entity for income tax purposes.
    - a. Owner is taxed on his/her personal income tax return for the *net income* of the proprietorship.
    - b. Owner's Equity on the balance sheet represents the *ending* capital account balance.
- B. Owners' Equity for a Partnership
  1. A partnership consists of two or more parties carrying on business with a profit motive. Most states have adopted this definition from the Uniform Partnership Act.
  2. The mutual understanding and consent of the partners should be contained in a written partnership agreement. The document should specify the details of formation, division of profits and losses, management responsibilities, transfer of interests, disposition of assets upon liquidation, and procedures to be followed in the case of a partner's death.
  3. Partnerships provide ease of formation and partner control. However, unlimited liability allows creditors to take personal assets of partners (except for limited partners) to satisfy partnership obligations.

5. Accounting for a partnership:
- a. Each partner has a *capital* account and a *withdrawal* account.
    - 1. Each partner's *capital account* is used to record owner investments of that partner.
      - a. Also used to accumulate income and losses attributable to that partner.
      - b. The partner's capital account reflects the *cumulative investments and earnings net of losses and withdrawals to date*.
    - 2. Each partner has a withdrawal account to reflect withdrawals of assets from the business during the year.
      - a. It is used to record the partner's "salary" since this is not considered to be an expense of the business.
  - b. There are a variety of profit/loss allocation procedures.
    - 1. They may be based on the partners' investment ratios, time and expertise devoted to the operations of the business, or a combination of these factors.
    - 2. The allocation may instead be done equally between the partners.
  - c. A partnership is *not a taxable entity* for income tax purposes. Rather, each partner is taxed for his/her distributive share of income.
  - d. The Owners' Equity on the balance sheet represents the ending capital account balance for each partner. A detailed schedule to arrive at these balances should be presented for full-disclosure.