Stockholders' Equity

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- This presentation contains information, in addition to the material prepared and provided by the professor, from the book Financial Accounting, 4^{th}. Ed., Spiceland which is the textbook assigned for the course CONT 3105 – "Introducción a los Fundamentos de Contabilidad" at the University of Puerto Rico, Río Piedras Campus.

Topics

Topics

1.0 Corporations
2.0 Common Stock
3.0 Preferred Stock
4.0 Treasury Stock
5.0 Retained Earnings
6.0 Dividends

Corporations

Corporations

1.1 Definition

Corporations

1.1 Definitions

- A **corporation** is an entity that is legally separate from its owners and even pays its own income taxes.
- Most corporations are owned by many stockholders, although some corporations are owned entirely by one individual. While sole proprietorships are the most common form of business, corporations dominate in terms of totals sales, assets, earnings, and employees.

Corporations

1.2 Organization

Corporations

1.2 Organization

- Corporations are formed in accordance with the laws of individual states. The state incorporation laws guide corporations as they write their **articles of incorporation** (sometimes called the corporate charter).

Corporations

1.2 Organization

- The articles of incorporation describe:
  1. The nature of the firm's business activities.
  2. The shares of stock to be issued.
  3. The initial board of directors.

Corporations

1.2 <u>Organization</u>

- The **Board of Directors**, elected by the stockholders, establishes corporate policies and appoints officers who manage the corporation. However, a corporation's stockholders control the company.

Corporations

1.3 Advantages of a Corporation

Corporations

1.3 Advantages of a Corporation

1. **Limited Liability**: The main advantage of being legally separate is that the stockholders have limited liability. The limited liability prevents stockholders from being held personally responsible for the financial obligations of the corporation. In addition, guarantees that stockholders can lose no more than the amount they invested in the corporation.

Corporations

1.3 Advantages of a Corporation

2. **Ability to Raise Capital and Transfer Ownership**: Because corporations sell ownership interest in the form of shares of stock, ownership rights are easily transferred.

Corporations

1.4 Disadvantages of a Corporation

Corporations

1.4 <u>Disadvantages of a Corporation</u>

- The mayor disadvantages of a corporation are:
  1. **Corporate Law**: The compliance with all requirement of the corporate law to maintain its corporate status, and
  2. **Double Taxation**: The corporation's income is taxed twice. First, the corporation pays corporate income taxes and then the stockholders pay income taxes out of the dividends received by the corporation.

Common Stock

Common Stock

2.1 Authorized, Issued, or Outstanding

Common Stock

2.1 Authorized, Issued, or Outstanding

- The number of shares of common stock in a corporation are described as being:
  - Authorized,
  - Issued, or
  - Outstanding.

Common Stock

2.1 Authorized, Issued, or Outstanding

- **Authorized stock** is the number of shares available to sell, stated in the company's articles of incorporation.
- The authorization is not recorded in the accounting records. However, the corporation is required to disclose in the financial statements the number of shares authorized.

Common Stock

2.1 Authorized, Issued, or Outstanding

- **Issued stock** is the number of shares that have been sold to investors (shareholders). A company usually does not issue all its authorized stock.
- **Outstanding stock** is the number of shares held by investors. Issued and outstanding shares are the same al long as the corporation has not repurchased any of its own shares.

Common Stock

2.1 Authorized, Issued, or Outstanding

- Repurchased shares, called **Treasury Stock**, are included as part of shares issued, but excluded from shares outstanding.

Common Stock

2.2 Par Value

Common Stock

2.2 Par Value

- **Par value** is the legal capital per share of stock that is assigned when the corporation is first established. Par value originally indicated the real value of a company share's of stock.
- Today, par value has no relationship to the market value of the common stock.

Common Stock

2.2 Par Value

- Laws in most states permit corporations to issue no-par stock.
- **No-par value stock** is common stock that has not been assigned a par value.

Common Stock

Example 1

Common Stock

Example 1

- Pamplona Corporation with 1,000,000 authorized common stock with par value $1.00, sell 5,000 common stock at $20 per share on January 2, 2018. The partial stockholders' equity section in the balance sheet follows:

Pamplona Corporation Balance Sheet (partial)	
Stockholders' Equity (partial)	
Common stock, $1.00 par value, 1,000,000 authorized, 5,000 issued and outstanding	

Common Stock

2.3 Accounting for Common Stock Issues

Common Stock

2.3 Accounting for Common Stock Issues

- When a company receives cash from issuing common stock, it debits Cash.
- If it issues no-par value stock, the corporation credits the equity account entitled Common Stock.

Common Stock

Example 2

Common Stock

Example 2

- Pamplona Corporation with 1,000,000 authorized common stock with no par value, sell 5,000 common stock at $20 per share on January 2, 2018. We record this transaction as:

GENERAL JOURNAL				JE #
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Jan. 2	Cash (5,000 x $20)		100,000	
	Common Stock			100,000
	(*Issue no-par value common stock.*)			

Common Stock

2.3 Accounting for Common Stock Issues

- If it issues par value stock, rather than no-par value stock, we credit two equity accounts:
  - **Common Stock** account for the number of shares issued times the par value per share, and
  - **Additional Paid-in Capital** for the portion of the cash proceeds above the par value.

Common Stock

Example 3

Common Stock

<u>Example 3</u>

- Pamplona Corporation with 1,000,000 authorized common stock with $1.00 par value, sell 5,000 common stock at $20 per share on January 2, 2018. We record this transaction as:

GENERAL JOURNAL				JE #
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Jan. 2	Cash (5,000 x $20)		100,000	
	Common Stock (5,000 x $1.00)			5,000
	Additional Paid-in Capital			95,000
	(*Issue common stock above par.*)			

Common Stock

Example 3

- After the issuance of the common stock with par value, the stockholders' equity section in the balance sheet of Pamplona Corporation follows:

Pamplona Corporation **Balance Sheet (partial)** **January 2, 2018**	
Stockholders' Equity (partial)	
Common stock, \$1.00 par value, 1,000,00 authorized, 5,000 issued and outstanding	\$5,000
Additional Paid-in Capital	95,000
Total Paid-in Capital	\$100,000

Preferred Stock

Preferred Stock

3.1 Definition

Preferred Stock

3.1 Definition

- **Preferred stock** is a special class of share that possesses certain preferences or priority to claim on earnings.
- Unlike common stock, most preferred stock does not have voting rights, leaving control of the company to common stockholders.

Preferred Stock

3.1 <u>Definition</u>

- Preferred stock is "preferred" over common stock in two ways:
  1. Preferred stockholders usually have <u>first rights to a specified amount of dividends</u> (a stated dollar amount per share or a percentage of par value per share). If the board of directors declares dividends, preferred shareholders will receive the designated dividends before common shareholders receive any.
  2. Preferred stockholders receive <u>preference</u> over common stockholders in the <u>distribution of assets</u> in the event the corporation is dissolved.

Preferred Stock

3.2 Accounting for Preferred Stock Issues

Preferred Stock

3.2 Accounting for Preferred Stock Issues

- We record the issuance of preferred stock similar to the way we did for the issue of common stock.

Preferred Stock

Example 4

- After Pamplona Corporation issued the common stock (**Example 3**), the company issued 1,000 shares of 5%, $30 par value preferred stock for $50 per share, out of the 50,000 preferred stock authorized, on January 31, 2018. We record this transaction as:

GENERAL JOURNAL				JE #
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Jan. 31	Cash (1,000 x $50)		50,000	
	Preferred Stock (1,000 x $30)			30,000
	Additional Paid-in Capital			20,000
	(*Issue preferred stock above par.*)			

Preferred Stock

Example 4

- After the issuance of the common stock (**Example 3**) and the preferred stock, the stockholders' equity section in the balance sheet of Pamplona Corporation follows:

Pamplona Corporation **Balance Sheet (partial)** **January 31, 2018**	
Stockholders' Equity (partial)	
Preferred stock, $30.00 par value, 50,00 authorized, 1,000 issued and outstanding	$30,000
Common stock, $1.00 par value, 1,000,00 authorized, 5,000 issued and outstanding	5,000
Additional Paid-in Capital ($95,000 + $20,000)	115,000
Total Paid-in Capital	$150,000

Preferred Stock

3.3 Features of Preferred Stock

Preferred Stock

3.3 Features of Preferred Stock

- Preferred stock is especially interesting due to the flexibility allowed in its contractual provisions. For instance, preferred stock might be:
  1. **Convertible**: Shares can be converted into common stock.
  2. **Redeemable**: Shares can be returned to (or redeemed by) the corporation at a fixed price.

Preferred Stock

3.3 Features of Preferred Stock

3. **Cumulative**:

- Share receive priority for future dividends, if dividends are not paid in a given year. Preferred stock usually is cumulative. If the specified dividend is not paid in a given year, unpaid dividends (called **dividends in arrears**) accumulate, and the corporation must pay them in a later year before paying any dividends on common stock.
- We calculate the dividends in arrears as follows:

Annual Dividends in Arrears = Number of shares x par value x percentage

Preferred Stock

Example 5

Preferred Stock

Example 5

- Refer to **Example 4**. Assume Pamplona Corporation declares a total dividend of $10,000 as of December 30, 2018.
  - *How will the total dividend of $10,000 be allocated between preferred stockholders and common stockholders?*

Preferred Stock

Example 5

- *How will the total dividend of $10,000 be allocated between preferred stockholders and common stockholders?*

Allocation of Dividend	
Total Dividend	$10,000
Less: Preferred stock dividends (1,000 shares x $30 par value x 5%)	(1,500)
Remaining Dividend to Common Stockholders	$8,500

Preferred Stock

Example 6

Preferred Stock

Example 6

- Refer to **Example 5**. Assume the corporation declares a total dividend of $10,000 as of December 30, 2020. No dividends were paid during 2018 and 2019.
  1. *How will the total dividend of $10,000 be allocated between preferred stockholders and common stockholders if preferred stock is **cumulative**?*
  2. *How will the total dividend of $10,000 be allocated between preferred stockholders and common stockholders if preferred stock is **noncumulative**?*

Preferred Stock

Example 6

1. *How will the total dividend of $10,000 be allocated between preferred stockholders and common stockholders if preferred stock is **cumulative**?*

Allocation of Dividend	
Total Dividend	$10,000
Less: Preferred stock dividends in **arrears**	
2018 (1,000 shares x $30 par value x 5%)	(1,500)
2019 (1,000 shares x $30 par value x 5%)	(1,500)
Less: Preferred stock dividends for 2020	
(1,000 shares x $30 par value x 5%)	(1,500)
Remaining Dividend to Common Stockholders	$5,500

Preferred Stock

Example 6

2. *How will the total dividend of $10,000 be allocated between preferred stockholders and common stockholders if preferred stock is **noncumulative**?*

Allocation of Dividend	
Total Dividend	$10,000
Less: Preferred stock dividends in **arrears** 2018 2019	 (0) (0)
Less: Preferred stock dividends for 2020 (1,000 shares x $30 par value x 5%)	 (1,500)
Remaining Dividend to Common Stockholders	$8,500

Treasury Stock

Treasury Stock

4.1 Definition and Purpose

Treasury Stock

4.1 Definition and Purpose

- **Treasury stock** is the name given to a corporation's own stock that it has acquired, when companies acquire shares they have previously issued.

Treasury Stock

4.1 Definition and Purpose

- Companies buy back their own stock for various reasons:
  1. **To boost underprice stock**: When company management feels the market price of its stock is too low, it may attempt to support the price by decreasing the supply of stock in the marketplace.
  2. **To distribute surplus cash without paying dividends**: Another way for a firm to distribute surplus cash to shareholders without giving them taxable dividend income is to use the excess cash to repurchase its own stock.

Treasury Stock

4.1 Definition and Purpose

- Companies buy back their own stock for various reasons:

3. **To boost earnings per share:** Earnings per share is calculated as earnings divided by the number of shares outstanding. Stock repurchases reduce the number of shares outstanding, thereby increasing earnings per share.
4. **To satisfy employee stock ownership plan**: Another motivation for stock repurchases is to acquire shares used in employee stock award and stock option compensation programs.

Treasury Stock

4.2 Accounting for Treasury Stock

Treasury Stock

4.2 Accounting for Treasury Stock

- Treasury stock is the repurchase of a company's own issued stock. Just as issuing shares increases stockholders' equity, buying back those shares decreases stockholders' equity.
- Rather than reducing the stock accounts directly, thought, we record treasury stock as a "negative" or **"contra" account**.

Treasury Stock

4.2 <u>Accounting for Treasury Stock</u>

- Treasury stock is included in the stockholders' equity section of the balance sheet with an opposite, or debit, balance.
- When a corporation repurchases its own stock, it increases (debits) Treasury Stock, while it decreases (credits) Cash.

Treasury Stock

Example 7

Treasury Stock

Example 7

- Pamplona Corporation repurchases 100 shares of its own $1 par value common stock at $35 per share, on November 30, 2018. We record this transaction as:

GENERAL JOURNAL				JE #
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Nov. 30	Treasury Stock (100 x $35)		3,500	
	Cash			3,500
	(*Repurchase treasury stock.*)			

Treasury Stock

Example 7

- The stockholders' equity section after the repurchase of Treasury Stock follows:

Pamplona Corporation Balance Sheet (partial) November 30, 2018		
Stockholders' Equity (partial)	Before the Repurchase	After the Repurchase
Preferred stock, $30.00 par value, 50,00 authorized, 1,000 issued and outstanding	$30,000	$30,000
Common stock, $1.00 par value, 1,000,00 authorized, 5,000 issued, **4,900 outstanding**	5,000	5,000
Additional Paid-in Capital ($95,000 + $20,000)	115,000	115,000
Total Paid-in Capital	150,000	150,000
Treasury Stock	0	(3,500)
Total Stockholders' Equity	$150,000	$146,500

Treasury Stock

Example 8

Treasury Stock

Example 8

- Assume Pamplona Corporation reissues the 100 shares of treasury stock for $40. We record this transaction as:

GENERAL JOURNAL				JE #
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
-	Cash (100 x $40)		4,000	
	Treasury Stock (100 x $35)			3,500
	Additional Paid-in Capital			500
	(*Reissue treasury stock above cost.*)			

Treasury Stock

Example 8

- The stockholders' equity section after the sale of Treasury Stock follows:

Pamplona Corporation Balance Sheet (partial) November 30, 2018		
Stockholders' Equity (partial)	Before the Sale	After the Sale
Preferred stock, $30.00 par value, 50,00 authorized, 1,000 issued and outstanding	$30,000	$30,000
Common stock, $1.00 par value, 1,000,00 authorized, 5,000 issued and outstanding	5,000	5,000
Additional Paid-in Capital ($95,000 + $20,000)	115,000	115,500
Total Paid-in Capital	150,000	150,500
Treasury Stock	(3,500)	(0)
Total Stockholders' Equity	$146,500	$150,500

Retained Earnings

Retained Earnings

5.1 Definition

Retained Earnings

5.1 Definition

- **Retained earnings** represent the earnings retained in the corporation earnings not paid out as dividends to stockholders.
- In other words, the balance in retained earnings equals all net income, less all dividends, since the company began operations.

Retained Earnings

5.1 Definition

- Retained earnings has a normal credit balance, consistent with other stockholders' equity accounts.
- However, if losses exceed income since the company began, Retained Earnings will have a debit balance. A debit balance in Retained Earnings is called an **accumulated deficit**.

Dividends

Dividends

6.1 Cash Dividends

Dividends

6.1 Cash Dividends

- Dividends are distributions by a corporation to its stockholders.
- Most of the time, dividends are paid in **cash**. However, corporations can pay the dividend using property or stock.

Dividends

6.1 Cash Dividends

- Note that it is the board of directors that declares the cash dividend to be paid. The day this occurs is known as the **declaration date**.
- The declaration of a dividend creates a binding legal obligation for the company declaring the dividend. On that date, we increase Dividends (temporary account) and increase a liability account, Dividends Payable.

Dividends

6.1 Cash Dividends

- The board of directors also indicates a specific date on which the company will determine the registered owners of stock and therefore who will receive the dividend. This date is called the **record date**.
- Investors who own stock on the date of record are entitled to receive the dividend. The date of the actual distribution is the **payment date**.

Dividends

6.1 Cash Dividends

- Dividends are paid only on share outstanding. Dividends are NOT paid on treasury stock.

Dividends

Example 9

Dividends

Example 9

- The stockholders’ equity section of Pamplona Corporation as of Jan. 1, 2019 follows:

Pamplona Corporation Balance Sheet (partial) January 1, 2019	
Stockholders’ Equity (partial)	
Preferred stock, $30.00 par value, 50,00 authorized, 1,000 issued and outstanding	$30,000
Common stock, $1.00 par value, 1,000,00 authorized, 5,000 issued, **4,900 outstanding**	5,000
Additional Paid-in Capital ($95,000 + $20,000)	115,000
Total Paid-in Capital	150,000
Retained Earnings	25,000
Treasury Stock	(3,500)
Total Stockholders’ Equity	$171,500

Dividends

Example 9

- On February 28, 2019, Pamplona Corporation declares a $2.00 per share dividend on its outstanding shares. Assume the preferred stock are noncumulative.
  1. What is the total outstanding shares?
  2. Calculate the cash dividend.
  3. Record the declaration of cash dividends.

Dividends

Example 9

- On February 28, 2019, Pamplona Corporation declares a \$2.00 per share dividend on its outstanding shares. Assume the preferred stock are noncumulative.
  1. *What is the total outstanding shares?*

Preferred stock	**1,000**	
Common stock	**4,900**	**(5,000 – 100 treasury stock)**
Outstanding shares	**5,900**	

Dividends

Example 9

- On February 28, 2019, Pamplona Corporation declares a \$2.00 per share dividend on its outstanding shares. Assume the preferred stock are noncumulative.

  2. *Calculate the cash dividend.*

Preferred stock	**1,000**	
Common stock	**4,900**	**(5,000 – 100 treasury stock)**
Outstanding shares	**5,900**	
x	**\$2.00**	
Cash Dividend	**\$11,800**	

Dividends

Example 9

- On February 28, 2019, Pamplona Corporation declares a $2.00 per share dividend on its outstanding shares. Assume the preferred stock are noncumulative.

  3. *Record the declaration of cash dividends*.

GENERAL JOURNAL				JE #
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Feb. 28	Dividends		11,800	
	Dividends Payable			11,800
	(*Declares cash dividends.*)			

Dividends

Example 10

Dividends

Example 10

- Refer to **Example 9**. On March 31, 2019, Pamplona Corporation paid the dividends. To record the payment of cash dividends:

GENERAL JOURNAL				JE #
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Mar. 31	Dividends Payable		11,800	
	Cash			11,800
	(*Pay cash dividends.*)			

Dividends

6.2 Stock Dividends and Stock Splits

Dividends

6.2 Stock Dividends and Stock Splits

- Sometimes corporations distribute to shareholders additional shares of the companies' own stock rather than cash. These are known as **stock dividends** or **stock splits** depending on the size of the stock distribution.
- Accounting standards distinguish between:
  1. Stock splits
  2. Large stock dividends
  3. Small dividends.