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chapter 11

Reporting and Interpreting Owners' Equity

The Kroger Co. (Kroger) is a familiar name for U.S. consumers. The popular supermarket chain was founded in 1883 and now operates 2,435 supermarkets, 791 convenience stores, and 348 fine jewelry stores. The company is one of the largest retailers in the United States based on annual sales, ranking in the top 25 of the Fortune 100 list. The typical Kroger supermarket stocks approximately 14,000 individual items with 27 percent of its sales volume coming from private label merchandise, many of which are manufactured by Kroger. The Kroger Co.'s growth strategy is based on increasing sales by improving its existing store base through remodels. The company currently makes nearly \$2 billion in capital expenditures each year. Through this strategy, management seeks to provide short-term results for shareholders while continuing to invest in the long-term growth of the company.

In this chapter, we study the role that stockholders' equity plays in building a successful business and strategies that managers use to maximize stockholders' wealth.

UNDERSTANDING THE BUSINESS

To some people, the words *corporation* and *business* are almost synonymous. You've probably heard friends refer to a career in business as "the corporate world." Equating business with corporations is understandable because corporations are the dominant form of business organization in terms of volume of operations. If you were to write the names of 50 familiar businesses on a piece of paper, probably all of them would be corporations.

Learning Objectives

After studying this chapter, you should be able to:

- 11- Explain the role of stock in the capital structure of a corporation. p. 547
1
- 11- Analyze the earnings per share ratio. p. 549
2
- 11- Describe the characteristics of common stock and analyze transactions affecting common stock. p. 549
3
- 11- Discuss dividends and analyze transactions. p. 553
4

- 11-** Analyze the dividend yield ratio. p. 553
5
- 11-** Discuss the purpose of stock dividends and stock splits, and report transactions. p. 556
6
- 11-** Describe the characteristics of preferred stock and analyze transactions affecting preferred stock. p.
7 560
- 11-** Discuss the impact of capital stock transactions on cash flows. p. 562
8

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FOCUS COMPANY:

The Kroger Co.

FINANCING CORPORATE GROWTH WITH CAPITAL SUPPLIED BY OWNERS

www.kroger.com

The popularity of the corporate form can be attributed to a critical advantage that corporations have over sole proprietorships and partnerships: They can raise large amounts of capital because both large and small investors can easily participate in their ownership. This ease of participation is related to several factors.

- Shares of stock can be purchased in small amounts. You could buy a single share of Kroger Co. stock for about \$25 and become one of the owners of this successful company.
- Ownership interests can be easily transferred through the sale of shares on established markets such as the New York Stock Exchange.

- Stock ownership provides investors with limited liability. In the event of bankruptcy, creditors have claims against only the corporation's assets, not the assets of the individual owners.

Many Americans own stock either directly or indirectly through a mutual fund or pension program. Stock ownership offers them the opportunity to earn higher returns than they could on deposits to bank accounts or investments in corporate bonds. Unfortunately, stock ownership also involves higher risk. The proper balance between risk and the expected return on an investment depends on individual preferences.

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EXHIBIT 11.1

Excerpt from Consolidated Balance Sheets for The Kroger Co.



REAL WORLD EXCERPT
Annual Report

THE KROGER CO.
Consolidated Balance Sheets
(on millions, except par values)

	January 28, 2012	January 29, 2011
Shareowners' Equity		
Preferred shares, \$100 par per share, 5 shares authorized and unissued	—	—
Common shares, \$1 par per share, 1,000 shares authorized; 959 shares issued in 2011 and 2010	959	959
Additional paid-in capital	3,427	3,394
Accumulated other comprehensive loss	(844)	(550)
Accumulated earnings	8,571	8,225
Common stock in treasury, at cost, 398 shares in 2011 and 339 shares in 2010	(8,132)	(6,732)
Total Shareowners' Equity—The Kroger Co.	<u>\$ 3,981</u>	<u>\$ 5,296</u>

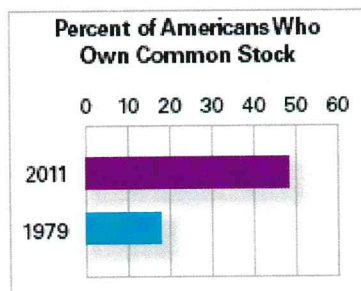
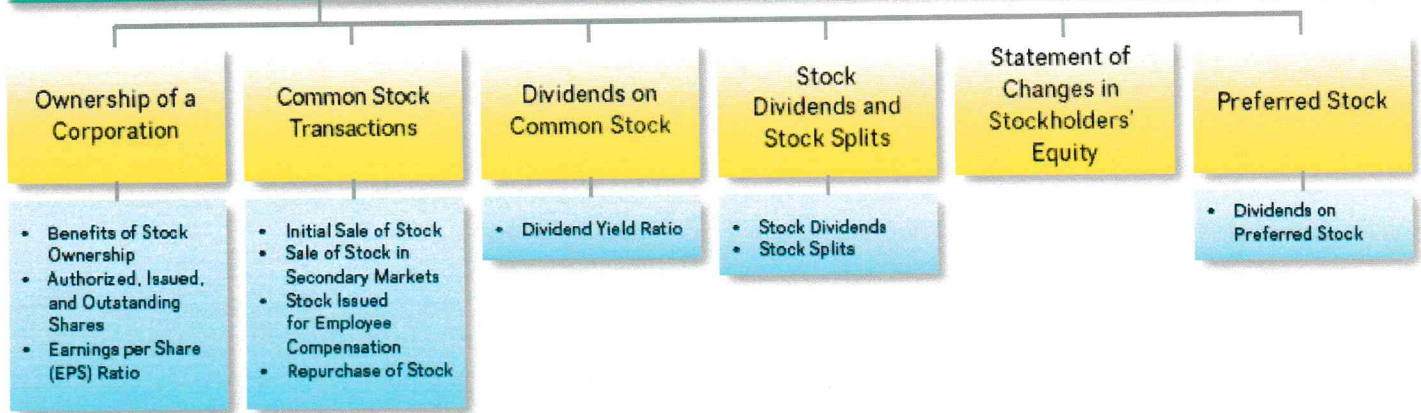


Exhibit 11.1 presents financial information from The Kroger Co.'s annual report. Notice that the stockholders' equity section of the balance sheet lists two primary sources of stockholders' equity:

1. Contributed capital from the sale of stock. This is the amount of money stockholders invested through the purchase of shares. For Kroger, contributed capital is the sum of common stock (\$959 million) plus additional paid-in capital (\$3,427 million).
2. Retained earnings (sometimes called accumulated earnings) generated by the company's profit-making activities. This is the cumulative amount of net income the corporation has earned since its organization less the cumulative amount of dividends paid since organization. While most companies call this amount retained earnings, Kroger uses the name accumulated earnings.

Most companies generate a significant portion of their stockholders' equity from retained earnings. In the case of The Kroger Co., retained earnings is actually more than the original capital invested by shareholders.

ORGANIZATION of the Chapter



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OWNERSHIP OF A CORPORATION

Page 547

The corporation is the only business form the law recognizes as a separate entity. As a distinct entity, the corporation enjoys a continuous existence separate and apart from its owners. It may own assets, incur liabilities, expand and contract in size, sue others, be sued, and enter into contracts independently of its stockholder owners.

To protect everyone's rights, the creation and governance of corporations are tightly regulated by law. Corporations are created by application to a state government (not the federal government). On approval of the application, the state issues a charter, sometimes called the articles of incorporation. Corporations are governed by a board of directors elected by the stockholders.

Each state has different laws governing the organization of corporations created within its boundaries. The Kroger Co. has its headquarters in Ohio and it has elected to incorporate in the state of Ohio. You will find that an unusually large number of corporations are incorporated in Delaware even though their headquarters are located in a different state. Companies choose Delaware for incorporation because the state has some of the most favorable laws for establishing corporations.

Benefits of Stock Ownership

LEARNING OBJECTIVE 11-1

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

When you invest in a corporation, you are known as a stockholder or shareholder. As a stockholder, you receive shares of stock that you subsequently can sell on established stock exchanges. Owners of common stock receive a number of benefits:

- **A voice in management.** You may vote in the stockholders' meeting on major issues concerning management of the corporation.
- **Dividends.** You receive a proportional share of the distribution of profits.
- **Residual claim.** You will receive a proportional share of the distribution of remaining assets upon the liquidation of the company.

Owners, unlike creditors, are able to vote at the annual stockholders' meeting with a number of votes equal to the number of shares owned. The following notice of the annual meeting of shareholders was recently sent to all owners of Kroger Co. stock:

NOTICE OF ANNUAL MEETING OF SHAREHOLDERS

*Cincinnati, Ohio,
May 11, 2012*

To All Shareholders of The Kroger Co.:

The annual meeting of shareholders of The Kroger Co. will be held at the MUSIC HALL BALLROOM, MUSIC HALL, 1241 Elm Street, Cincinnati, Ohio 45202, on June 21, 2012, at 11 a.m., eastern time, for the following purposes:

- 1. To elect the directors for the ensuing year;*
- 2. To consider and act upon an advisory vote to approve executive compensation;*
- 3. To consider and act upon a proposal to ratify the selection of independent public accountants for the year 2012;*
- 4. To act upon two shareholder proposals, if properly presented at the annual meeting; and*
- 5. To transact such other business as may properly be brought before the meeting;*

all as set forth in the Proxy Statement accompanying this Notice. Holders of common shares of record at the close of business on April 23, 2012, will be entitled to vote at the meeting.



REAL WORLD EXCERPT
Notice of
Shareholders' Meeting

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This notice also contained several pages of information concerning the people who were nominated to be members of the board of directors as well as a variety of financial information. Since most owners do not actually attend the annual meeting, the notice included a proxy card, which is similar to an absentee ballot. Owners may complete the proxy and mail it to the company, which includes it in the votes at the annual meeting.

Page 548

Stockholders have ultimate authority in a corporation. The board of directors and, indirectly, all employees are accountable to the stockholders.

Authorized, Issued, and Outstanding Shares

The **AUTHORIZED NUMBER OF SHARES** is the maximum number of shares of a corporation's capital stock that can be issued as specified in the charter.

ISSUED SHARES represent the total number of shares of stock that have been sold.

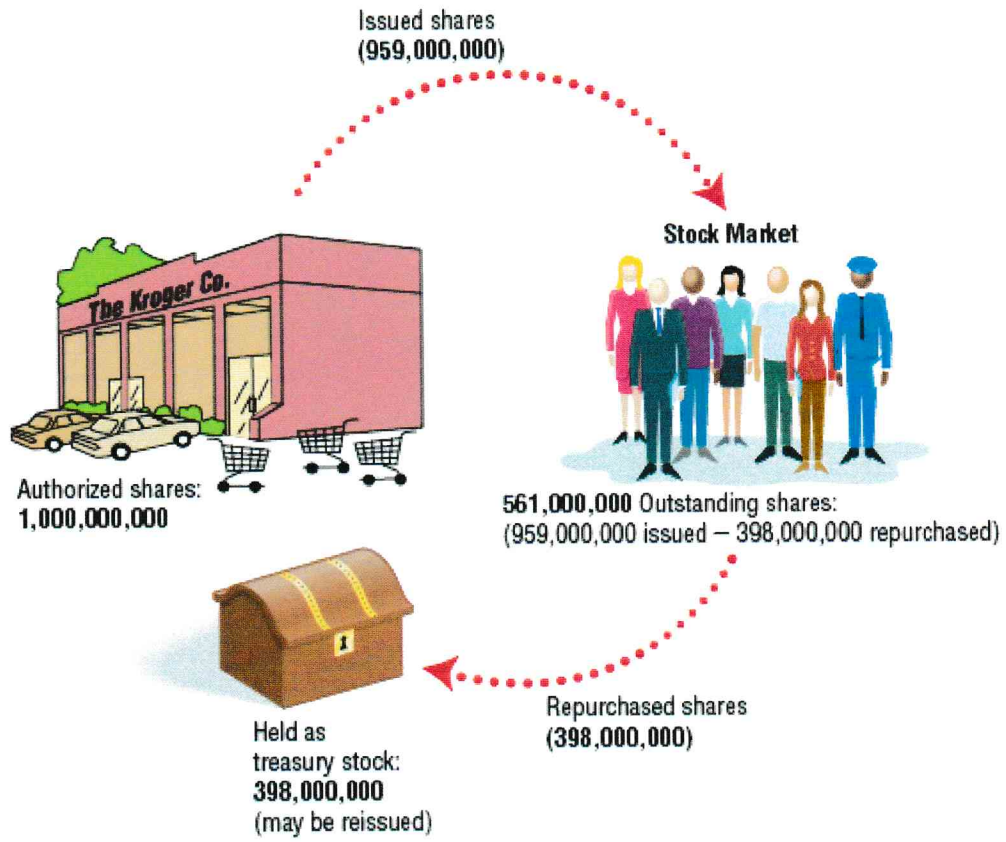
The corporate charter specifies the maximum number of shares that can be sold to the public. The financial statements must report information concerning the number of shares that have been sold to date. Let's look at the share information reported by The Kroger Co. as of January 28, 2012, shown in Exhibit 11.1. For Kroger, the maximum number of common shares that can be sold, called the **authorized number of shares**, is 1,000,000,000. As of January 28, 2012, the company had sold 959,000,000 shares. Stock that has been sold to the public is called **issued shares**.

OUTSTANDING SHARES refer to the total number of shares of stock that are owned by stockholders on any particular date.

For a number of reasons, a company might want to buy back stock that has already been sold to the public. Stock that has been bought back is called *treasury stock*. When a company buys back its stock, a difference is created between the number of issued shares and the number of **outstanding shares**, or shares currently held by individual stockholders. We can compute outstanding shares for The Kroger Co. using data from the January 28, 2012, balance sheet shown in Exhibit 11.1:

Issued shares	959,000,000
Less: Treasury stock	(398,000,000)
Outstanding shares	561,000,000

Notice that when treasury stock is held, the number of shares issued and the number of shares outstanding differ by the number of shares of treasury stock held (treasury stock is included in "issued" but not in "outstanding"). The number of shares outstanding is important to financial analysts who need to express certain dollar amounts on a per share basis. One example is the earnings per share ratio.



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KEY RATIO ANALYSIS



Earnings Per Share (EPS)

Page 549

? ANALYTICAL QUESTION

How well is a company performing?

% RATIO AND COMPARISONS

Earnings per share is computed as follows:

$$\text{Earnings per Share} = \text{Net Income}^* \div \text{Average Number of Common Shares Outstanding}$$

*Preferred dividends, if any, should be subtracted from net income.

The 2012 ratio for The Kroger Co.:

$$\$602 \text{ million} \div 597 \text{ (million) shares}^* = \$1.01$$

COMPARISONS OVER TIME			COMPARISONS WITH COMPETITORS	
Kroger			Whole Foods	Safeway
2010	2011	2012	2012	2012
\$0.11	\$1.75	\$1.01	\$1.96	\$1.49

*As reported in the notes to the financial statements.

💡 INTERPRETATIONS

In General All analysts and investors are interested in a company's earnings. You have probably seen newspaper headlines announcing a company's earnings. Notice that those news stories normally report earnings on an earnings per share (EPS) basis. EPS is a popular measure because income numbers are much easier to compare on a per share basis. For example, in 2012, The Kroger Co. earned income of \$596 (million) compared to \$1,249 (million) in the previous year, a very significant decrease. If we make that comparison on a per share basis, we see a similar decrease but a smaller percent. The EPS declined by a smaller percent because fewer shares were outstanding in 2012. EPS is also useful in comparing companies of different sizes. Whole Foods is a smaller company than Kroger, with income of \$342.6 (million) in 2012. While net income for Whole Foods was less than 58 percent of the net income earned by The Kroger Co., EPS for Whole Foods was nearly twice the EPS for Kroger.

Focus Company Analysis The Kroger Co. has a strategy of growth and reinvestment of earnings. Analysts are watching EPS to be sure the company will achieve its strategy. Kroger's EPS increased significantly between 2010 and 2012, indicating a strong level of growth considering the difficult economic environment during that period.

A Few Cautions While EPS is an effective and widely used measure of profitability, it can be misleading if there are significant differences in the market values of the shares being compared. Two companies earning \$1.50 per share might appear to be comparable, but if shares in one company cost \$10 while shares of the other cost \$175, they are not comparable. The stock price for Whole Foods is over \$80 per share while the price for Kroger stock is \$25. Obviously, investors expect a large EPS number for companies with higher stock prices.

LEARNING OBJECTIVE 11-2

Analyze the earnings per share ratio.

COMMON STOCK TRANSACTIONS

LEARNING OBJECTIVE 11-3

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

Most corporations issue two types of stock, common stock and preferred stock. All corporations must issue common stock, but only some issue preferred stock. In this section, we discuss common stock and in a subsequent section, we discuss preferred stock.

COMMON STOCK is the basic voting stock issued by a corporation.

Common stock is held by individuals who are often thought of as the “owners” of the corporation because they have the right to vote and share in the profitability of the business through dividends. Periodically, the board of directors declares dividends based on the company's profitability.

The fact that common stock dividends may increase with increases in the company's profitability helps to explain why investors can make money in the stock market. Basically, you can think of the price of a share of stock as the present value of all its future dividends. If a company's profitability improves so that it can pay higher dividends, the present value of its common stock will increase.

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PAR VALUE is the nominal value per share of capital stock specified in the charter; serves as the basis for legal capital. **Page 550**

Common stock normally has a **par value**, a nominal value per share established in the corporate charter. Par value has no relationship to the market value of a stock. The annual report for The Kroger Co. states that the common stock has a par value of \$1, while its market value is more than \$20 per share.

LEGAL CAPITAL is the permanent amount of capital defined by state law that must remain invested in the business; serves as a cushion for creditors.

Most states require stock to have a par value. The original purpose of this requirement was to protect creditors by specifying a permanent amount of capital that owners could not withdraw before a bankruptcy, which would leave creditors with an empty corporate shell. This permanent amount of capital is called **legal capital**. Today, this requirement has little importance because of other contractual protections for creditors.

NO-PAR VALUE STOCK is capital stock that has no par value specified in the corporate charter.

Some states require the issuance of **no-par value stock**, which does not have a specified amount per share. When a corporation issues no-par stock, legal capital is as defined by the state law.

Initial Sale of Stock

Two names are applied to transactions involving the initial sale of a company's stock to the public. An **initial public offering**, or IPO, involves the very first sale of a company's stock to the public (i.e., when the company first "goes public"). You have probably heard stories of Internet stocks that have increased dramatically in value the day of the IPO. While investors sometimes earn significant returns on IPOs, they also take significant risks. Once a company's stock has been traded on established markets, additional sales of new stock to the public are called **seasoned new issues**.

Most sales of stock to the public are cash transactions. To illustrate the accounting for an initial sale of stock, assume that The Kroger Co. sold 100,000 shares of its \$1 par value stock for \$20 per share. The company would record the following journal entry:

Cash (+A) (100,000 × \$20)	2,000,000	
Common stock (+SE) (100,000 × \$1)		100,000
Capital in excess of par (+SE)		1,900,000

Assets	=	Liabilities	+	Stockholders' Equity
Cash				Common stock
+2,000,000				+100,000
				Capital in excess of par
				+1,900,000

Notice that the Common Stock account is credited for the number of shares sold times the par value per share, and the Capital in Excess of Par account is credited for the remainder. If the corporate charter does not specify a par value for the stock, the stated value is used in the same manner that par value is used. If there is no par or stated value, the entire proceeds from the sale will be entered in the common stock account.

Sale of Stock in Secondary Markets

When a company sells stock to the public, the transaction is between the issuing corporation and the buyer. Subsequent to the initial sale, investors can sell shares to other investors without directly affecting the corporation. For example, if investor Jon Drago sold 1,000 shares of The Kroger Co. stock to Jennifer Lea, The Kroger Co. would not record a journal entry on its books. Mr. Drago received cash for the shares he sold, and Ms. Lea received stock for the cash she paid. The Kroger Co. did not receive or pay anything.

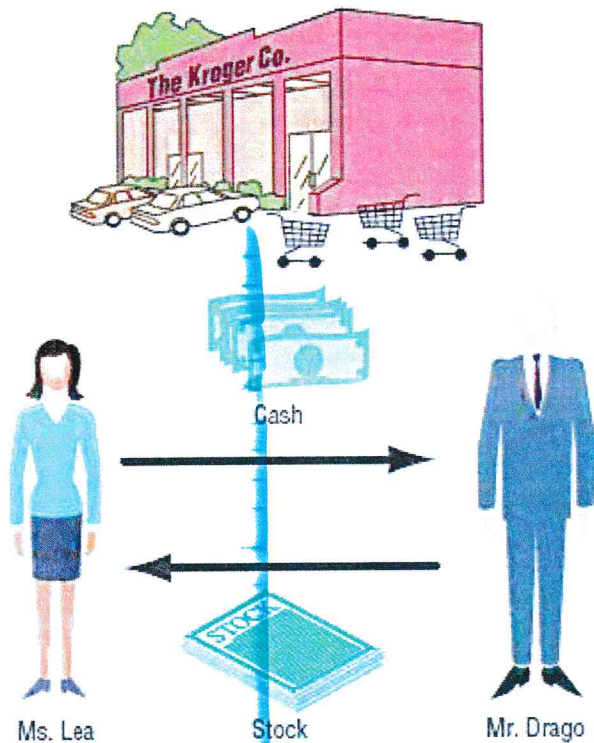
Each business day, *The Wall Street Journal* reports the results of thousands of transactions between investors in secondary markets, such as the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), and the NASDAQ market. Managers of corporations closely follow the price movements of their company's stock. Stockholders expect to earn money on their investments through both dividends and increases in the stock price. In many



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instances, senior management has been replaced because of a stock's poor performance in the stock market. While managers watch the stock price on a daily basis, transactions between investors do not directly affect the company's financial statements.

Page 551



Stock Issued for Employee Compensation

One of the advantages of the corporate form is the ability to separate the management of a business from its ownership. Separation can also be a disadvantage because some managers may not act in the owners' best interests. This problem can be overcome in a number of ways. Compensation packages can be developed to reward managers for meeting goals that are important to stockholders. Another strategy is to offer managers stock options, which permit them to buy stock at a fixed price.

The holder of a stock option has an interest in a company's performance just as an owner does. Stock option plans have become an increasingly common form of compensation over the past few years. Indeed, 98 percent of the companies surveyed by *Accounting Trends & Techniques*¹ now offer stock option plans to their employees.

The Kroger Co. offers employees stock options as part of their compensation. The options specify that shares may be bought at the then-current market price. Granting a stock option is a form of compensation, even if the grant price and the current stock price are the same. You can think of a stock option as a risk-free investment. If you hold a stock option and the stock price declines, you have lost nothing. If the stock price increases, you can exercise your option at the low grant price and sell the stock at the higher price for a profit.

Companies must estimate and report compensation expense associated with stock options. These procedures are discussed in more detail in intermediate accounting courses.

Repurchase of Stock

TREASURY STOCK is a corporation's own stock that has been issued but subsequently reacquired and is still being held by that corporation.

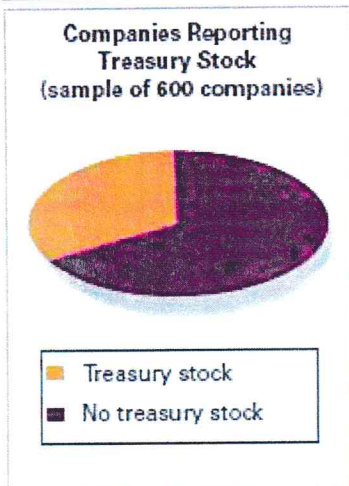
A corporation may want to repurchase its stock from existing stockholders for a number of reasons. One common reason is the existence of an employee bonus plan that provides workers with shares of the company's stock as part of their compensation. Because of Securities and Exchange Commission regulations concerning newly issued shares, most companies find it less costly to give employees repurchased shares than to issue new ones. Stock that has been reacquired and is held by the issuing corporation is called **treasury stock**. These shares have no voting, dividend, or other stockholder rights while they are held as treasury stock.

Most companies record the purchase of treasury stock based on the cost of the shares that were purchased. Assume that The Kroger Co. bought 100,000 shares of its stock in the open market when it was selling for \$20 per share. Using the cost method, the company would record the following journal entry:

		2,000,000															
Treasury stock (+XSE, -SE) (100,000 × \$20)		2,000,000															
Cash (-A)		2,000,000															
<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 33%; border-top: 1px solid black; text-align: center;">Assets</td> <td style="width: 5%; text-align: center;">=</td> <td style="width: 33%; border-top: 1px solid black; text-align: center;">Liabilities</td> <td style="width: 5%; text-align: center;">+</td> <td style="width: 24%; border-top: 1px solid black; text-align: center;">Stockholders' Equity</td> </tr> <tr> <td style="border-top: 1px solid black; padding-top: 5px;">Cash</td> <td></td> <td style="border-top: 1px solid black; padding-top: 5px;"></td> <td></td> <td style="border-top: 1px solid black; padding-top: 5px;">Treasury stock</td> </tr> <tr> <td style="text-align: right; padding-right: 10px;">-2,000,000</td> <td></td> <td></td> <td></td> <td style="text-align: right; padding-right: 10px;">-2,000,000</td> </tr> </table>			Assets	=	Liabilities	+	Stockholders' Equity	Cash				Treasury stock	-2,000,000				-2,000,000
Assets	=	Liabilities	+	Stockholders' Equity													
Cash				Treasury stock													
-2,000,000				-2,000,000													

Intuitively, many students expect the Treasury Stock account to be reported as an asset. Such is not the case because a company cannot create an asset by investing in itself. The Treasury Stock account is actually a contra-equity account, which means that it is subtracted from total stockholders' equity. This practice makes sense because treasury stock is stock that is no longer outstanding and therefore should not be included in stockholders' equity.

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As the information in Exhibit 11.1 indicates, The Kroger Co. reported treasury stock in the amount of \$8,132 (million) on its balance sheet as of January 28, 2012. The statement of stockholders' equity reports the same amount plus additional information.

When a company sells its treasury stock, it does not report an accounting profit or loss on the transaction, even if it sells the stock for more or less than it paid. GAAP does not permit a corporation to report income or losses from investments in its own stock because transactions with the owners are not considered normal profit-making activities. Based on the previous example, assume that The Kroger Co. re-sold 10,000 shares of treasury stock for \$30 per share. Remember that the company had purchased the stock for \$20 per share. Kroger would record the following journal entry:

Cash (+A) (10,000 × \$30).....	300,000	
Treasury stock (-XSE, +SE) (10,000 × \$20)		200,000
Capital in excess of par (+SE)		100,000

Assets	=	Liabilities	+	Stockholders' Equity
Cash				Treasury stock
+300,000				+200,000
				Capital in excess of par
				+100,000

If treasury stock were sold at a price below its purchase price (i.e., at an economic loss), stockholders' equity would be reduced by the amount of the difference between the purchase price and the sale price. Assume that Kroger had sold the stock in the previous illustration for only \$15 per share:

Cash (+A) (100,000 × \$15).....	150,000	
Capital in excess of par (-SE) (10,000 × \$5).....		50,000
Treasury stock (-XSE, +SE) (10,000 × \$20)		200,000

Assets	=	Liabilities	+	Stockholders' Equity
Cash				Treasury stock
+150,000				+200,000
				Capital in excess of par
				-50,000



We have looked at several transactions involving the sale and repurchase of common stock. In the next section, we will discuss dividends. Before you move on, complete the following questions to test your understanding of these concepts.

SELF-STUDY QUIZ

1. Assume that Applied Technology Corporation issued 10,000 shares of its common stock, par value \$2, for \$150,000 cash. Prepare the journal entry to record this transaction.
2. Assume that Applied Technology repurchased 5,000 shares of its stock in the open market when the stock was selling for \$12 per share. Record this transaction.

After you have completed your answers, check them with the solutions at the bottom of the next page.

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DIVIDENDS ON COMMON STOCK

Page 553

LEARNING OBJECTIVE 11-4

Discuss dividends and analyze transactions.

Investors buy common stock because they expect a return on their investment. This return can come in two forms: stock price appreciation and dividends. Some investors prefer to buy stocks that pay little or no dividends because companies that reinvest the majority of their earnings tend to increase their future earnings potential, along with their stock price. Wealthy investors in high tax brackets prefer to receive their return in the form of higher stock prices because capital gains may be taxed at a lower rate than dividend income. Other investors, such as retired people who need a steady income, prefer to receive their return in the form of dividends. These people often seek stocks that will pay very high dividends, such as utility stocks. Because of the importance of dividends to many investors, analysts often compute the dividend yield ratio to evaluate a corporation's dividend policy.

KEY RATIO ANALYSIS



Dividend Yield

ANALYTICAL QUESTION

What is return on investment based on dividends?

RATIO AND COMPARISONS

The dividend yield ratio is computed as follows:

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

The 2012 ratio for The Kroger Co.:

$$\$0.36 \div \$22 = 1.6\%$$

COMPARISONS OVER TIME			COMPARISONS WITH COMPETITORS	
Kroger			Whole Foods	Safeway
2010	2011	2012	2012	2012
1.0%	1.1%	1.6%	0.7%	4.6%

INTERPRETATIONS

In General Investors in common stock earn a return from both dividends and capital appreciation (increases in the market price of the stock). Growth-oriented companies often rely mainly on increases in their market price to provide a return to investors. Others pay large dividends but have more stable market prices. Each type of stock appeals to different types of investors with different risk and return preferences.

Focus Company Analysis Like many companies, The Kroger Co. pays a modest dividend and reinvests the majority of its earnings in the company. The Kroger Co. also repurchases a significant amount of stock each year from current stockholders. Clearly, investors in The Kroger Co. hope to earn a significant return on the increased value of the company.

A Few Cautions Remember that the dividend yield ratio tells only part of the return on investment story. Often potential capital appreciation is a much more important consideration. The Kroger Co. is currently

reinvesting a large portion of its earnings. Analysts should assess the future earnings potential of the company, not just its current dividend yield. Also, note that a high dividend yield may be the result of a large dividend or a low stock price. The yield for Safeway is much larger than the yield for its competitors, but it reflects a decline in the stock price from \$35 four years ago to \$15 today.

LEARNING OBJECTIVE 11-5

Analyze the dividend yield ratio.

Solutions to SELF-STUDY QUIZ

1. Cash (+A).....	150,000	
Common stock (+SE).....		20,000
Capital in excess of par (+SE).....		130,000
2. Treasury stock (+XSE, -SE).....	60,000	
Cash (-A).....		60,000

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The declaration and payment of a dividend involve several significant events. Let's review these events based on a dividend announcement reported by *Barron's*.



REAL WORLD EXCERPT
Dividend Announcement

CINCINNATI, June 21, 2012/PRNewswire-FirstCall—The Kroger Co. (NYSE: KR) announced today that its Board of Directors declared a quarterly dividend of \$0.115 per share to be paid on September 1, 2012, to shareholders of record as of the close of business on August 15, 2012.

This announcement contains three important dates:

The **DECLARATION DATE** is the date on which the board of directors officially approves a dividend.

1. **Declaration date—June 21, 2012.** The **declaration date** is the date on which the board of directors officially approves the dividend. As soon as it makes the declaration, it creates a dividend liability.

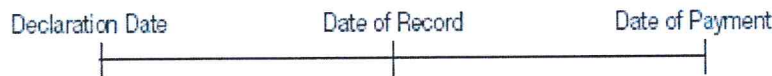
The **RECORD DATE** is the date on which the corporation prepares the list of current stockholders as shown on its records; dividends can be paid only to the stockholders who own stock on that date.

2. **Date of record—August 15, 2012.** The **record date** follows the declaration; it is the date on which the corporation prepares the list of current stockholders based on its records. The dividend is payable only to those names listed on the record date. No journal entry is made on this date.

The **PAYMENT DATE** is the date on which a cash dividend is paid to the stockholders of record.

3. **Date of payment—September 1, 2012.** The **payment date** is the date on which the cash is disbursed to pay the dividend liability. It follows the date of record, as specified in the dividend announcement.

These three dates apply for all cash dividends and can be shown graphically as follows:



On the declaration date, a company records a liability related to the dividend. To illustrate, on June 21, The Kroger Co. records the following journal entry. Assuming 561 million shares are outstanding, the dividend amounts to \$64,515,000 ($\$0.115 \times 561,000,000$):

Retained earnings (–SE).....		64,515,000		
Dividends payable (+L).....			64,515,000	
<hr/>				
Assets	=	Liabilities	+	Stockholders' Equity
<hr/>				
		Dividends payable	+64,515,000	Retained earnings –64,515,000

The payment of the liability on September 1 is recorded as follows:

Dividends payable (-L)	64,515,000	
Cash (-A)		64,515,000

<u>Assets</u>		=	<u>Liabilities</u>		+	<u>Stockholders' Equity</u>	
Cash	-64,515,000		Dividends payable	-64,515,000			

Notice that the declaration and payment of a cash dividend reduce assets (cash) and stockholders' equity (retained earnings) by the same amount. This observation explains the two fundamental requirements for payment of a cash dividend:

1. **Sufficient retained earnings.** The corporation must have accumulated a sufficient amount of retained earnings to cover the amount of the dividend. State incorporation laws often limit cash dividends to the balance in the Retained Earnings account.
2. **Sufficient cash.** The corporation must have sufficient cash to pay the dividend and meet the operating needs of the business. The mere fact that the Retained Earnings account

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has a large credit balance does not mean that the board of directors can declare and pay a cash dividend. The cash generated in the past by earnings represented in the Retained Earnings account may have been expended to acquire inventory, buy operational assets, and pay liabilities. Consequently, no necessary relationship exists between the balance of retained earnings and the balance of cash on any particular date. Quite simply, retained earnings is not cash.

Page 555

Investors should be careful to understand a company's dividend policy because in the United States, there is no legal obligation for companies to ever declare dividends. Many very successful companies have never paid dividends while others pay out a large percentage of their income each year. The dividend policy for a company is determined by the board of directors. In some other countries, dividend payments are not discretionary and are required by law. In Brazil, for example, companies are legally required to pay out at least 25 percent of their net income in dividends each year.

While companies are under no legal obligation to declare dividends, once the board of directors declares a dividend (i.e., creates a dividend payable) there is a legal obligation to pay that dividend. In the case of a corporate bankruptcy, dividends payable would be a legally enforceable claim against the company.



Another date that is important in understanding dividends has no accounting implications. The date two business days before the date of record is known as the *ex-dividend date*. This date is established by the stock exchanges to make certain that dividend checks are sent to the right people. If you buy stock before the ex-dividend date, you will receive the dividend. If you buy stock on the ex-dividend date or later, the previous owner will receive the dividend.

If you follow stock prices, you will notice that they often fall on the ex-dividend date. The stock is worth less on that date because it no longer includes the right to receive the next dividend.



One of the reasons that investors buy common stock is to earn dividends. We have looked at dividends paid in cash. In the next section, we will look at dividends paid in stock. Before you move on, complete the following questions to test your understanding of these concepts.

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SELF-STUDY QUIZ

Page 556

1. On which dividend date is a liability created?
2. A cash outflow occurs on which dividend date?
3. What are the two fundamental requirements for the payment of a dividend?

After you have completed your answers, check them with the solutions at the bottom of the page.

STOCK DIVIDENDS AND STOCK SPLITS

Stock Dividends

LEARNING OBJECTIVE 11-6

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

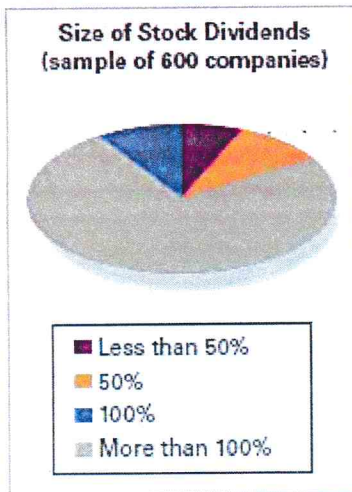
A **STOCK DIVIDEND** is a distribution of additional shares of a corporation's own stock.

Without a qualifier, the term *dividend* means a cash dividend, but dividends can also be paid with additional shares of stock. A **stock dividend** is a distribution of additional shares of a corporation's own stock to its stockholders on a pro rata basis at no cost to the stockholder. The phrase *pro rata basis* means that each stockholder receives additional shares equal to the percentage of shares held. A stockholder with 10 percent of the outstanding shares would receive 10 percent of any additional shares issued as a stock dividend.

The term *stock dividend* is sometimes misused in annual reports and news articles. A recent *Wall Street Journal* headline announced that a particular company had just declared a "stock dividend." A close reading of the article revealed that the company had actually declared a cash dividend on the stock.



The value of a stock dividend is the subject of much debate. In reality, a stock dividend by itself has no economic value. All stockholders receive a pro rata distribution of shares, which means that each stockholder owns exactly the same portion of the company as before. The value of an investment is determined by the percentage of the company that is owned, not the number of shares held. If you get change for a dollar, you do not have more wealth because you hold four quarters instead of only one dollar. Similarly, if you own 10 percent of a company, you are not wealthier simply because the company declares a stock dividend and gives you (and all other stockholders) more shares of stock.



The stock market reacts immediately when a stock dividend is issued, and the stock price falls proportionally. Theoretically, if the stock price was \$60 before a stock dividend and the number of shares is doubled, in the absence of events affecting the company, the price would fall to \$30. Thus, an investor would own 100 shares worth \$6,000 before the stock dividend ($100 \times \$60$) and 200 shares worth \$6,000 after the stock dividend ($200 \times \$30$).

In reality, the fall in price is not exactly proportional to the number of new shares issued. In some cases, the stock dividend makes the stock more attractive to new investors. Many investors prefer to buy stock in round lots, which are multiples of 100 shares. An investor with \$10,000 might not buy a stock selling for \$150, for instance, because she cannot afford to buy 100 shares. She might buy the stock if the price were less than \$100 as the result of a stock dividend. In other cases, stock dividends are associated with increases in cash dividends, which are attractive to some investors.

When a stock dividend occurs, the company must transfer an additional amount from the Retained Earnings account (or Capital in Excess of Par Value account, if there is not a sufficient balance in Retained Earnings) into the Common Stock account to reflect the additional shares issued. The amount transferred depends on whether the stock dividend is classified as large or small. Most stock dividends are classified as large. A large stock dividend involves the distribution of additional shares that amount to more than 20–25 percent of currently outstanding shares. A small stock dividend involves the distribution of shares that amount to less than 20–25 percent of the outstanding shares. If the stock dividend is classified as large, the amount transferred to the Common Stock account is based on the par value of the additional shares issued. If the stock dividend is small (i.e., less than 20–25 percent), the amount transferred should be the total market value of the shares issued, with the par value of the stock transferred to the Common Stock account and the excess transferred to the Capital in Excess of Par Value account. According to *Accounting Trends & Techniques*, most stock dividends are larger than 50 percent of the outstanding stock.²

Solutions to SELF-STUDY QUIZ

1. Declaration date.
 2. Date of payment.
 3. Dividends can be paid only if sufficient retained earnings and sufficient cash are both available.
-

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Assume The Kroger Co. issued a large stock dividend. The company issued 400,000,000 shares and made the following journal entry:

Retained earnings (-SE) (\$1 × 400,000,000).....	400,000,000
Common stock (+SE)	400,000,000

Assets	=	Liabilities	+	Stockholders' Equity
				Retained earnings -400,000,000
				Common stock +400,000,000

This journal entry moves an amount from Retained Earnings to the company's Common Stock account. Notice that the stock dividend did not change total stockholders' equity. It changed only the balances of some of the accounts that constitute stockholders' equity.

Stock Splits

A **STOCK SPLIT** is an increase in the total number of authorized shares by a specified ratio; it does not decrease retained earnings.

Stock splits are not dividends. While they are similar to a stock dividend, they are quite different in terms of their impact on the stockholders' equity accounts. In a **stock split**, the total number of authorized shares is increased by a specified amount, such as 2-for-1. In this instance, each share held is called in and two new shares are issued in its place. Typically, a stock split is accomplished by reducing the par or stated value per share of all authorized shares, so that their total par value is unchanged. For instance, if The Kroger Co. executes a 2-for-1 stock split, it reduces the par value of its stock from \$1 to \$0.50 and doubles the number of shares outstanding. In contrast to a stock dividend, a stock split does not result in the transfer of a dollar amount to the Common Stock account. The reduction in the par value per share compensates for the increase in the number of shares, so that no transfer is needed.

In both a stock dividend and a stock split, the stockholder receives more shares of stock without having to invest additional resources to acquire the shares. A stock dividend requires a journal entry; a stock split does not but is disclosed in the notes to the financial statements. The comparative effects of a large stock dividend versus a stock split may be summarized as follows:

	STOCKHOLDERS' EQUITY		
	Before	After a 100% Stock Dividend	After a 2-for-1 Stock Split
Number of shares outstanding	30,000	60,000	60,000
Par value per share	\$ 10	\$ 10	\$ 5
Total par value outstanding	300,000	600,000	300,000
Retained earnings	650,000	350,000	650,000
Total stockholders' equity	950,000	950,000	950,000

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We have concluded our discussion of common stock by looking at stock dividends and stock splits. In the next section, we will provide a brief introduction to the statement of changes in stockholders' equity and then proceed to examine preferred stock. Before you move on, complete the following questions to test your understanding of these concepts.

SELF-STUDY QUIZ

Barton Corporation issued 100,000 new shares of common stock (par value \$10) in a stock dividend when the market value was \$30 per share.

1. Record this transaction, assuming that it was a small stock dividend.
2. Record this transaction, assuming that it was a large stock dividend.
3. What journal entry would be required if the transaction were a stock split?

After you have completed your answers, check them with the solutions at the bottom of the page.

GUIDED HELP



www.mhhe.com/libby8e

For additional step-by-step video instruction, go to the URL or scan the QR code in the margin with your smartphone or iPad.

STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

In the previous chapters, we have emphasized three financial statements: the income statement, the balance sheet, and the statement of cash flows. Under GAAP, these statements are required in addition to a fourth statement, the statement of changes in stockholders' equity. The purpose of this statement is to show changes in the key components of stockholders' equity, including common stock, paid-in capital, treasury stock, and retained earnings. The statement of changes in stockholders' equity for Kroger is shown in Exhibit 11.2. Under GAAP requirements, the statement must show three years of data but, for illustrative purposes, we show only the current year.

As you review Exhibit 11.2, you will observe many of the issues discussed in this chapter. Notice for example:

1. Treasury stock was purchased at a cost of \$1,420 (million).
2. Cash dividends of \$256 (million) were paid, which reduced retained earnings (in this statement, called *accumulated earnings*).
3. Net income (called *net earnings* in this statement) was reported in the amount of \$602 million, which increased retained earnings.

The statement also contains a number of other changes that involve topics that will be covered in your next accounting course. Perhaps the most important one is accumulated other comprehensive gain (loss), which is defined as net income plus certain items that bypass the income statement because they have not satisfied the revenue recognition criteria. Examples of items that bypass the income statement include:

Solutions to SELF-STUDY QUIZ

1. Retained earnings.....	3,000,000	
Common stock.....		1,000,000
Capital in excess of par.....		2,000,000
2. Retained earnings.....	1,000,000	
Common stock.....		1,000,000
3. No journal entry is required in the case of a stock split.		

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EXHIBIT 11.2

Excerpt from Statement of
Changes in Stockholders'
Equity for The Kroger Co.

THE KROGER CO.									
Consolidated Statement of Changes in Shareowners' Equity									
(Years Ended January 28, 2012, January 29, 2011, and January 30, 2010)									
(In millions, except per share amounts)	Common Stock		Additional Paid-In Capital	Treasury Stock		Accumulated Other Comprehensive Gain (Loss)	Accumulated Earnings	Noncontrolling Interest	Total
	Shares	Amount		Shares	Amount				
Balances at January 29, 2011	959	\$959	\$3,394	339	\$(6,732)	\$(550)	\$8,225	\$ 2	\$ 5,298
Issuance of common stock:									
Stock options exercised	—	—	—	(5)	118	—	—	—	118
Restricted stock issued	—	—	(55)	(2)	34	—	—	—	(21)
Treasury stock activity:									
Treasury stock purchases, at cost	—	—	—	61	(1,420)	—	—	—	(1,420)
Stock options exchanged	—	—	—	5	(127)	—	—	—	(127)
Share-based employee compensation	—	—	81	—	—	—	—	—	81
Other comprehensive loss net of income tax of \$(167)	—	—	—	—	—	(294)	—	—	(294)
Other	—	—	7	—	(5)	—	—	(11)	(9)
Cash dividends declared (\$0.44 per common share)	—	—	—	—	—	—	(256)	—	(256)
Net earnings (loss) including noncontrolling interests	—	—	—	—	—	—	602	(6)	596
Balances at January 28, 2012	<u>959</u>	<u>\$959</u>	<u>\$3,427</u>	<u>398</u>	<u>\$(8,132)</u>	<u>\$(844)</u>	<u>\$8,571</u>	<u>\$(15)</u>	<u>\$ 3,966</u>

1. *Unrealized hold gains or losses from available-for-sale securities.* These gains and losses occur when a company holds stock in another company and is prepared to sell them when cash is needed. Under GAAP, gains and losses are reported on the income statement only when the stock is sold. Unrealized gains and losses that occur before the stock is sold would be included in comprehensive income.
2. *Foreign currency translation gains and losses.* When a company invests in a foreign country, the investment is made in that country's currency. The exchange rate between the U.S. dollar and foreign currencies changes on a daily basis, resulting in foreign currency translation gains and losses. These gains and losses are not recorded on the income statement until the foreign currency is converted back into U.S. dollars, but the unrealized translation gains and losses are reported as a component of comprehensive income.

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Comprehensive income will be discussed in greater detail in your next course. We have briefly introduced the topic at this point to give you a better understanding of the items included on the statement of changes in stockholders' equity.

Page 560

PREFERRED STOCK

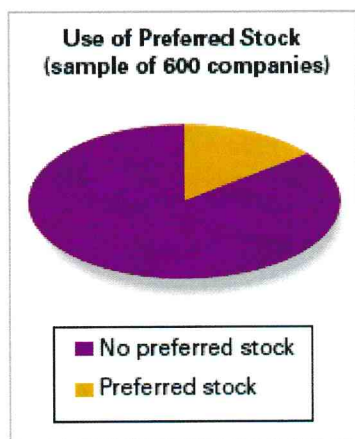
LEARNING OBJECTIVE 11-7

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

PREFERRED STOCK is stock that has specified rights over common stock.

In addition to common stock, some corporations issue **preferred stock**. Notice in Exhibit 11.1 that The Kroger Co. is authorized to issue 5 (million) shares of preferred stock but has not done so. Kroger included this amount in its corporate charter so that it could raise additional funds, if needed, without having to amend its charter.

Preferred stock differs from common stock based on a number of rights granted to the stockholders. The most significant differences are:



- **Preferred stock does not grant voting rights.** As a result, preferred stock does not appeal to investors who want some control over the operations of a corporation. Indeed, this is one of the main reasons some corporations issue preferred stock to raise their equity capital: Preferred stock permits them to raise funds without diluting common stockholders' control. The chart in the margin shows the percentage of companies surveyed by *Accounting Trends & Techniques*³ that include preferred stock in their capital structure.
- **Preferred stock is less risky.** Generally, preferred stock is less risky than common stock because holders receive priority payment of dividends and distribution of assets if the corporation goes out of business. Usually a specified amount per share must be paid to preferred stockholders upon dissolution, before any remaining assets can be distributed to the common stockholders.
- **Preferred stock typically has a fixed dividend rate.** For example, "6 percent preferred stock, par value \$10 per share" pays an annual dividend of 6 percent of par, or \$0.60 per share. If preferred stock had no par value, the preferred dividend would be specified as \$0.60 per share. The fixed dividend is attractive to certain investors who want a stable income from their investments.



INTERNATIONAL PERSPECTIVE



What's in a Name?

It is often confusing when different words are used to describe exactly the same thing. Such is the case with International Financial Accounting Standards (IFRS) and U.S. GAAP. The following table serves as a translation guide. Remember the actual elements are exactly the same. It is only their names that differ:

GAAP		IFRS
Capital stock	=	Issued capital or share capital
Paid-in capital	=	Share premium
Treasury stock	=	Treasury shares
Preferred stock	=	Preference shares

Dividends on Preferred Stock

Because investors who purchase preferred stock give up certain advantages that are available to investors in common stock, preferred stock offers a dividend preference. The two most common dividend preferences are current and cumulative.

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Current Dividend Preference

Page 561

CURRENT DIVIDEND PREFERENCE is the feature of preferred stock that grants priority on preferred dividends over common dividends.

The **current dividend preference** requires the current preferred dividend to be paid before any dividends are paid on the common stock. This preference is always a feature of preferred stock. After the current dividend preference has been met and if no other preference is operative, dividends can be paid to the common stockholders.

Declared dividends must be allocated between preferred stock and common stock. First, the preferred stock preference must be met; then the remainder of the total dividend can be allocated to the common stock. To illustrate, assume the Sophia Company has the following stock outstanding:

SOPHIA COMPANY	
Preferred stock outstanding, 6%, par \$20; 2,000 shares = \$40,000 par	
Common stock outstanding, par \$10; 5,000 shares = \$50,000 par	

Assuming a current dividend preference only, dividends would be allocated as follows:

Example	Total Dividends	6% Preferred Stock*	Common Stock
No. 1	\$ 3,000	\$2,400	\$ 600
No. 2	18,000	2,400	15,600

*Preferred dividend preference, $\$40,000 \times 6\% = \$2,400$.

Cumulative Dividend Preference

CUMULATIVE DIVIDEND PREFERENCE is the preferred stock feature that requires specified current dividends not paid in full to accumulate for every year in which they are not paid. These cumulative preferred dividends must be paid before any common dividends can be paid.

DIVIDENDS IN ARREARS are dividends on cumulative preferred stock that have not been declared in prior years.

The **cumulative dividend preference** states that if all or a part of the current dividend is not paid in full, the cumulative unpaid amount, known as **dividends in arrears**, must be paid before any common dividends can be paid. Of course, if the preferred stock is noncumulative, dividends can never be in arrears; any preferred dividends that are not declared are permanently lost. Because preferred stockholders are unwilling to accept this unfavorable feature, preferred stock is usually cumulative.

To illustrate the cumulative preference, assume that Sophia Company has the same amount of stock outstanding as in the last example. In this case, dividends have been in arrears for two years.

Example	Total Dividends	6% Preferred Stock*	Common Stock
No. 1	\$ 8,000	\$7,200	\$ 800
No. 2	30,000	7,200	22,800

*Current dividend preference, $\$40,000 \times 6\% = \$2,400$; dividends in arrears preference, $\$2,400 \times 2 \text{ years} = \$4,800$; current dividend preference plus dividends in arrears = $\$7,200$.

FINANCIAL ANALYSIS



Restrictions on the Payment of Dividends

Two common constraints on the ability of a corporation to pay dividends are the existence of loan covenants and preferred stock dividends in arrears. For additional security, some creditors include a loan covenant that limits the amount of dividends a corporation can pay. These debt covenants often also include a limit on borrowing and require a minimum balance of cash or working capital. If debt covenants are violated, the creditor can demand immediate repayment of the debt. The full-disclosure principle requires the disclosure of loan covenants, typically in a separate note to the financial statements.

The existence of dividends in arrears on preferred stock can also limit a company's ability to pay dividends to common stockholders and can affect a company's future cash flows. Because dividends are never an actual liability until the board of directors declares them, dividends in arrears are not reported

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on the balance sheet. Instead, they are disclosed in the notes to the statements. The following note from Lone Star Industries is typical:

Page 562

The total of dividends in arrears on the \$13.50 preferred stock at the end of the year was \$11,670,000. The aggregate amount of such dividend must be paid before any dividends are paid on common stock.

Analysts are particularly interested in information concerning these restrictions because of the impact they have on the company's dividend policy and future cash flows.

Lone Star Industries

REAL WORLD EXCERPT

Annual Report

FOCUS ON CASH FLOWS



Transactions involving capital stock have a direct impact on the capital structure of a business. Because of the importance of these transactions, they are reported in the section of the statement of cash flows called Cash Flows from Financing Activities. Examples of cash flows associated with capital stock are included in the statement of cash flows for The Kroger Co. shown in Exhibit 11.3.

EFFECT ON STATEMENT OF CASH FLOWS

In General Cash received from owners is reported as an inflow; cash payments made to owners are reported as outflows. See the following example:

	Effect on Cash Flows
Financing activities	
Issuance of capital stock	+
Purchase of treasury stock	-
Sale of treasury stock	+
Payment of cash dividends	-

Focus Company Analysis Notice that for each of the last three years, The Kroger Co. has paid out a significant amount of cash for purchases of treasury stock and has increased the cash paid out for dividends each year (see Exhibit 11.3).

LEARNING OBJECTIVE 11-8

Discuss the impact of capital stock transactions on cash flows.

Selected Focus

Company Comparisons:
Dividends Paid (in millions)

Lowe's \$260



Starbucks \$871



Home Depot \$595



EXHIBIT 11.3

Excerpt from Statement of
Cash Flows for The Kroger Co.REAL WORLD EXCERPT
Annual Report

THE KROGER CO.

Consolidated Statements of Cash Flows

Years Ended January 28, 2012, January 29, 2011, and January 30, 2010

(in millions)	2012 (52 weeks)	2011 (52 weeks)	2010 (52 weeks)
Cash Flows from Financing Activities:			
Proceeds from issuance of long-term debt	\$ 453	\$ 381	\$ 511
Payments on long-term debt	(547)	(553)	(432)
Borrowings (payments) on credit facility	370	—	(129)
Proceeds from issuance of capital stock	118	29	51
Treasury stock purchases	(1,547)	(545)	(218)
Dividends paid	(257)	(250)	(238)
Investment in the remaining interest of a variable interest entity	—	(86)	—
Other	23	20	21
Net cash used by financing activities	\$(1,387)	\$(1,004)	\$(434)

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(Try to resolve the requirements before proceeding to the suggested solution that follows.)

This case focuses on the organization and operations for the first year of Owners' Club, Inc., which was organized by 10 local entrepreneurs on January 1, 2014, for the purpose of operating a business to operate a portfolio of exclusive vacation properties. The charter authorized the following capital stock:

Common stock, no-par value, 20,000 shares

Preferred stock, 5 percent, \$100 par value, 5,000 shares

The laws of the state specify that the legal capital for no-par stock is the full sale amount.

The following summarized transactions, selected from 2014, were completed on the dates indicated:

- a. Jan. Sold a total of 8,000 shares of common stock to the 10 entrepreneurs for cash at \$50 per share.
1 Credit the Common Stock account for the total issue amount.
- b. Feb. Sold 2,000 shares of preferred stock at \$102 per share; cash collected in full.
- c. Mar. Declared cash dividend of \$1 on common stock.
- d. July Purchased 100 shares of preferred stock that had been sold and issued earlier. Owners' Club paid the stockholder \$104 per share.
- e. Sold 20 shares of the preferred treasury stock at \$105 per share.
- Aug.

Required:

1. Give the appropriate journal entries with a brief explanation for each transaction.
2. Prepare the Stockholders' Equity section of the balance sheet for Owners' Club at December 31, 2014. Assume retained earnings is \$23,000.

SUGGESTED SOLUTION

1. Journal entries:

a. Cash (+A)	400,000	
Common stock (+SE)		400,000
Sale of no-par common stock ($\$50 \times 8,000$ shares = $\$400,000$).		
b. Cash (+A)	204,000	
Preferred stock (+SE)		200,000
Capital in excess of par, preferred stock (+SE)		4,000
Sale of preferred stock ($\$102 \times 2,000$ shares = $\$204,000$).		
c. Retained earnings (-SE)	8,000	
Dividend payable (+L)		8,000
Declared cash dividend		
d. Treasury stock (+XSE, -SE)	10,400	
Cash (-A)		10,400
Purchased 100 shares of preferred stock ($\$104 \times 100$ shares = $\$10,400$).		
e. Cash (+A)	2,100	
Treasury stock (-XSE, +SE)		2,080
Capital in excess of par, preferred stock (+SE)		20
Sold 20 shares of the preferred treasury stock at $\$105$.		

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Stockholders' equity section of the balance sheet:

Page 564

OWNERS' CLUB, INC.	
Partial Balance Sheet	
At December 31, 2014	
Stockholders' Equity	
Contributed capital	
Preferred stock, 5% (par value \$100; authorized 5,000 shares, issued 2,000 shares of which 80 shares are held as treasury stock)	\$200,000
Capital in excess of par, preferred stock	4,020
Common stock (no-par value; authorized 20,000 shares, issued and outstanding 8,000 shares)	<u>400,000</u>
Total contributed capital	\$604,020
Retained earnings	<u>23,000</u>
Total contributed capital and retained earnings	\$627,020
Less cost of preferred treasury stock held (80 shares)	<u>(8,320)</u>
Total stockholders' equity	<u>\$618,700</u>

Chapter Supplement

Accounting for Owners' Equity for Sole Proprietorships and Partnerships

Owners' Equity for a Sole Proprietorship

A *sole proprietorship* is an unincorporated business owned by one person. Only two owners' equity accounts are needed: (1) a capital account for the proprietor (J. Doe, Capital) and (2) a drawing (or withdrawal) account for the proprietor (J. Doe, Drawings).

The capital account of a sole proprietorship serves two purposes: to record investments by the owner and to accumulate periodic income or loss. The drawing account is used to record the owner's withdrawals of cash or other assets from the business. The drawing account is closed to the capital account at the end of each accounting period. Thus, the capital account reflects the cumulative total of all investments by the owner and all earnings of the entity less all withdrawals from the entity by the owner.

In most respects, the accounting for a sole proprietorship is the same as for a corporation. Exhibit 11.4 presents the recording of selected transactions of Doe Retail Store and the statement of owners' equity.

Because a sole proprietorship does not pay income taxes, its financial statements do not reflect income tax expense or income taxes payable. Instead, the net income of a sole proprietorship is taxed when it is included on the owner's personal income tax return. Likewise, the owner's salary is not recognized as an expense in a sole proprietorship because an employer/employee contractual relationship cannot exist with only one party involved. The owner's salary is therefore accounted for as a distribution of profits (i.e., a withdrawal).

Owners' Equity for a Partnership

The Uniform Partnership Act, which most states have adopted, defines a partnership as "an association of two or more persons to carry on as co-owners of a business for profit." Small businesses and professionals such as accountants, doctors, and lawyers often use the partnership form of business.

A partnership is formed by two or more persons reaching mutual agreement about the terms of the relationship. The law does not require an application for a charter as in the case of a corporation. Instead, the agreement between the partners constitutes a partnership contract. This agreement should specify matters such as division of periodic income, management responsibilities, transfer or sale of partnership interests, disposition of assets upon liquidation, and procedures to be followed in case of the death of a

partner. If the partnership agreement does not specify these matters, the laws of the resident state are binding.

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EXHIBIT 11.4

Accounting for Owners' Equity for a Sole Proprietorship

Selected Entries during 2014

January 1, 2014

J. Doe started a retail store by investing \$150,000 of personal savings. The journal entry follows:

Cash (+A)	150,000	
J. Doe, capital (+OE)		150,000

Assets	=	Liabilities	+	Owners' Equity
Cash +150,000				J. Doe, capital +150,000

During 2014

Each month during the year, Doe withdrew \$1,000 cash from the business for personal living costs. Accordingly, each month the following journal entry was made:

J. Doe, drawings (-OE)	1,000	
Cash (-A)		1,000

Assets	=	Liabilities	+	Owners' Equity
Cash -1,000				J. Doe, drawings -1,000

Note: At December 31, 2014, after the last withdrawal, the drawings account reflected a debit balance of \$12,000.

December 31, 2014

The usual journal entries for the year, including adjusting and closing entries for the revenue and expense accounts, resulted in an \$18,000 net income, which was closed to the capital account as follows:

Individual revenue and expense accounts (-R&E)	18,000	
J. Doe, capital (+OE)		18,000

Assets	=	Liabilities	+	Owners' Equity
				Revenues and expenses -18,000
				J. Doe, capital +18,000

December 31, 2014

The drawings account was closed as follows:

J. Doe, capital (-OE)	12,000	
J. Doe, drawings (+OE)		12,000

Assets	=	Liabilities	+	Owners' Equity
				J. Doe, capital -12,000
				J. Doe, drawings +12,000

Balance Sheet December 31, 2014 (partial)

Owners' equity	
J. Doe, capital, January 1, 2014	\$150,000
Add: Net income for 2014	18,000
Total	168,000
Less: Withdrawals for 2014	(12,000)
J. Doe, capital, December 31, 2014	\$156,000

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The primary advantages of a partnership are (1) ease of formation, (2) complete control by the partners, and (3) lack of income taxes on the business itself. The primary disadvantage is the unlimited liability of each partner for the partnership's debts. If the partnership does not have sufficient assets to satisfy outstanding debt, creditors of the partnership can seize the partners' personal assets.

As with a sole proprietorship, accounting for a partnership follows the same underlying principles as any other form of business organization, except for those entries that directly affect owners' equity. Accounting for partners' equity follows the same pattern as for a sole proprietorship, except that separate capital and drawing accounts must be established for each partner. Investments by each partner are credited to that partner's capital account; withdrawals are debited to the respective partner's drawing account. The net income of a partnership is divided among the partners in accordance with the partnership agreement and credited to each account. The respective drawing accounts are closed to the partner capital accounts. After the closing process, each partner's capital account reflects the cumulative total of all of that partner's investments plus that partner's share of the partnership earnings less all that partner's withdrawals.

Exhibit 11.5 presents selected journal entries and partial financial statements for AB Partnership to illustrate the accounting for the distribution of income and partners' equity.

The financial statements of a partnership follow the same format as those for a corporation except that (1) the income statement includes an additional section entitled Distribution of Net Income, (2) the partners' equity section of the balance sheet is detailed for each partner, (3) the partnership has no income tax expense because partnerships do not pay income tax (partners must report their share of the partnership profits on their individual tax returns), and (4) salaries paid to the partners are not recorded as expenses but are treated as distributions of earnings.

EXHIBIT 11.5

Accounting for Partners' Equity

Selected Entries during 2014
January 1, 2014

A. Able and B. Baker organized AB Partnership on this date. Able contributed \$60,000 and Baker \$40,000 cash to the partnership and agreed to divide net income (and net loss) 60 percent and 40 percent, respectively. The journal entry for the business to record the investment was as follows:

Cash (+A)	100,000	
A. Able, capital (+OE)		60,000
B. Baker, capital (+OE)		40,000

Assets	=	Liabilities	+	Owners' Equity
Cash	+100,000			A. Able, capital +60,000 B. Baker, capital +40,000

During 2014

The partners agreed that Able would withdraw \$1,000 and Baker \$650 per month in cash. Accordingly, each month the following journal entry was made:

A. Able, drawings (-OE)	1,000	
B. Baker, drawings (-OE)		650
Cash (-A)		1,650

Assets	=	Liabilities	+	Owners' Equity
Cash	-1,650			A. Able, drawings -1,000 B. Baker, drawings -650

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EXHIBIT 11.5

December 31, 2014

Assume that the normal closing entries for the revenue and expense accounts resulted in a net income of \$30,000. The partnership agreement specified Able would receive 60 percent of earnings and Baker would receive 40 percent. The closing entry was as follows:

Individual revenue and expense accounts (–R&E).....	30,000	
A. Able, capital (+OE).....		18,000
B. Baker, capital (+OE).....		12,000

<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Owners' Equity</u>
				Revenues and expenses –30,000
				A. Able, capital +18,000
				B. Baker, capital +12,000

December 31, 2014

The journal entry required to close the drawing accounts follows:

A. Able, capital (–OE).....	12,000	
B. Baker, capital (–OE).....	7,800	
A. Able, drawings (+OE).....		12,000
B. Baker, drawings (+OE).....		7,800

<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Owners' Equity</u>
				A. Able, capital –12,000
				B. Baker, capital –7,800
				A. Able, drawings +12,000
				B. Baker, drawings +7,800

A separate statement of partners' capital, similar to the following, is customarily prepared to supplement the balance sheet:

AB PARTNERSHIP
Statement of Partners' Capital
For the Year Ended December 31, 2014

	A. Able	B. Baker	Total
Investment, January 1, 2014	\$60,000	\$40,000	\$100,000
Add: Additional investments during the year	0	0	0
Net income for the year	<u>18,000</u>	<u>12,000</u>	<u>30,000</u>
Totals	78,000	52,000	130,000
Less: Drawings during the year	<u>(12,000)</u>	<u>(7,800)</u>	<u>(19,800)</u>
Partners' equity, December 31, 2014	<u>\$66,000</u>	<u>\$44,200</u>	<u>\$110,200</u>

11-1. Explain the role of stock in the capital structure of a corporation. p. 547

The law recognizes corporations as separate legal entities. Owners invest in a corporation and receive capital stock that can be traded on established stock exchanges. Stock provides a number of rights,

including the right to receive dividends.



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11-2. Analyze the earnings per share ratio. p. 549

Page 568

The earnings per share ratio facilitates the comparison of a company's earnings over time or with other companies' earnings at a single point in time. By expressing earnings on a per share basis, differences in the size of companies become less important.

Describe the characteristics of common stock and analyze transactions affecting common stock. p. 549

Common stock is the basic voting stock issued by a corporation. Usually it has a par value, but no-par stock also can be issued. Common stock offers some special rights that appeal to certain investors.

A number of key transactions involve capital stock: (1) initial sale of stock, (2) treasury stock transactions, (3) cash dividends, and (4) stock dividends and stock splits. Each is illustrated in this chapter.

Discuss dividends and analyze transactions. p. 553

The return associated with an investment in capital stock comes from two sources: appreciation and dividends. Dividends are recorded as a liability when they are declared by the board of directors (i.e., on the date of declaration). The liability is satisfied when the dividends are paid (i.e., on the date of payment).

Analyze the dividend yield ratio. p. 553

The dividend yield ratio measures the percentage of return on an investment from dividends. For most companies, the return associated with dividends is very small.

Discuss the purpose of stock dividends and stock splits, and report transactions. p. 556

Stock dividends are pro rata distributions of a company's stock to existing owners. The transaction involves transferring an additional amount into the common stock account. A stock split also involves the distribution of additional shares to owners but no additional amount is transferred into the common stock account. Instead, the par value of the stock is reduced.

Describe the characteristics of preferred stock and analyze transactions affecting preferred stock. p. 560

Preferred stock provides investors certain advantages, including dividend preferences and a preference on asset distributions in the event the corporation is liquidated.

Discuss the impact of capital stock transactions on cash flows. p. 562

Both inflows (e.g., the issuance of capital stock) and outflows (e.g., the purchase of treasury stock) are reported in the Financing Activities section of the statement of cash flows. The payment of dividends is reported as an outflow in this section.

This chapter concludes a major section of the book. In the previous several chapters, we have discussed individual sections of the balance sheet. We will now shift our focus to a common business transaction that affects many accounts on each of the financial statements. For a number of strategic reasons, businesses often invest in other businesses. In the next chapter, you will see why companies invest in other companies and how those investments affect their financial statements.

The **earnings per share ratio** states the net income of a corporation on a per share of common stock basis. The ratio is computed as follows (p. 549):

$$\text{Earnings per Share} = \frac{\text{Net Income}}{\text{Average Number of Shares of Common Stock Outstanding}}$$

The **dividend yield ratio** measures the dividend return on the current price of the stock. The ratio is computed as follows (p. 553):

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

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Balance Sheet

Under Current Liabilities

Dividends, once declared by the board of directors, are reported as a liability (usually current).

Under Noncurrent Liabilities

Transactions involving capital stock do not generate noncurrent liabilities.

Under Stockholders' Equity

Typical accounts include

- Preferred stock
- Common stock
- Capital in excess of par
- Retained earnings
- Treasury stock

Statement of Changes in Stockholders' Equity

This statement reports detailed information concerning stockholders' equity, including

- (1) Amounts in each equity account,
- (2) Number of shares outstanding,
- (3) Impact of transactions such as earning income, payment of dividends, and purchase of treasury stock.
- (4) Information concerning comprehensive gain (loss).

Income Statement

Capital stock is never shown on the income statement. Dividends paid are not an expense. They are a distribution of income and are, therefore, not reported on the income statement.

Statement of Cash Flows

Under Financing Activities

- + Cash inflows from initial sale of stock
- + Cash inflows from sale of treasury stock
- Cash outflows for dividends
- Cash outflows for purchase of treasury stock

Notes

Under Summary of Significant Accounting Policies

Usually, very little information concerning capital stock is provided in this summary.

Under a Separate Note

Most companies report information about their stock option plans and information about major transactions such as stock dividends or significant treasury stock transactions. A historical summary of dividends paid per share is typically provided. Also, dividends in arrears on preferred stock, if any, would be reported as a note.

Authorized Number of Shares p. 548
 Common Stock p. 549
 Cumulative Dividend Preference p. 561
 Current Dividend Preference p. 561
 Declaration Date p. 554
 Dividends in Arrears p. 561
 Issued Shares p. 548
 Legal Capital p. 550
 No-Par Value Stock p. 550
 Outstanding Shares p. 548
 Par Value p. 550
 Payment Date p. 554
 Preferred Stock p. 560
 Record Date p. 554
 Stock Dividend p. 556
 Stock Split p. 557

Treasury Stock p. 551

1. Define the term *corporation* and identify the primary advantages of this form of business organization.
2. What is the charter of a corporation?
3. Explain each of the following terms: (a) authorized capital stock, (b) issued capital stock, and (c) outstanding capital stock.