

CHAPTER 11

Stockholders' Equity: Paid-In Capital

After studying this chapter, you should be able to:

Learning Objectives

LO11-1

Explain the advantages and disadvantages of organizing a business as a corporation.

LO11-2

Distinguish between publicly owned and closely held corporations.

LO11-3

Explain the rights of stockholders and the roles of corporate directors and officers.

LO11-4

Account for paid-in capital and prepare the equity section of a corporate balance sheet.

LO11-5

Contrast the features of common stock with those of preferred stock.

LO11-6

Discuss the factors affecting the market price of preferred stock and common stock.

LO11-7

Explain the significance of book value and market value of capital stock.

LO11-8

Explain the purpose and effects of a stock split.

LO11-9

Account for treasury stock transactions.



TARGET CORPORATION

Stockholders' equity is a major source of resources for corporations. As we learn in this chapter, stockholders' equity comes from two primary sources, the first being the original contributions of stockholders when they purchase shares of common or preferred stock directly from the company. The second source is the company's accumulated earnings, less dividends and other adjustments, that have been achieved since the company's inception.

How important is stockholders' equity as a source of funds for a company like Target Corporation? The answer is "very important." In a recent Target statement of financial position (balance sheet), stockholders' equity totals \$13,997 million, which represents about 34 percent of total assets. Of the total stockholders' equity of \$13,997 million, only \$4,952 million came from the original investments of stockholders. The

remainder came primarily from profitable operations that were retained in the business. Clearly the original investment of owners in Target has been enhanced via profitable operations of the company. In fact, the amount of retained earnings is almost as large as the original stockholders' investment.

Companies like Target carefully manage their relationship of debt to stockholders' equity. Unlike debt, equity has no maturity date. If a stockholder in a company like Target wants to sell his or her investment, the shares owned are offered for sale on a stock exchange or over-the-counter market in which sellers and buyers come together in exchange transactions. The numbers you often see in the business news about stock prices usually represent transactions between willing buyers and sellers, not between buyers and the issuing corporation. ■

In Chapter 10, we learned that debt financing can be a major source of funds for a corporation. In this chapter, we explore issues related to equity financing, which represents ownership of the company, as another major source of funding. Included in our discussion are types of capital stock, (common and preferred), treasury stock, and stock splits. We also discuss why many businesses decide to incorporate and we describe factors that influence the price of a company's stock in the open market.

Corporations

The corporate form is the organization of choice for many businesses—large and small. The owners of a corporation are called **stockholders**. In many small corporations, there are only one or two stockholders. But in large corporations, such as IBM and AT&T, there are literally millions of stockholders.

EXHIBIT 11-1 Advantages and Disadvantages of the Corporate Form

Advantages

1. *Stockholders are not personally liable for the debts of a corporation.* This concept is called limited personal liability and often is cited as the greatest advantage of the corporate form of organization.
2. *Transferability of ownership.* Ownership of a corporation is evidenced by transferable shares of stock, which may be sold by one investor to another.
3. *Professional management.* The stockholders own a corporation, but they do not manage it on a daily basis. To administer the affairs of the corporation, the stockholders elect a board of directors. The directors, in turn, hire professional managers to run the business.
4. *Continuity of existence.* Changes in the names and identities of stockholders do not directly affect the corporation. Therefore, the corporation may continue its operations without disruption, despite the retirement or death of individual stockholders.

Disadvantages

1. *Heavy taxation.* Corporate earnings are subject to **double taxation**. First, the corporation must pay corporate income taxes on its earnings. Second, stockholders must pay personal income taxes on any portion of these earnings that they receive as dividends.
2. *Greater regulation.* Corporations are affected by state and federal laws to a far greater extent than are unincorporated businesses.
3. *Cost of formation.* An unincorporated business can be formed at little or no cost. Forming a corporation, however, normally requires the services of an attorney.
4. *Separation of ownership and management.* If stockholders do not approve of the manner in which management runs the business, they may find it difficult to take the united action necessary to remove that management group.

A **corporation** is a form of business organization that is recognized under the law as a separate legal entity, with rights and responsibilities apart from those of its owners. The assets of a corporation belong to the corporation itself, not to the stockholders. The corporation is responsible for its own debts and must pay income taxes on its earnings. As a separate legal entity, a corporation has status in court; it may enter into contracts, and it may sue and be sued as if it were a person. The major advantages and disadvantages of this form of business organization are summarized in Exhibit 11-1.

What types of businesses choose the corporate form of organization? The answer, basically, is all kinds. When we think of corporations, we often think of large, well-known companies such as ExxonMobil, General Motors, and Procter & Gamble. Indeed, almost all large businesses are organized as corporations. Limited shareholder liability, transferability of ownership, professional management, and continuity of existence make the corporation the best form of organization for pooling the resources of a great many equity investors. Not all corporations, however, are large and publicly owned. Many small businesses are organized as corporations.

WHY BUSINESSES INCORPORATE

Businesses incorporate for many reasons, but the two of greatest importance are (1) limited shareholder liability and (2) transferability of ownership. The term **limited personal liability** means that shareholders are not personally responsible for the debts of the corporation. If the corporation has financial problems, the most that a stockholder usually can lose is the amount of his or her equity investment.

LO11-1

LEARNING OBJECTIVE

Explain the advantages and disadvantages of organizing a business as a corporation.

Another special feature of the corporation is the transferability of ownership—that is, ownership is represented by shares of **capital stock** that can be bought and sold. For a small, family-owned business, this provides a convenient means of gradually transferring ownership and control of the business from one generation to the next. For a large company, it makes ownership of the business a highly liquid investment, which can be purchased and sold in organized securities exchanges.¹



YOUR TURN

You as a Loan Officer

GOTCHA! is a small business that manufactures board games. It is one of the many business ventures of Gayle Woods, who is very wealthy and one of your bank's most valued customers. She has done business with your bank for more than 20 years, and the balance in her personal checking, savings, and money market accounts normally exceeds \$500,000. **GOTCHA!** is organized as a corporation, and Woods is the only stockholder.

GOTCHA! has applied for a \$200,000 line of credit, which it intends to use to purchase copyrights to additional board games. Although the company is profitable, its most recent balance sheet shows total assets of only \$52,000, including \$47,000 in copyrights. The corporation has just under \$3,000 in liabilities and over \$49,000 in stockholders' equity.

Do you consider **GOTCHA!** a good credit risk? Would you make the loan? Under what conditions?

(See our comments in Connect.)

PUBLICLY OWNED CORPORATIONS

The capital stock of many large corporations is bought and sold (traded) through organized securities exchanges. Because these shares are available for purchase by the general public, these large corporations are said to be **publicly owned corporations**.

Far more people have a financial interest in the shares of publicly owned corporations than one might expect. If you purchase the stock of such a corporation, you become a stockholder with a direct ownership interest—that is, you are a stockholder. But mutual funds and pension funds also invest heavily in the stocks of many publicly owned corporations. If you invest in a mutual fund or you are covered by a pension plan, you have an indirect financial interest in the stocks of many publicly owned corporations.

Corporations whose shares are *not* traded on any organized stock exchanges are said to be **closely held corporations**. Because there is no organized market for buying and selling their shares, these corporations usually have relatively few stockholders. Often, a closely held corporation is owned by one individual or by the members of one family.

Publicly Owned Corporations Face Different Rules The government seeks to protect the interests of the public. Therefore, publicly owned corporations are subject to more regulation than those that are closely held. For example, publicly owned corporations are required by law to:

- Prepare and issue quarterly and annual financial statements in conformity with generally accepted accounting principles. (These statements are **public information**.)
- Have their annual financial statements audited by an independent firm of certified public accountants.
- Comply with federal securities laws, which include both criminal penalties and civil liability for deliberately or carelessly distributing misleading information to the public.
- Submit much of their financial information to the Securities and Exchange Commission for review.

LO11-2

LEARNING OBJECTIVE
Distinguish between publicly owned and closely held corporations.

¹ These securities exchanges include, among others, the New York Stock Exchange, the National Association of Securities Dealers' Automated Quotations (NASDAQ), the Tokyo Stock Exchange, and Mexico's Bolsa. Collectively, stock exchanges often are described simply as *the stock market*.

Closely held corporations normally are exempt from these requirements. Our discussions will focus primarily on the accounting and reporting issues confronting publicly owned companies.

Formation of a Corporation

In the United States, a corporation is brought into existence under the laws of a particular state. The state in which the corporation is formed is called the **state of incorporation**.

The state of incorporation is not necessarily where the corporation does business. Rather, a state often is selected because of the leniency of its laws regulating corporate activities. Indeed, many corporations conduct most—sometimes all—of their business activities outside the state in which they are incorporated.

The first step in forming a corporation is to obtain a corporate charter from the state of incorporation. To obtain this charter, the organizers of the corporation submit an application called the articles of incorporation. Once the charter is obtained, the stockholders in the new corporation hold a meeting to elect a board of directors and to pass bylaws that will govern the corporation's activities. The directors in turn hold a meeting at which the top corporate officers and managers are appointed.

Organization Costs Forming a corporation is more costly than starting a sole proprietorship. The costs may include, for example, attorneys' fees, incorporation fees paid to the state, and other outlays necessary to bring the corporation into existence. Conceptually, organization costs are an intangible asset that will benefit the corporation over its entire life. As a practical matter, however, most corporations expense those costs immediately, even though they are often spread over a five-year period for income tax purposes.

You seldom see organization costs in the balance sheet of a publicly owned corporation. They have long since been recognized as an expense.

Rights of Stockholders A corporation is owned collectively by its stockholders. Each stockholder's ownership interest is determined by the number of *shares* that he or she owns. Assume that a corporation issues 10,000 shares of capital stock. If you own 1,000 of these shares, you own 10 percent of the corporation. If you acquire another 500 shares from another stockholder, you will own 15 percent.

Each stockholder, or the stockholder's brokerage firm, receives from the corporation a **stock certificate** indicating the number of shares he or she owns.

The ownership of capital stock in a corporation usually carries the following basic rights:

1. *To vote for directors and on certain other key issues.* A stockholder has one vote for each share owned. The issues on which stockholders may vote are specified in the corporation's bylaws. Any stockholder—or group of stockholders—that owns more than 50 percent of the capital stock has the power to elect the board of directors and to set basic corporate policies. Therefore, these stockholders control the corporation.
2. *To participate in dividends declared by the board of directors.* Stockholders in a corporation may not make withdrawals of company assets, as may the owners of unincorporated businesses. However, the directors may decide to distribute some or all of the earnings of a profitable corporation to its stockholders in the form of cash dividends. Dividends can be distributed only after they have been formally declared (authorized) by the board of directors. Dividends are paid to all shareholders in proportion to the number of shares owned.
3. *To share in the distribution of assets if the corporation is liquidated.* When a corporation ends its existence, the creditors must first be paid in full. The shareholders have a residual interest, and any remaining assets are divided among the shareholders in proportion to the number of shares owned.

Stockholders' meetings usually are held once each year. At these meetings, stockholders may ask questions of management and vote on certain issues. In large corporations, these meetings usually are attended by relatively few people—often less than 1 percent of the company's stockholders. Prior to these meetings, however, the management group requests that

LO11-3

LEARNING OBJECTIVE

Explain the rights of stockholders and the roles of corporate directors and officers.

Formation of a Corporation

stockholders who do not plan to attend send in proxy statements, granting management the voting rights associated with their shares.

Functions of the Board of Directors The primary functions of the **board of directors** are to set corporate policies and to protect the interests of the stockholders. Specific duties of the directors include hiring corporate officers and setting those officers' salaries, declaring dividends, and reviewing the findings of both internal auditors and independent auditors.

The board of a large corporation always includes several members of top management. In recent years, increasing importance has been attached to the inclusion of "outside" directors. The term *outside directors* refers to individuals who are not officers of the corporation and, therefore, bring an independent perspective to the board.

Functions of the Corporate Officers The top management of a corporation is appointed (hired) by the board of directors. These individuals are called the corporate officers. Individual stockholders do not have the right to transact corporate business unless they have been properly appointed to a managerial position.

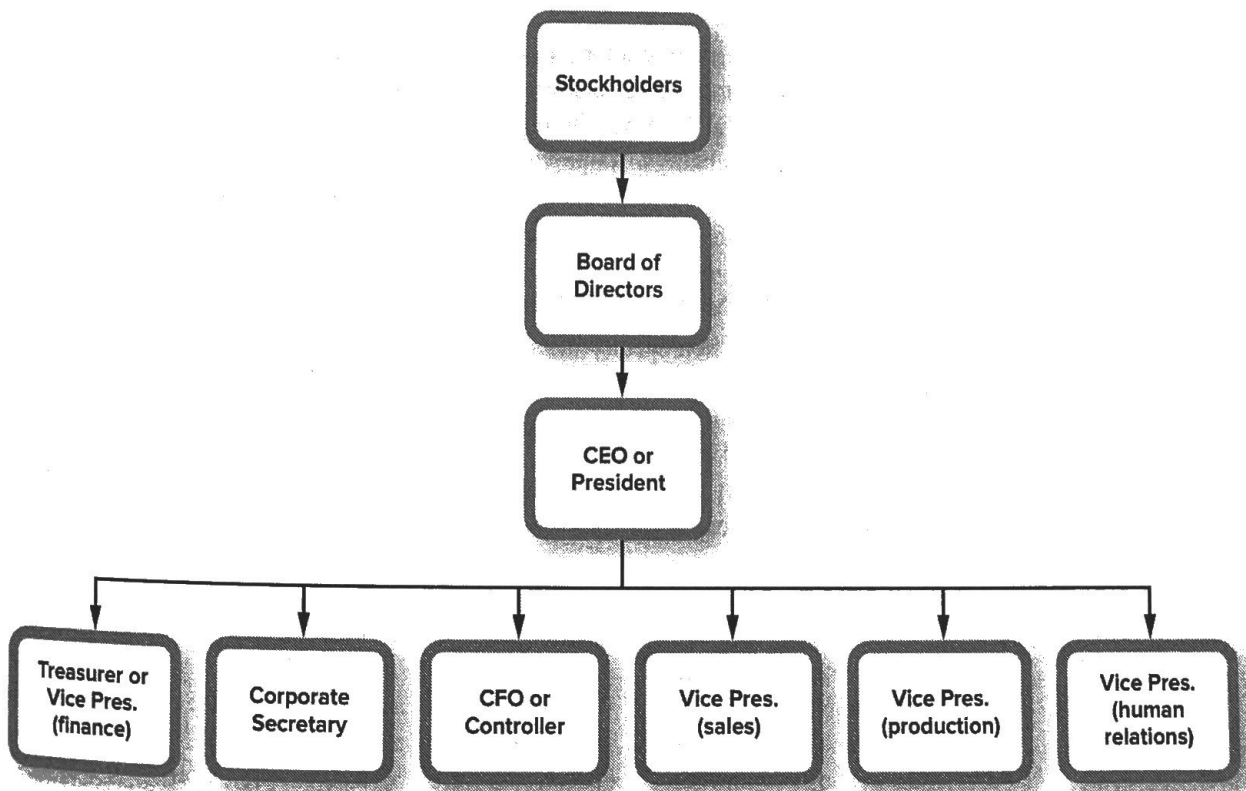
The top level of management usually includes a chief executive officer (CEO) or president, a chief financial officer (CFO) or controller, a treasurer, and a secretary. In addition, a vice president usually oversees each functional area, such as sales, personnel, and production.

The responsibilities of the CFO (controller), treasurer, and secretary are most directly related to the accounting phase of business operation. The CFO is responsible for the maintenance of adequate internal control and for the preparation of accounting records and financial statements. Such specialized activities as budgeting, tax planning, and preparation of tax returns are usually placed under the CFO's jurisdiction. The treasurer has custody of the company's funds and is generally responsible for planning and controlling the company's cash position. The treasurer's department also has responsibility for relations with the company's financial institutions and major creditors.

The secretary represents the corporation in many contractual and legal matters and maintains minutes of the meetings of directors and stockholders. Other responsibilities of the secretary are to coordinate the preparation of the annual report and to manage the investor relations department. In small corporations, one officer frequently acts as both secretary and treasurer.

The organization chart in Exhibit 11-2 is an example of how lines of authority may extend from stockholders, through the directors, and to the CEO and other officers.

EXHIBIT 11-2 Corporate Organization Chart



STOCKHOLDER RECORDS IN A CORPORATION

Many corporations with shares listed on the New York Stock Exchange have millions of shares outstanding and hundreds of thousands of stockholders. Each day many stockholders sell their shares; the buyers of these shares become new members of the company's family of stockholders.

A corporation must maintain an up-to-date record of the names and addresses of this constantly changing group of stockholders so that it can send dividend checks, financial statements, and voting forms to the right people.

Stockholders Subsidiary Ledger When there are numerous stockholders, it is not practical to include a separate account for each stockholder in the general ledger. Instead, a single controlling account entitled Capital Stock appears in the general ledger, and a **stockholders subsidiary ledger** is maintained. This ledger contains an account for each individual stockholder. Entries in the stockholders subsidiary ledger are made in number of shares, rather than in dollars. Each stockholder's account shows the number of shares owned and the dates of acquisitions and sales. This record enables the corporation to send each stockholder a single dividend check, even though the stockholder may have acquired shares on different dates.

Stock Transfer Agent and Stock Registrar Many large publicly owned corporations use an independent **stock transfer agent** and a **stock registrar** to maintain their stockholder records and to establish strong internal control over the issuance of stock certificates. These transfer agents and registrars are usually banks or trust companies. When stock certificates are transferred from one owner to another, the old certificates are sent to the transfer agent, who cancels them, makes the necessary entries in the stockholders subsidiary ledger, and prepares a new certificate for the new owner of the shares. This new certificate then must be registered with the stock registrar before it represents valid and transferable ownership of stock in the corporation.

Small closely held corporations generally do not use the services of independent registrars and transfer agents. In these companies, the stockholder records usually are maintained by a corporate officer. To prevent the accidental or fraudulent issuance of an excessive number of stock certificates, the corporation should require that each certificate be signed by at least two designated corporate officers.

Paid-In Capital of a Corporation

Stockholders' equity of a corporation is normally increased in one of two ways: (1) from contributions by investors in exchange for capital stock—called **paid-in capital** or **contributed capital**—and (2) from the retention of profits earned by the corporation over time—called **retained earnings**. As previously noted, our focus in this chapter is primarily on issues related to paid-in capital. In Chapter 12, we shift our attention to issues concerning retained earnings.

AUTHORIZATION AND ISSUANCE OF CAPITAL STOCK

The articles of incorporation specify the number of shares that a corporation is authorized to issue by the state of incorporation. Issues of capital stock that will be sold to the general public must be approved by the federal Securities and Exchange Commission, as well as by state officials.

Corporations normally obtain authorization for more shares than they initially plan to issue. This way, if more capital is needed later, the corporation already has the authorization to issue additional shares.

Shares that have been issued and are in the hands of stockholders are called **outstanding shares**. At any time, these outstanding shares represent 100 percent of the stockholders' investment in the corporation.

When a large amount of stock is to be issued, most corporations use the services of an investment banking firm, frequently referred to as an **underwriter**. The underwriter guarantees the issuing corporation a specific price for the stock and earns a profit by selling the

LO11-4

LEARNING OBJECTIVE
Account for paid-in capital and prepare the equity section of a corporate balance sheet.

shares to the investing public at a slightly higher price. The corporation records the issuance of the stock at the net amount received from the underwriter. The use of an underwriter assures the corporation that the entire stock issue will be sold without delay and that the entire amount of funds to be raised will be available on a specific date.

The price that a corporation will seek for a new issue of stock is based on such factors as (1) expected future earnings and dividends, (2) the financial strength of the company, and (3) the current state of the investment markets. If the corporation asks too high a price, it will not find an underwriter or other buyers willing to purchase the shares.

State Laws Affect the Balance Sheet Presentation of Stockholders' Equity The number of different accounts that a corporation must use in the stockholders' equity section of its balance sheet is determined largely by state laws. We have seen that corporations use separate stockholders' equity accounts to represent (1) contributed capital, or paid-in capital, and (2) earned capital, or retained earnings. Up to this point, we have assumed that all paid-in capital is presented in a single account entitled Capital Stock. But this often is not the case.

Some corporations issue several different types (or classes) of capital stock. In these situations, a separate account is used to indicate each type of stock outstanding. A legal concept called *par value* also affects the balance sheet presentation of paid-in capital.

Par Value **Par value (or stated value)** represents the **legal capital** per share—the amount below which stockholders' equity cannot be reduced, except by losses from business operations (or by special legal action). Par value, therefore, may be regarded as a minimum cushion of equity capital existing for the protection of creditors.

Because of the legal restrictions associated with par value, most state laws require corporations to show separately in the stockholders' equity section of the balance sheet the par value of shares issued. This special balance sheet presentation has led some people to believe that par value has some special significance. In many corporations, however, the par value of the shares issued is a small portion of total stockholders' equity.

A corporation may set the par value of its stock at \$1 per share, \$5 per share, or any other amount that it chooses. Most large corporations set the par value of their common stocks at nominal amounts, such as 1 cent per share or \$1 per share. The par value of the stock is not an indication of its market value; the par value merely indicates the amount per share to be entered in the Capital Stock account. For example, the common stock of Ford has a par value of \$0.01, and Target's common stock has a par value of \$1. The market values of each of these securities are far above their par values.

Issuance of Par Value Stock Authorization of a stock issue does not create an asset for the corporation, nor does it give the corporation any capital. The obtaining of authorization from the state for a stock issue merely affords a legal opportunity to obtain assets through the sale of stock. Additional capital is created for the company only when that stock is sold to stockholders.

When par value stock is issued, the Capital Stock account is credited with the par value of the shares issued, regardless of whether the issuance price is more or less than par. Assuming that 50,000 shares of \$2 par value stock have been authorized and that 10,000 of these authorized shares are sold at a price of \$2 each, Cash is debited and Capital Stock is credited for \$20,000. When stock is sold for more than par value, the Capital Stock account is credited with the par value of the shares issued, and a separate account, **Additional Paid-in Capital**, is credited for the excess of selling price over par. If, for example, our 10,000 shares were issued at a price of \$8 per share, the entry would be as follows.

Cash	80,000	
Capital Stock		20,000
Additional Paid-in Capital		60,000
Issued 10,000 shares of \$2 par value stock at a price of \$8 per share.		

A-1-10E

Stockholders' investment in excess of par value

Chapter 11 Stockholders' Equity: Paid-In Capital

492

The additional paid-in capital does not represent a profit to the corporation. It is part of the invested capital, and it is added to the capital stock in the balance sheet to show the total paid-in capital. The stockholders' equity section of the balance sheet follows. (The \$150,000 in retained earnings is assumed in order to have a complete illustration.)

Stockholders' equity:	
Capital stock, \$2 par value; authorized, 50,000 shares; issued and outstanding, 10,000 shares	\$ 20,000
Additional paid-in capital	60,000
Total paid-in capital	\$ 80,000
Retained earnings	150,000
Total stockholders' equity	<u>\$230,000</u>

If stock is issued by a corporation for less than par, the account Discount on Capital Stock should be debited for the difference between the issuance price and the par value. A discount on capital stock reduces, rather than increases, the amount of stockholders' equity in the balance sheet. The issuance of stock at a discount is seldom encountered.

In some cases, stock is issued in exchange for assets other than cash. When this occurs, the appropriate asset account is debited (for example, Inventory or Land) and the stock accounts are credited as if the stock had been sold for cash. Establishing a value for recording a transaction of this type is sometimes difficult, but should be based on either the fair value of the assets received or the stock issued, whichever can be more objectively determined.

No-Par Stock Some states allow corporations to issue stock without designating a par or stated value. When this "no-par" stock is issued, the entire issue price is credited to the Capital Stock account and is viewed as legal capital not subject to withdrawal.

COMMON STOCK AND PREFERRED STOCK

The account title Capital Stock is widely used when a corporation has issued only one type of stock. In order to appeal to as many investors as possible, however, some corporations issue several types (or classes) of capital stock, each providing investors with different rights and opportunities.

The basic type of capital stock issued by every corporation often is called **common stock**. Common stock possesses the traditional rights of ownership—voting rights, participation in dividends, and a residual claim to assets in the event of liquidation. When the rights of stockholders are modified, the term **preferred stock** is often used to describe the resulting type of capital stock. Some corporations issue two or more classes of preferred stock, with each class having distinctive features designed to appeal to a particular type of investor.

The following stockholders' equity section illustrates the balance sheet presentation for a corporation having both preferred and common stock. As before, a retained earnings amount is assumed so we can provide a complete example.

Stockholders' equity:	
9% cumulative preferred stock, \$100 par value, authorized 100,000 shares, issued and outstanding 50,000 shares	\$ 5,000,000
Common stock, \$5 par value, authorized 3 million shares, issued and outstanding 2 million shares	10,000,000
Additional paid-in capital:	
Preferred stock	500,000
Common stock	20,000,000
Total paid-in capital	<u>\$35,500,000</u>
Retained earnings	17,500,000
Total stockholders' equity	<u>\$53,000,000</u>

L011-5

LEARNING OBJECTIVE

Contrast the features of common stock with those of preferred stock.

A=L+LOE

Balance sheet presentation of common stock and preferred stock

CHARACTERISTICS OF PREFERRED STOCK

Preferred stocks typically have some combination of the following distinctive features:

1. Preference over common stock as to dividends.
2. Cumulative dividend rights in which unpaid dividends carry forward to future periods.
3. Preference over common stock as to assets in the event of liquidation of the company.
4. Call feature that allows the corporation to repurchase its own stock.
5. The absence of voting power.

Another important but less common feature of some preferred stocks is a clause permitting the conversion of preferred stock into common stock at the option of the holder. Preferred stocks vary widely with respect to the special rights and privileges granted. Careful study of the terms of the individual preferred stock contract is a necessary step in the evaluation of any preferred stock.



INTERNATIONAL CASE IN POINT

Specific preferred stock characteristics can affect the reporting location on the balance sheet. For example, preferred stock that is mandatorily redeemable by the issuing company is required by international accounting standards to be classified as a liability (rather than an equity) on the balance sheet. In 2003, the FASB changed U.S. GAAP reporting requirements from allowing redeemable preferred stock to be reported in the equity section to requiring it to be reported in the liability section, consistent with international standards.

Stock Preferred as to Dividends Corporations often make periodic cash payments, called **dividends**, to stockholders.² Dividends normally involve a distribution of cash that represents accumulated earnings and therefore cannot exceed the amount of a corporation's retained earnings.

Preferred stock is said to have dividend preference because preferred stock investors are entitled to receive a specified amount each year before any dividend is paid to common stock investors. The specified dividend may be stated as a dollar amount, such as \$5 per share. Some preferred stocks, however, state the specified dividend as a percentage of par value. For example, a share of preferred stock with a par value of \$100 and a dividend preference of 7 percent must provide a \$7 dividend ($\$100 \times 7\%$) each year to each share of preferred stock before any dividends can be paid on the common shares.

The holders of preferred stock have no guarantee that they will receive the indicated dividend. A corporation is obligated to pay dividends to stockholders only when cash is available and the board of directors declares a dividend. Dividends must be paid on preferred stock before anything is paid to the common stockholders, but if the corporation is not prospering, it may decide not to pay any dividends at all. For a corporation to pay dividends, profits must be earned and cash must be available.

Cumulative Preferred Stock The dividend preference carried by most preferred stocks is cumulative. If all or any part of the regular dividend on the preferred stock is omitted in a given year, the amount omitted is said to be *in arrears* and must be paid in a subsequent year before any dividend can be paid on the common stock.

Assume that a corporation is organized on January 1, 2016, with 10,000 shares of \$8 preferred stock and 50,000 shares of common stock. If the preferred stock is noncumulative, the

² In Chapter 12, we will discuss specific accounting issues related to cash dividends and other forms of distributions to stockholders. For the purposes of this chapter, dividends may be viewed simply as the distribution to stockholders of accumulated profits that reduce both cash and retained earnings.

Chapter 11 Stockholders' Equity: Paid-In Capital

494

\$8 per share dividend does not carry forward if it is not paid each year. On the other hand, if the preferred stock is cumulative, the \$8 per share dividend carries forward to future years if it is not paid, and the accumulated amount must be paid before any dividend can be paid on common stock. Assume that the \$8 preferred dividend is paid in 2016, a partial dividend of \$2 per share is paid on preferred stock in 2017, and no preferred dividend is paid in 2018. Following is an analysis of the status of the preferred dividend at the end of 2018.

	2016	2017	2018
If preferred stock is noncumulative			
Dividend paid	\$80,000	\$20,000	—
Dividend in arrears		Not applicable	—
If preferred stock is cumulative			
Dividend paid	\$80,000	\$20,000	—
Dividends in arrears	—	\$60,000	\$140,000

In the case of noncumulative preferred stock, the unpaid dividend does *not* carry forward to future years and has no effect on the company's ability to pay dividends on common stock in the future. In the case of cumulative preferred stock, however, any unpaid dividend on preferred stock carries forward and must be paid before dividends can be paid on common stock. In 2017, the partial unpaid dividend of \$60,000 would have to have been paid before any dividend could have been paid on common stock. At the end of 2018, this amount has grown to \$140,000 (the \$60,000 carried forward from 2017, plus the \$80,000 that was not paid for 2018). Before a dividend could have been paid on common stock in 2018, the \$60,000 preferred dividend in arrears from 2017 and the current preferred dividend of \$80,000 for 2018 would have to have been paid.

Dividends in arrears are not included among the liabilities of a corporation, because no liability exists until a dividend is declared by the board of directors. The amount of any dividends in arrears on preferred stock is an important factor to investors, however, and should always be disclosed. This disclosure is usually made by a note accompanying the balance sheet such as the following.

Note 6: Dividends in arrears

As of December 31, 2018, dividends on the \$8 cumulative preferred stock were in arrears to the extent of \$14 per share and amounted in total to \$140,000.

In 2019, we shall assume that the company earned large profits, has available cash, and decided to pay dividends on both the preferred and common stocks. Before paying a dividend on the common stock, the corporation must pay the \$140,000 in arrears on the cumulative preferred stock *plus* the regular \$8 per share applicable to the current year. The preferred stockholders would, therefore, receive a total of \$220,000 (\$140,000 + \$80,000) in dividends in 2019 (\$22 per share); the board of directors would then be free to declare dividends on the common stock.

Other Features of Preferred Stock To add to the attractiveness of preferred stock as an investment, corporations sometimes offer a conversion privilege that entitles the preferred stockholders to exchange their shares for common stock at a stipulated ratio. If the corporation prospers, its common stock will probably rise in market value, and dividends on the common stock will probably increase. The investor who buys a convertible preferred stock rather than common stock has greater assurance of regular dividends. In addition, through the conversion privilege, the investor is assured of an opportunity to share in any substantial increase in value of the company's common stock.

The three primary elements of stockholders' equity for most companies are common stock, preferred stock, and retained earnings. While important, other elements that we learn about

Paid-In Capital of a Corporation

495

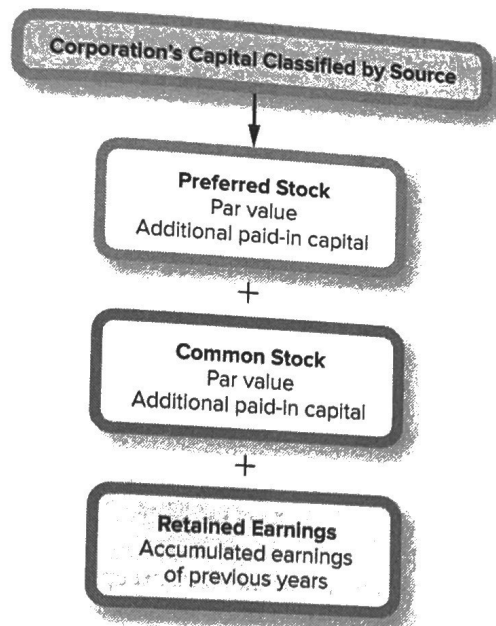


EXHIBIT 11-3
Primary Sources of
Corporate Equity

later in this chapter, as well as in Chapter 12, are typically smaller in amount than these three primary elements. The relationship of common stock, preferred stock, and retained earnings is depicted in Exhibit 11-3.

BOOK VALUE PER SHARE OF COMMON STOCK

Because the equity of each stockholder in a corporation is determined by the number of shares he or she owns, an accounting measurement of interest to some stockholders is book value per share of common stock. **Book value per share** is the amount of net assets represented by each share of stock. The term *net assets* means total assets minus total liabilities; in other words, net assets are equal to total stockholders' equity. For a corporation that has issued common stock only, the book value per share is computed by dividing total stockholders' equity by the number of shares outstanding.

For example, assume that a corporation has 4,000 shares of common stock outstanding and the stockholders' equity section of the balance sheet is as follows.

Stockholders' equity:	
Common stock, \$1 par value (4,000 shares issued and outstanding)	\$ 4,000
Additional paid-in capital	50,000
Retained earnings	76,000
Total stockholders' equity	<u>\$130,000</u>

The book value per share is \$32.50; it is computed by dividing the stockholders' equity of \$130,000 by the 4,000 shares of outstanding stock.

Book Value When a Company Has Both Preferred and Common Stock Book value is usually computed only for common stock. If a company has both preferred and common stock outstanding, the computation of book value per share of common stock requires two steps. First, the amount assigned to preferred stock and any dividends in arrears are deducted from total stockholders' equity. Second, the remaining amount of stockholders' equity is divided by the number of common shares outstanding to determine book value per common share. This procedure reflects the fact that the common stockholders are the residual owners of the corporate entity.

How much is book value per share?

Chapter 11 Stockholders' Equity: Paid-In Capital

To illustrate the computation of book value per share when preferred stock is outstanding, assume that the stockholders' equity of Hart Company at December 31 is as follows.

Stockholders' equity:

8% preferred stock, \$100 par value, 10,000 shares authorized, issued, and outstanding	\$1,000,000
Common stock, \$10 stated value, authorized 100,000 shares, issued and outstanding 50,000 shares	500,000
Additional paid-in capital: common stock	750,000
Total paid-in capital	\$2,250,000
Retained earnings	130,000
Total stockholders' equity	<u>\$2,380,000</u>

Because of a weak cash position, Hart Company has paid no dividends during the current year. As of December 31, dividends in arrears on the cumulative preferred stock total \$80,000 (10,000 shares \times 100 par value \times 8%).

All the equity belongs to the common stockholders, except the \$1,000,000 par value applicable to the preferred stock plus the \$80,000 of dividends in arrears on preferred stock. The calculation of book value per share of common stock is as follows.

Total stockholders' equity	\$2,380,000
Less: Equity of preferred stockholders:	
Par value of preferred stock	\$1,000,000
Dividends in arrears	80,000
Equity of common stockholders	<u>1,300,000</u>
Number of common shares outstanding	50,000
Book value per share of common stock (\$1,300,000 \div 50,000 shares)	\$ 26

In a statement of cash flows, transactions with the stockholders of a corporation are classified as financing activities. For example, the issuance of capital stock for cash represents a receipt from financing activities. Distributions of cash to stockholders—including the payment of cash dividends—represent cash outlays, which are also classified as financing activities.

Transactions with owners do not always have an immediate effect on cash flows. Consider an exchange of the corporation's capital stock for a noncash asset, such as land. Cash is not increased or decreased by this event. These types of noncash transactions are described in a special schedule that accompanies the statement of cash flows.

Market Value

After shares of stock have been issued, they may be sold by one investor to another. The price at which these shares change hands between investors represents the market price of the stock. This market price may differ substantially from such amounts as par value, the original issue price, and the current book value. Which is the most relevant amount? That depends on your point of view.

After shares are issued, they belong to the stockholder, not to the issuing corporation. Changes in the market price of these shares directly affect the financial position of the stockholder, but not that of the issuing company. This concept explains why the issuing company and stockholders apply different accounting principles to the same outstanding shares.

Accounting by the Issuer From the viewpoint of the issuing company, outstanding stock represents an amount invested in the company by its owners at a particular date. This amount represents capital available to the company from the original sale of the stock. While the market value of the stockholders' investment may change, the amount of resources that they originally invested in the company does not change.

Market Value

The company issuing stock records the issue price—that is, the proceeds received from issuing the stock—in its paid-in capital accounts. The balances in these accounts remain unchanged unless (1) more shares are issued or (2) outstanding shares are permanently retired (for example, preferred stock is called or stock is purchased on the open market and then retired).

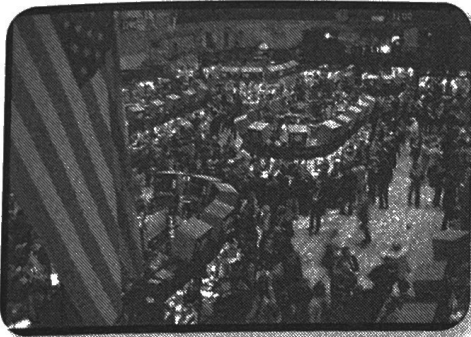
Accounting by the Investor From the investor's point of view, shares owned in a publicly owned company are an asset, usually called Marketable Securities.

To the investor, the current market value of securities owned is more relevant than the original issue price—or than the securities' par values or book values. The market value indicates what the securities are worth today. Changes in market value directly affect the investor's liquidity and financial position. For these reasons, investors show investments in marketable securities at current market value in their balance sheets.

497

CASE IN POINT

In a single day, the market price of IBM's capital stock dropped over \$31 per share, falling from \$135 to \$103.25. Of course, this was not a typical day. The date, October 19, 1987, will long be remembered as "Black Monday." On this day, stock prices around the world suffered the greatest one-day decline in history.



©Royalty-Free/Corbis

Stocks listed on the New York Stock Exchange lost about 20 percent of their value in less than six hours. Given that the annual dividends on these stocks averaged about 2 percent of their market value, this one-day market loss was approximately equal to the loss by investors of all dividend revenue for about 10 years.

How did this disastrous decline in IBM's stock price directly affect the balance sheet of IBM on October 19, 1987? Actually, it didn't. IBM's stock isn't owned by IBM—it is owned by the company's stockholders.

Because market prices are of such importance to investors, we will briefly discuss the factors that most affect the market prices of preferred and common stocks.

MARKET PRICE OF PREFERRED STOCK

Investors buy preferred stocks primarily to receive the dividends that these shares pay. This means that the dividend rate is one important factor in determining the market price of a preferred stock. A second important factor is risk. In the long run, a company must be profitable enough to pay dividends. If there is a distinct possibility that the company will not operate profitably and pay dividends, the price of its preferred stock will probably decline.

A third factor greatly affecting the value of preferred stocks is the level of interest rates. What happens to the market price of an 8 percent preferred stock, originally issued at a par value of \$100, if government policies and other factors cause long-term interest rates to rise to, say, 10 percent or 12 percent? If investments offering a return of 12 percent with a similar level of risk are readily available, investors will no longer pay \$100 for a share of preferred stock that provides a dividend of only 8 percent per year. The market price of the preferred stock will fall to about two-thirds of its original issue price, or about \$67 per share. At this market price, the stock offers a competitive return of about 12 percent ($\$8 \div \67) (called the **dividend yield**) to an investor purchasing the stock.

However, if the prevailing long-term interest rates should again decline to the 8 percent range, the market price of an 8 percent preferred stock should rise to approximately par value.

LO11-6

LEARNING OBJECTIVE

Discuss the factors affecting the market price of preferred stock and common stock.

Chapter 11 Stockholders' Equity: Paid-In Capital

498

In summary, the market price of preferred stock varies inversely with interest rates. As interest rates rise, preferred stock prices decline; as interest rates fall, preferred stock prices rise.

MARKET PRICE OF COMMON STOCK

Prevailing interest rates also affect the market price of common stock. However, dividends paid to common stockholders are not fixed in amount. Both the amount of the dividend and the market price of the stock may increase dramatically if the corporation is successful. Alternatively, if the company is unsuccessful, the common stockholders may not even recover their original investment. The most important factors in the market price of common stock are investors' expectations as to the future profitability of the business and the risk that this level of profitability may not be achieved.

BOOK VALUE AND MARKET PRICE

To some extent, book value is used in evaluating the reasonableness of the market price of a stock. However, it must be used with caution; the fact that a stock is selling at less than book value does not necessarily indicate a bargain.

Book value is a historical concept, representing the amounts invested by stockholders plus the amounts earned and retained by the corporation. If a stock is selling at a price *above* book value, investors believe that management has created a business worth more than the historical cost of the resources entrusted to its care. This, in essence, is the sign of a successful corporation.

On the other hand, if the market price of a stock is less than book value, investors believe that the company's resources are worth less than their cost while under the control of current management. The relationship between book value and market price is one measure of investors' confidence in a company's management.

STOCK SPLITS

Over time, the market price of a corporation's common stock may increase in value so much that it becomes too expensive for many investors. When this happens, a corporation may split its stock by increasing the number of its common shares outstanding. The purpose of a **stock split** is to reduce the market price of the company's common stock, with the intent of making it more affordable to investors while not reducing the amount of equity financing of the company.

For example, assume that Felix Corporation has outstanding 1 million shares of \$10 par value common stock. The market price is currently \$90 per share. To make the stock more affordable, the corporation decides to increase the number of outstanding shares from one million to two million. This action is called a 2-for-1 stock split. A stockholder who owned 100 shares of the stock before the split will own 200 shares after the split. Since the number of outstanding shares has doubled without any change in total assets or total stockholders' equity, the market price of the stock should drop from \$90 to approximately \$45 per share. In splitting its stock, a corporation will reduce the par value per share in proportion to the size of the split. As this was a 2-for-1 split, the company will reduce the par value of the stock from \$10 to \$5 per share. Had it been a 4-for-1 split, the par value would have been reduced from \$10 to \$2.50 per share and the stock price would have declined to approximately 25 percent of its former amount.

A stock split does not change the balance of any accounts in the balance sheet; consequently, the transaction is recorded merely by a memorandum entry. For Felix Corporation, this memorandum entry for a 2-for-1 stock split might read as follows.

Sept. 30 Memorandum: Issued additional one million shares of common stock in a 2-for-1 stock split. Par value reduced from \$10 per share to \$5 per share.

The description of common stock also is changed in the balance sheet to reflect the lower par value and the greater number of shares outstanding.

Another form of stock distribution to current stockholders is a stock dividend. While stock dividends are similar to stock splits in some respects, they are much smaller in size and have a different intent. Because they are important considerations in a company's dividend policy, we defer the detailed coverage of stock dividends to Chapter 12.

LO11-7

LEARNING OBJECTIVE
Explain the significance of book value and market value of capital stock.

LO11-8

LEARNING OBJECTIVE
Explain the purpose and effects of a stock split.

A-LOE

Memorandum entry to record a stock split

Treasury Stock

Treasury stock is defined as shares of a corporation's own capital stock that have been issued and later reacquired by the issuing company but that have not been canceled or permanently retired. Treasury shares may be held indefinitely or may be issued again at any time. Shares of capital stock held in the treasury ordinarily are not entitled to receive dividends, to vote, or to share in assets upon dissolution of the company.

Stock option plans are an important part of employee compensation for many companies. They permit employees to purchase stock in the company, often at advantageous prices, and are a means of creating employee loyalty to the company. Treasury stock purchases are one means by which the company can have available the shares of stock needed to satisfy the requirement of stock option plans to issue shares of stock to employees. Rather than increasing the total number of outstanding shares, thereby reducing or diluting the ownership of each share, the company purchases shares of stock from the current owners and then sells the same shares a second time to its employees.

LO11-9

LEARNING OBJECTIVE
Account for treasury stock transactions.

RECORDING PURCHASES OF TREASURY STOCK

Purchases of treasury stock are usually recorded by debiting the Treasury Stock account with the cost of the stock. For example, if Riley Corporation reacquires 1,600 shares of its own \$5 par stock at a price of \$90 per share, the entry is as follows.

Treasury Stock	144,000	
Cash		144,000
Purchased 1,600 shares of \$5 par treasury stock at \$90 per share.		

Note that the Treasury Stock account is debited for the cost of the shares purchased, not their par value. Treasury stock is a contra-equity account. When treasury stock is purchased, the corporation is eliminating part of its stockholders' equity by a payment to one or more stockholders. The purchase of treasury stock is regarded as a reduction of stockholders' equity, not as the acquisition of an asset. For this reason, the Treasury Stock account appears in the balance sheet as a deduction in the stockholders' equity section. Treasury shares are both authorized and issued, but while they are held by the issuing company, they are not outstanding.

The presentation of treasury stock in Riley Corporation's balance sheet appears as follows, based on assumed numbers (except for treasury stock).

Stockholders' equity:		
Common stock, \$5 par value, authorized 250,000 shares, issued 100,000 shares (of which 1,600 are held in treasury)		\$ 500,000
Additional paid-in capital: common stock		800,000
Total paid-in capital		\$1,300,000
Retained earnings		600,000
Subtotal		\$1,900,000
Less: Treasury stock (1,600 shares of common, at \$90 cost)		144,000
Total stockholders' equity		<u>\$1,756,000</u>

REISSUANCE OF TREASURY STOCK

When treasury shares are reissued, the Treasury Stock account is credited for the cost of the shares reissued, and Additional Paid-in Capital from Treasury Stock Transactions is debited or credited for any difference between cost and the reissue price. To illustrate, assume that

Chapter 11 Stockholders' Equity: Paid-In Capital

1,000 of the treasury shares acquired by Riley Corporation at a cost of \$90 per share are now reissued at a price of \$115 per share. The entry to record the reissuance of these shares at a price above cost is as follows.

Treasury stock reissued at a price above cost

Cash	115,000	
Treasury Stock		90,000
Additional Paid-in Capital: Treasury Stock		25,000
Sold 1,000 shares of treasury stock, which cost \$90,000, at a price of \$115 per share.		

The \$25,000 of additional paid-in capital resulting from the reissuance of Riley's treasury stock is reported in the stockholders' equity section of the company's balance sheet. It appears immediately after additional paid-in capital from common stock, as shown below. For purposes of illustration, we assume that retained earnings increased by \$50,000 while the original purchase of treasury stock was held.

Stockholders' equity:

Common stock, \$5 par value, authorized 250,000 shares, issued 100,000 shares (of which 600 are held in treasury)	\$ 500,000
Additional paid-in capital:	
Common stock	800,000
Treasury stock	25,000
Total paid-in capital	\$1,325,000
Retained earnings	650,000
Subtotal	\$1,975,000
Less: Treasury stock (600 shares of common, at \$90 cost)	54,000
Total stockholders' equity	<u>\$1,921,000</u>

If treasury stock is reissued at a price below cost, additional paid-in capital from previous treasury stock transactions is reduced (debited) by the excess of cost over the reissue price. To illustrate, assume that Riley Corporation later reissues its remaining 600 shares of treasury stock (acquired at a cost of \$90 per share) at a price of \$75 per share. The entry is as follows.

Reissued at a price below cost

Cash	45,000	
Additional Paid-in Capital: Treasury Stock	9,000	
Treasury Stock		54,000
Sold 600 shares of treasury stock, which cost \$54,000, at a price of \$75 each.		

If there is no additional paid-in capital from previous treasury stock transactions, the excess of the cost of the treasury shares over the reissue price is recorded as a reduction in the Additional Paid-in Capital: Common Stock account. If that account is not sufficient, Retained Earnings is reduced.

Notice that no gain or loss is recognized on treasury stock transactions, even when the shares are reissued at a price above or below cost. A corporation earns profits by selling goods and services to outsiders, not by issuing or reissuing shares of its own capital stock. When treasury shares are reissued at a price above cost, the corporation receives from the new stockholder an amount of paid-in capital that is larger than the reduction in stockholders' equity that occurred when the corporation acquired the treasury shares. Conversely, if treasury shares are reissued at a price below cost, the corporation has less paid-in capital as a result of the purchase and reissuance of the shares.

STOCK BUYBACK PROGRAMS

501

Historically, most treasury stock transactions involved relatively small dollar amounts. Some corporations have buyback programs, in which they repurchase large amounts of their own common stock. As a result of these programs, treasury stock may become a material item in the balance sheets of these corporations.

Transactions between the corporation and its stockholders are classified in the statement of cash flows as financing activities. When treasury stock is purchased, a financing cash *outflow* is reported in the statement of cash flows. When treasury stock is reissued, the amount of cash received is reported as a financing cash *inflow* in the statement of cash flows.

Because treasury stock transactions do not give rise to gains or losses, they have no direct effect on the corporation's net income. Any difference between the purchase price of the treasury stock and the cash received when it is reissued is reported as an increase or decrease in the corporation's paid-in capital.



PATHWAYS CONNECTION

Has management effectively used the assets that have been entrusted to them to enhance the financial interests of the equity holders? The Pathways Model that we have referred to in each chapter emphasizes the importance of using financial information to make informed decisions. Two measures that are sometimes used to help answer this question are return on assets and return on stockholders' equity. While neither of these appear in the company's financial statements, both can be computed with information taken directly from the statement of financial position (balance sheet) and the income statement.

For example, the following information was taken from a recent annual report of Verizon Communications (in millions).

Net income	\$ 11,965
Average total assets	\$253,403
Average stockholders' equity	\$ 54,546

Several frequently used measures of profitability that are based, in part, on capital stock concepts covered in this chapter can be derived from the previous figures.

Profitability Measure	Computation	Significance
Return on total assets	$\frac{\text{Net Income}}{\text{Average Total Assets}}$	The rate of return on the total asset investment used to earn that return
Return on stockholders' equity	$\frac{\text{Net Income}}{\text{Average Stockholders' Equity}}$	The rate of return earned on the stockholders' equity when the company has only common stock

Using the figures provided, Verizon's profitability measures would be as follows.

Return on total assets:	$\$11,957 \div \$253,403 = 4.7\%$
Return on common shareholders' equity:	$\$11,957 \div \$ 54,546 = 21.9\%$

When these figures are compared with comparable figures over several years, as well as with those of similar companies, the effectiveness of management in using the company's assets and enhancing the investment of owners can become clear.



YOUR TURN

You as a Financial Analyst

You are working for a stock market research firm and your boss has asked you to assess Verizon's return on assets and on common shareholders' equity. How might you proceed?

(See our comments in Connect.)

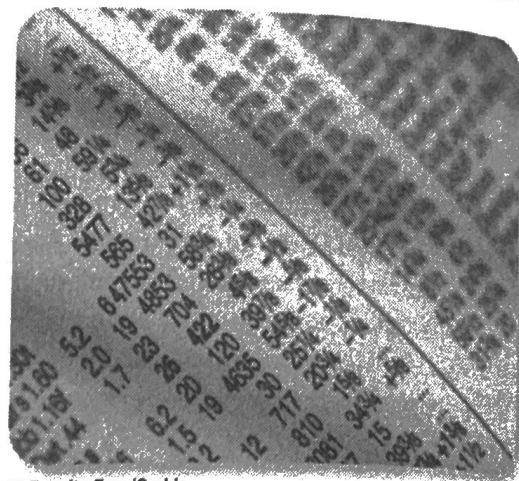


ETHICS, FRAUD, & CORPORATE GOVERNANCE

A learning objective for this chapter is to understand the advantages of organizing a business as a corporation. Corporations often choose to go public in order to raise equity capital from many investors.

On rare occasions, the process of going public can be abused and can result in the defrauding of investors. One scheme is the use of "shell companies" in a "pump-and-dump scheme." The Securities and Exchange Commission (SEC) defines a shell company as a company with little or no operating activities, little or no assets, or assets consisting solely of cash and cash equivalents. Most commonly, a private operating business is combined with the public shell company in a reverse merger. In a reverse merger, the public shell company is the surviving entity but it is controlled by the shareholders of the previously private business. The rest of the "pump-and-dump scheme" works as follows: (1) The owners (promoters) of the company claim that the previously private business has high growth potential, (2) limited financial and other information on the combined company is filed with the SEC, (3) the owners (promoters) "pump" the stock through unduly positive press releases and other manipulative devices, (4) high-pressure sales tactics are often employed to get individuals to buy the stock, and (5) the owners (promoters) "dump" their stock at artificially high prices.

An example of a stock manipulation scheme using a shell company occurred in the case of 2DoTrade, Inc. 2DoTrade was a public shell company when a group of promoters secretly acquired over 99 percent of its shares. The promoters merged 2DoTrade with a private company controlled by a convicted



© Royalty-Free/Corbis

felon. The promoters pumped the stock by claiming that the company had import/export contracts worth more than \$300 million and that the company was developing an anti-anthrax compound. In reality, the contracts were worthless because no anti-anthrax compound was in development, and one was never seriously contemplated. At one point during the pump campaign the market value of the company exceeded \$46 million, yet the company had no assets and no revenue. The promoters then dumped their shares, reaping almost \$2 million in profits.

The SEC brought civil enforcement actions against the promoters of 2DoTrade, and the FBI arrested a number of the promoters as criminal charges were filed by the U.S. Justice Department.

Concluding Remarks

In this chapter, we covered the aspects of stockholders' equity that result primarily from various transactions between the company and its stockholders, including the sale and repurchase of capital stock. We explored different characteristics of stock, including the unique features of preferred stock.

Another major source of stockholders' equity is the accumulated earnings of previous years that have been retained for purposes of expansion and meeting other business objectives. This is the subject of Chapter 12, which follows. While paid-in capital and retained earnings are two distinct aspects of stockholders' equity, they are closely related and, therefore, are virtually impossible to discuss totally independently of each other. For that reason, in this chapter there were occasional references to retained earnings. Similarly, in Chapter 12 you will find references to common and preferred stock, additional paid-in capital, treasury stock, and other aspects of stockholders' equity that we covered primarily in this chapter. Combining the content of Chapters 11 and 12, you will have a good working knowledge of stockholders' equity and how it fits together with assets and liabilities to form the basis for a company's balance sheet.