LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Discuss the characteristics of the corporate form of organization.
2. Identify the key components of stockholders' equity.
3. Explain the accounting procedures for issuing shares of stock.
4. Describe the accounting for treasury stock.
5. Explain the accounting for and reporting of preferred stock.
6. Describe the policies used in distributing dividends.
7. Identify the various forms of dividend distributions.
8. Explain the accounting for small and large stock dividends, and for stock splits.
9. Indicate how to present and analyze stockholders' equity.

It’s a Global Market

As mentioned in prior chapters, we are moving rapidly toward one set of global financial reporting standards and one “common language” for financial information. This change will probably lead to more consolidation of our capital markets. To understand how quickly the global financial world is changing, let’s examine a few trends occurring on stock exchanges around the world.

In 2007, the New York Stock Exchange (NYSE) merged with Paris-based Euronext, creating the world’s first transatlantic stock exchange. NYSE Euronext is the world’s largest exchange group, now with 8,000 listed issuers representing over 40 percent of global equity trading in 2010. Similarly, NASDAQ, the world’s largest electronic stock market, merged with OMX, the Nordic stock market operator. This electronic exchange operates in 29 countries, on six continents, and has over 4,000 listed issuers, with a market value of approximately $5.5 trillion.

Another reason behind the movement to international financial reporting standards can be found in recent initial public offerings (IPOs). The emerging markets are driving the global IPO market. As shown in the following table, in the first three months of 2008, only one of the top ten IPOs occurred on the NYSE.

<table>
<thead>
<tr>
<th>Ranking</th>
<th>Issuer Name</th>
<th>Domicile Nation</th>
<th>Industry Description</th>
<th>Proceeds (US$m)</th>
<th>Primary Exchange</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Visa Inc</td>
<td>United States</td>
<td>Financials</td>
<td>19,650</td>
<td>NYSE</td>
</tr>
<tr>
<td>2</td>
<td>China Railway Construction Corp</td>
<td>China</td>
<td>Industrials</td>
<td>5,709</td>
<td>Shanghai, HKEx</td>
</tr>
<tr>
<td>3</td>
<td>Reliance Power Ltd</td>
<td>India</td>
<td>Energy and power</td>
<td>2,964</td>
<td>Bombay</td>
</tr>
<tr>
<td>4</td>
<td>Mobile Telecommunications Company</td>
<td>Saudi Arabia</td>
<td>Telecommunications</td>
<td>1,867</td>
<td>Riyadh</td>
</tr>
<tr>
<td>5</td>
<td>Rabigh Refining &amp; Petrochemical Company</td>
<td>Saudi Arabia</td>
<td>Materials</td>
<td>1,228</td>
<td>Riyadh</td>
</tr>
<tr>
<td>6</td>
<td>Want Want China Holdings</td>
<td>China</td>
<td>Consumer staples</td>
<td>1,046</td>
<td>Hong Kong</td>
</tr>
<tr>
<td>7</td>
<td>Seven Bank Ltd</td>
<td>Japan</td>
<td>Financials</td>
<td>486</td>
<td>JASDAQ</td>
</tr>
<tr>
<td>8</td>
<td>TGK-7 (Volzhskaya TGK)</td>
<td>Russia</td>
<td>Energy and power</td>
<td>464</td>
<td>RTS</td>
</tr>
<tr>
<td>9</td>
<td>Rural Electrification Corp</td>
<td>India</td>
<td>Energy and power</td>
<td>417</td>
<td>Bombay</td>
</tr>
<tr>
<td>10</td>
<td>Honghua Group Ltd</td>
<td>China</td>
<td>Energy and power</td>
<td>409</td>
<td>Hong Kong</td>
</tr>
</tbody>
</table>
The trend continued in 2009, with Euronext leading world markets with the amount of capital raised in IPOs. As another example, Brazil, Russia, India, and China—often referred to as the BRIC countries—generated 41 percent of total IPO proceeds in 2007, compared with just 14 percent for the BRIC countries in 2004.

Finally, consider the international sales of some of the largest U.S. corporations: General Electric now has approximately 50 percent of its sales overseas, Boeing in a recent year sold more planes overseas than in the United States, and Ford Motor Company’s sales would be much less except for success in the European market.

The corporate form of organization

Of the three primary forms of business organization—the proprietorship, the partnership, and the corporation—the corporate form dominates. The corporation is by far the leader in terms of the aggregate amount of resources controlled, goods and services produced, and people employed. All of the “Fortune 500” largest industrial firms are corporations. Although the corporate form has a number of advantages (as well as disadvantages) over the other two forms, its principal advantage is its facility for attracting and accumulating large amounts of capital.

The special characteristics of the corporate form that affect accounting include:

1. Influence of state corporate law.
2. Use of the capital stock or share system.
3. Development of a variety of ownership interests.

State Corporate Law

Anyone who wishes to establish a corporation must submit articles of incorporation to the state in which incorporation is desired. After fulfilling requirements, the state issues a corporation charter, thereby recognizing the company as a legal entity subject to state law. Regardless of the number of states in which a corporation has operating divisions, it is incorporated in only one state.

It is to the company’s advantage to incorporate in a state whose laws favor the corporate form of business organization. General Motors, for example, is incorporated in Delaware; U.S. Steel is a New Jersey corporation. Some corporations have increasingly been incorporating in states with laws favorable to existing management. For example, to thwart possible unfriendly takeovers, at one time, Gulf Oil changed its state of incorporation to Delaware. There, the board of directors alone, without a vote of the shareholders, may approve certain tactics against takeovers.

Each state has its own business incorporation act. The accounting for stockholders’ equity follows the provisions of these acts. In many cases, states have adopted the principles contained in the Model Business Corporate Act prepared by the American Bar Association.

State laws are complex and vary both in their provisions and in their definitions of certain terms. Some laws fail to define technical terms. As a result, terms often mean one thing in one state and another thing in a different state. These problems may be further compounded because legal authorities often interpret the effects and restrictions of the laws differently.

Capital Stock or Share System

Stockholders’ equity in a corporation generally consists of a large number of units or shares. Within a given class of stock, each share exactly equals every other share. The number of shares possessed determines each owner’s interest. If a company has one class of stock divided into 1,000 shares, a person who owns 500 shares controls one-half of the ownership interest. One holding 10 shares has a one-hundredth interest.

Each share of stock has certain rights and privileges. Only by special contract can a company restrict these rights and privileges at the time it issues the shares. Owners must examine the articles of incorporation, stock certificates, and the provisions of the state law to ascertain such restrictions on or variations from the standard rights and privileges. In the absence of restrictive provisions, each share carries the following rights:

1. To share proportionately in profits and losses.
2. To share proportionately in management (the right to vote for directors).
3. To share proportionately in corporate assets upon liquidation.
4. To share proportionately in any new issues of stock of the same class—called the preemptive right.¹

The first three rights are self-explanatory. The last right is used to protect each stockholder’s proportional interest in the company. The preemptive right protects an existing stockholder from involuntary dilution of ownership interest. Without this right, stockholders might find their interest reduced by the issuance of additional stock without their knowledge, and at prices unfavorable to them. However, many corporations have eliminated the preemptive right. Why? Because this right makes it inconvenient for corporations to issue large amounts of additional stock, as they frequently do in acquiring other companies.

The share system easily allows one individual to transfer an interest in a company to another investor. For example, individuals owning shares in Best Buy may sell them to others at any time and at any price without obtaining the consent of the company or other stockholders. Each share is personal property of the owner, who may dispose of it at will. Best Buy simply maintains a list or subsidiary ledger of stockholders as a guide to dividend payments, issuance of stock rights, voting proxies, and the like. Because owners freely and frequently transfer shares, Best Buy must revise the subsidiary ledger of stockholders periodically, generally in advance of every dividend payment or stockholders’ meeting.

In addition, the major stock exchanges require ownership controls that the typical corporation finds uneconomic to provide. Thus, corporations often use registrars and transfer agents who specialize in providing services for recording and transferring stock. The Uniform Stock Transfer Act and the Uniform Commercial Code govern the negotiability of stock certificates.

Variety of Ownership Interests

In every corporation, one class of stock must represent the basic ownership interest. That class is called common stock. Common stock is the residual corporate interest that bears the ultimate risks of loss and receives the benefits of success. It is guaranteed neither dividends nor assets upon dissolution. But common stockholders generally control the management of the corporation and tend to profit most if the company is successful. In the event that a corporation has only one authorized issue of capital stock, that issue is by definition common stock, whether so designated in the charter or not.

In an effort to broaden investor appeal, corporations may offer two or more classes of stock, each with different rights or privileges. In the preceding section we pointed out that each share of stock of a given issue has the same four inherent rights as other shares of the same issue. By special stock contracts between the corporation and its stockholders, however, the stockholder may sacrifice certain of these rights in return for other special rights or privileges. Thus special classes of stock, usually called preferred stock, are created. In return for any special preference, the preferred stockholder always sacrifices some of the inherent rights of common stock ownership.

A common type of preference is to give the preferred stockholders a prior claim on earnings. The corporation thus assures them a dividend, usually at a stated rate, before it distributes any amount to the common stockholders. In return for this preference, the preferred stockholders may sacrifice their right to a voice in management or their right to share in profits beyond the stated rate.

¹This privilege is referred to as a stock right or warrant. The warrants issued in these situations are of short duration, unlike the warrants issued with other securities.
CORPORATE CAPITAL

Owner’s equity in a corporation is defined as stockholders’ equity, shareholders’ equity, or corporate capital. The following three categories normally appear as part of stockholders’ equity:

2. Additional paid-in capital.
3. Retained earnings.

The first two categories, capital stock and additional paid-in capital, constitute contributed (paid-in) capital. Retained earnings represents the earned capital of the company. Contributed (paid-in) capital is the total amount paid in on capital stock—the amount provided by stockholders to the corporation for use in the business. Contributed capital includes items such as the par value of all outstanding stock and premiums less discounts on issuance. Earned capital is the capital that develops from profitable operations. It consists of all undistributed income that remains invested in the company.

Stockholders’ equity is the difference between the assets and the liabilities of the company. That is, the owners’ or stockholders’ interest in a company like Walt Disney Co. is a residual interest. Stockholders’ (owners’) equity represents the cumulative net

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A CLASS (B) ACT

Some companies grant preferences to different shareholders by issuing different classes of common stock. Recent stock bids put the spotlight on dual-class stock structures. For example, ownership of Dow Jones & Co. was controlled by family members who owned Class B shares, which carry super voting powers. The same is true for the Ford family’s control of Ford Motor Co. Class B shares are often criticized for protecting owners’ interest at the expense of shareholder return. These shares often can determine if a takeover deal gets done, or not. Here are some notable companies with two-tiered shares.

<table>
<thead>
<tr>
<th>Company</th>
<th>Votes Controlled by Class B Shareholders</th>
<th>Company</th>
<th>Votes Controlled by Class B Shareholders</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ford</td>
<td>40%</td>
<td>Estée Lauder</td>
<td>88%</td>
</tr>
<tr>
<td>New York Times</td>
<td>70%</td>
<td>Polo Ralph Lauren</td>
<td>88%</td>
</tr>
<tr>
<td>Meredith</td>
<td>71%</td>
<td>Martha Stewart Living</td>
<td>91%</td>
</tr>
<tr>
<td>Cablevision Systems</td>
<td>73%</td>
<td>1-800-Flowers</td>
<td>93%</td>
</tr>
<tr>
<td>Google</td>
<td>78%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


For most retail investors, voting rights are not that important. But for family-controlled companies, issuing newer classes of lower or nonvoting stock effectively creates currency for acquisitions, increases liquidity, or puts a public value on the company without diluting the family’s voting control. This was one of the main reasons Facebook gave when it created a dual-class share structure in 2009. Thus, investors must carefully compare the apparent bargain prices for some classes of stock—they may end up as second-class citizens with no voting rights.

contributions by stockholders plus retained earnings. As a residual interest, stockholders’ equity has no existence apart from the assets and liabilities of Disney—stockholders’ equity equals net assets. Stockholders’ equity is not a claim to specific assets but a claim against a portion of the total assets. Its amount is not specified or fixed; it depends on Disney’s profitability. Stockholders’ equity grows if it is profitable. It shrinks, or may disappear entirely, if Disney loses money.

**Issuance of Stock**

In issuing stock, companies follow these procedures: First, the state must authorize the stock, generally in a certificate of incorporation or charter. Next, the corporation offers shares for sale, entering into contracts to sell stock. Then, after receiving amounts for the stock, the corporation issues shares. The corporation generally makes no entry in the general ledger accounts when it receives its stock authorization from the state of incorporation.

We discuss the accounting problems involved in the issuance of stock under the following topics.

1. **Accounting for par value stock.**
2. **Accounting for no-par stock.**
3. **Accounting for stock issued in combination with other securities (lump-sum sales).**
4. **Accounting for stock issued in noncash transactions.**
5. **Accounting for costs of issuing stock.**

**Par Value Stock**

The par value of a stock has no relationship to its fair value. At present, the par value associated with most capital stock issuances is very low. For example, PepsiCo’s par value is $1.25, Kellogg’s is $0.25, and Hershey’s is $1. Such values contrast dramatically with the situation in the early 1900s, when practically all stock issued had a par value of $100. Low par values help companies avoid the contingent liability associated with stock sold below par.

To show the required information for issuance of par value stock, corporations maintain accounts for each class of stock as follows.

1. **Preferred Stock or Common Stock.** Together, these two stock accounts reflect the par value of the corporation’s issued shares. The company credits these accounts when it originally issues the shares. It makes no additional entries in these accounts unless it issues additional shares or retires them.
2. **Paid-in Capital in Excess of Par (also called Additional Paid-in Capital).** The Paid-in Capital in Excess of Par account indicates any excess over par value paid in by stockholders in return for the shares issued to them. Once paid in, the excess over par becomes a part of the corporation’s additional paid-in capital. The individual stockholder has no greater claim on the excess paid in than all other holders of the same class of shares.

**No-Par Stock**

Many states permit the issuance of capital stock without par value, called no-par stock. The reasons for issuance of no-par stock are twofold: First, issuance of no-par stock

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3 Companies rarely, if ever, issue stock at a value below par value. If issuing stock below par, the company records the discount as a debit to Additional Paid-in Capital. In addition, the corporation may call on the original purchaser or the current holder of the shares issued below par to pay in the amount of the discount to prevent creditors from sustaining a loss upon liquidation of the corporation.
avoids the contingent liability (see footnote 3) that might occur if the corporation issued par value stock at a discount. Second, some confusion exists over the relationship (or rather the absence of a relationship) between the par value and fair value. If shares have no-par value, the **questionable treatment of using par value as a basis for fair value never arises.** This is particularly advantageous whenever issuing stock for property items such as intangible or tangible fixed assets.

A major disadvantage of no-par stock is that some states levy a high tax on these issues. In addition, in some states the total issue price for no-par stock may be considered legal capital, which could reduce the flexibility in paying dividends.

Corporations sell no-par shares, like par value shares, for whatever price they will bring. However, unlike par value shares, corporations issue them without a premium or a discount. The exact amount received represents the credit to common or preferred stock. For example, Video Electronics Corporation is organized with authorized common stock of 10,000 shares without par value. Video Electronics makes only a memorandum entry for the authorization, inasmuch as no amount is involved. If Video Electronics then issues 500 shares for cash at $10 per share, it makes the following entry:

<table>
<thead>
<tr>
<th>Cash</th>
<th>5,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Stock (no-par value)</td>
<td>5,000</td>
</tr>
</tbody>
</table>

If it issues another 500 shares for $11 per share, Video Electronics makes this entry:

<table>
<thead>
<tr>
<th>Cash</th>
<th>5,500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Stock (no-par value)</td>
<td>5,500</td>
</tr>
</tbody>
</table>

**True no-par stock should be carried in the accounts at issue price without any additional paid-in capital or discount reported.** But some states require that no-par stock have a **stated value.** The stated value is a minimum value below which a company cannot issue it. Thus, instead of being no-par stock, such stated-value stock becomes, in effect, stock with a very low par value. It thus is open to all the criticism and abuses that first encouraged the development of no-par stock.4

If no-par stock has a stated value of $5 per share but sells for $11, all such amounts in excess of $5 are recorded as additional paid-in capital, which in many states is fully or partially available for dividends. Thus, no-par value stock, with a low stated value, permits a new corporation to commence its operations with additional paid-in capital that may exceed its stated capital. For example, if a company issued 1,000 of the shares with a $5 stated value at $15 per share for cash, it makes the following entry:

<table>
<thead>
<tr>
<th>Cash</th>
<th>15,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Stock</td>
<td>5,000</td>
</tr>
<tr>
<td>Paid-in Capital in Excess of Stated Value—Common Stock</td>
<td>10,000</td>
</tr>
</tbody>
</table>

Most corporations account for no-par stock with a stated value as if it were par value stock with par equal to the stated value.

**Stock Issued with Other Securities (Lump-Sum Sales)**

Generally, corporations sell classes of stock separately from one another. The reason to do so is to track the proceeds relative to each class, as well as relative to each lot. Occasionally, a corporation issues two or more classes of securities for a single payment or lump sum (e.g., in the acquisition of another company). The accounting problem in such **lump-sum sales** is how to allocate the proceeds among the several classes of securities. Companies use one of two methods of allocation: (1) the proportional method and (2) the incremental method.

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4 *Accounting Trends and Techniques—2010* indicates that its 500 surveyed companies reported 478 issues of outstanding common stock, 467 par value issues, and 52 no-par issues; 5 of the no-par issues were shown at their stated (assigned) values.
Proportional Method. If the fair value or other sound basis for determining relative value is available for each class of security, the company allocates the lump sum received among the classes of securities on a proportional basis. For instance, assume a company issues 1,000 shares of $10 stated value common stock having a fair value of $20 a share, and 1,000 shares of $10 par value preferred stock having a fair value of $12 a share, for a lump sum of $30,000. Illustration 15-1 shows how the company allocates the $30,000 to the two classes of stock.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of common</td>
<td>$20,000</td>
</tr>
<tr>
<td>Fair value of preferred</td>
<td>$12,000</td>
</tr>
<tr>
<td>Aggregate fair value</td>
<td>$32,000</td>
</tr>
<tr>
<td>Allocated to common</td>
<td>$20,000</td>
</tr>
<tr>
<td>$30,000 × $32,000  = $18,750</td>
<td></td>
</tr>
<tr>
<td>Allocated to preferred</td>
<td>$12,000</td>
</tr>
<tr>
<td>$30,000 × $32,000  = $11,250</td>
<td></td>
</tr>
<tr>
<td>Total allocation</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

Incremental Method. In instances where a company cannot determine the fair value of all classes of securities, it may use the incremental method. It uses the fair value of the securities as a basis for those classes that it knows, and allocates the remainder of the lump sum to the class for which it does not know the fair value. For instance, if a company issues 1,000 shares of $10 stated value common stock having a fair value of $20, and 1,000 shares of $10 par value preferred stock having no established fair value, for a lump sum of $30,000, it allocates the $30,000 to the two classes as shown in Illustration 15-2.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Lump-sum receipt</td>
<td>$30,000</td>
</tr>
<tr>
<td>Allocated to common</td>
<td>$20,000</td>
</tr>
<tr>
<td>(1,000 × $20)</td>
<td></td>
</tr>
<tr>
<td>Balance allocated to preferred</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

If a company cannot determine fair value for any of the classes of stock involved in a lump-sum exchange, it may need to use other approaches. It may rely on an expert’s appraisal. Or, if the company knows that one or more of the classes of securities issued will have a determinable fair value in the near future, it may use a best estimate basis with the intent to adjust later, upon establishment of the future fair value.

Stock Issued in Noncash Transactions

Accounting for the issuance of shares of stock for property or services involves an issue of valuation. The general rule is: Companies should record stock issued for services or property other than cash at either the fair value of the stock issued or the fair value of the noncash consideration received, whichever is more clearly determinable.

If a company can readily determine both, and the transaction results from an arm’s-length exchange, there will probably be little difference in their fair values. In such cases, the basis for valuing the exchange should not matter.

If a company cannot readily determine either the fair value of the stock it issues or the property or services it receives, it should employ an appropriate valuation technique. Depending on available data, the valuation may be based on market transactions involving comparable assets or the use of discounted expected future cash flows. Companies should avoid the use of the book, par, or stated values as a basis of valuation for these transactions.

A company may exchange unissued stock or treasury stock (issued shares that it has reacquired but not retired) for property or services. If it uses treasury shares, the cost of
the treasury shares should not be considered the decisive factor in establishing the fair value of the property or services. Instead, it should use the fair value of the treasury stock, if known, to value the property or services. Otherwise, if it does not know the fair value of the treasury stock, it should use the fair value of the property or services received, if determinable.

The following series of transactions illustrates the procedure for recording the issuance of 10,000 shares of $10 par value common stock for a patent for Marlowe Company, in various circumstances.

1. Marlowe cannot readily determine the fair value of the patent, but it knows the fair value of the stock is $140,000.

   Patents 140,000
   Common Stock (10,000 shares × $10 per share)  100,000
   Paid-in Capital in Excess of Par—Common Stock  40,000

2. Marlowe cannot readily determine the fair value of the stock, but it determines the fair value of the patent is $150,000.

   Patents 150,000
   Common Stock (10,000 shares × $10 per share)  100,000
   Paid-in Capital in Excess of Par—Common Stock  50,000

3. Marlowe cannot readily determine the fair value of the stock nor the fair value of the patent. An independent consultant values the patent at $125,000 based on discounted expected cash flows.

   Patents 125,000
   Common Stock (10,000 shares × $10 share)  100,000
   Paid-in Capital in Excess of Par—Common Stock  25,000

In corporate law, the board of directors has the power to set the value of noncash transactions. However, boards sometimes abuse this power. The issuance of stock for property or services has resulted in cases of overstated corporate capital through intentional overvaluation of the property or services received. The overvaluation of the stockholders’ equity resulting from inflated asset values creates watered stock. The corporation should eliminate the “water” by simply writing down the overvalued assets.

If, as a result of the issuance of stock for property or services, a corporation undervalues the recorded assets, it creates secret reserves. An understated corporate structure (secret reserve) may also result from other methods: excessive depreciation or amortization charges, expensing capital expenditures, excessive write-downs of inventories or receivables, or any other understatement of assets or overstatement of liabilities. An example of a liability overstatement is an excessive provision for estimated product warranties that ultimately results in an understatement of owners’ equity, thereby creating a secret reserve.

Costs of Issuing Stock

When a company like Walgreens issues stock, it should report direct costs incurred to sell stock, such as underwriting costs, accounting and legal fees, printing costs, and taxes, as a reduction of the amounts paid in. Walgreens therefore debits issue costs to Paid-in Capital in Excess of Par—Common Stock because they are unrelated to corporate operations. In effect, issue costs are a cost of financing. As such, issue costs should reduce the proceeds received from the sale of the stock.

Walgreens should expense management salaries and other indirect costs related to the stock issue because it is difficult to establish a relationship between these costs and the sale proceeds. In addition, Walgreens expenses recurring costs, primarily registrar and transfer agents’ fees, as incurred.
Reacquisition of Shares

Companies often buy back their own shares. In fact, share buybacks now exceed dividends as a form of distribution to stockholders. For example, oil producer ConocoPhillips, health-care–products giant Johnson & Johnson, and discount retailer Wal-Mart Stores have ambitious buyback plans.

Buybacks more than doubled from 2004 to 2007. However, as a result of the financial crisis, the buyback trend slowed in 2008, with buybacks declining 40 percent from 2007 highs. But 2009 buybacks rebounded, led by major companies like IBM, which announced a $5 billion buyback.5

Corporations purchase their outstanding stock for several reasons:

1. To provide tax-efficient distributions of excess cash to shareholders. Capital gain rates on sales of stock to the company by the stockholders have been approximately half the ordinary tax rate for many investors. This advantage has been somewhat diminished by recent changes in the tax law related to dividends.

2. To increase earnings per share and return on equity. Reducing both shares outstanding and stockholders’ equity often enhances certain performance ratios. However, strategies to hype performance measures might increase performance in the short-run, but these tactics add no real long-term value.

3. To provide stock for employee stock compensation contracts or to meet potential merger needs. Honeywell Inc. reported that it would use part of its purchase of one million common shares for employee stock option contracts. Other companies acquire shares to have them available for business acquisitions.

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5R. Waters, “IBM Plans to Boost Buybacks by $5 Billion,” Financial Times (October 27, 2009).

In the early 1990s, share buybacks were less than half the level of dividends. Companies are extremely reluctant to reduce or eliminate their dividends, because they believe that the market negatively views this action.
Chapter 15 Stockholders’ Equity

4. **To thwart takeover attempts or to reduce the number of stockholders.** By reducing the number of shares held by the public, existing owners and managements bar “outsiders” from gaining control or significant influence. When Ted Turner attempted to acquire CBS, CBS started a substantial buyback of its stock. Companies may also use stock purchases to eliminate dissident stockholders.

5. **To make a market in the stock.** As one company executive noted, “Our company is trying to establish a floor for the stock.” Purchasing stock in the marketplace creates a demand. This may stabilize the stock price or, in fact, increase it.

Some publicly held corporations have chosen to “go private,” that is, to eliminate public (outside) ownership entirely by purchasing all of their outstanding stock. Companies often accomplish such a procedure through a **leveraged buyout (LBO)**, in which the company borrows money to finance the stock repurchases.

After reacquiring shares, a company may either retire them or hold them in the treasury for reissue. If not retired, such shares are referred to as **treasury stock** (treasury shares). Technically, treasury stock is a corporation’s own stock, reacquired after having been issued and fully paid.

**Treasury stock is not an asset.** When a company purchases treasury stock, a reduction occurs in both assets and stockholders’ equity. It is inappropriate to imply that a corporation can own a part of itself. A corporation may sell treasury stock to obtain funds, but that does not make treasury stock a balance sheet asset. When a corporation buys back some of its own outstanding stock, it has not acquired an asset; it reduces net assets.

The possession of treasury stock does not give the corporation the right to vote, to exercise preemptive rights as a stockholder, to receive cash dividends, or to receive assets upon corporate liquidation. **Treasury stock is essentially the same as unissued capital stock.** No one advocates classifying unissued capital stock as an asset in the balance sheet.

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**SIGNALS TO BUY?**

Market analysts sometimes look to stock buybacks as a buy signal for a stock. That strategy is not that surprising if you look at the performance of companies that did buybacks. For example, in one study, buyback companies outperformed similar companies without buybacks by an average of 23 percent. In a recent three-year period, companies followed by Buybackletter.com were up 16.4 percent, while the S&P 500 Stock Index was up just 7.1 percent in that period. Why the premium? Well, the conventional wisdom is that companies who buy back shares believe their shares are undervalued. Thus, analysts view the buyback announcement as an important piece of inside information about future company prospects.

On the other hand, buybacks can actually hurt businesses and their shareholders over the long-run. For example, drug-makers Merck, Pfizer, and Amgen spent heavily on stock repurchases, possibly at the expense of research and development. Whether the buyback is a good thing appears to depend a lot on why the company did the buyback and what the repurchased shares were used for. One study found that companies often increased their buybacks when earnings growth slowed. This allowed the companies to prop up earnings per share (based on fewer shares outstanding). Furthermore, many buybacks do not actually result in a net reduction in shares outstanding. For example, companies such as Microsoft and Broadcom bought back shares to meet share demands for stock option exercises, resulting in higher net shares outstanding when it reissued the repurchased shares to the option holders upon exercise.

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6. The possible justification for classifying these shares as assets is that the company will use them to liquidate a specific liability that appears on the balance sheet. Accounting Trends and Techniques—2010 reported that out of 500 companies surveyed, 340 disclosed treasury stock, but none classified it as an asset.
Purchase of Treasury Stock
Companies use two general methods of handling treasury stock in the accounts: the cost method and the par value method. Both methods are generally acceptable. The cost method enjoys more widespread use.\(^7\)

- The **cost method** results in debiting the Treasury Stock account for the reacquisition cost and in reporting this account as a deduction from the total paid-in capital and retained earnings on the balance sheet.

- The **par or stated value method** records all transactions in treasury shares at their par value and reports the treasury stock as a deduction from capital stock only.

No matter which method a company uses, most states consider the cost of the treasury shares acquired as a restriction on retained earnings.

Companies generally use the cost method to account for treasury stock. This method derives its name from the fact that a company maintains the Treasury Stock account at the cost of the shares purchased.\(^8\) Under the cost method, the company debits the Treasury Stock account for the cost of the shares acquired. Upon reissuance of the shares, it credits the account for this same cost. The original price received for the stock does not affect the entries to record the acquisition and reissuance of the treasury stock.

To illustrate, assume that Pacific Company issued 100,000 shares of $1 par value common stock at a price of $10 per share. In addition, it has retained earnings of $300,000.

**ILLUSTRATION 15-3**

**Stockholders’ Equity**

<table>
<thead>
<tr>
<th>Paid-in capital</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock, $1 par value, 100,000 shares issued and outstanding</td>
<td>$100,000</td>
<td></td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>900,000</td>
<td></td>
</tr>
<tr>
<td>Total paid-in capital</td>
<td>1,000,000</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>300,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total stockholders’ equity</strong></td>
<td><strong>$1,300,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

On January 20, 2012, Pacific acquires 10,000 shares of its stock at $11 per share. Pacific records the reacquisition as follows.

**January 20, 2012**

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treasury Stock</td>
<td>110,000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>110,000</td>
</tr>
</tbody>
</table>

Note that Pacific debited Treasury Stock for the cost of the shares purchased. The original paid-in-capital account, Common Stock, is not affected because the number of issued shares changed.

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\(^7\)Accounting Trends and Techniques—2010 indicates that of its selected list of 500 companies, 321 carried common stock in treasury at cost and only 19 at par or stated value; no companies carried preferred stock in treasury.

\(^8\)If making numerous acquisitions of blocks of treasury shares at different prices, a company may use inventory costing methods—such as specific identification, average cost, or FIFO—to identify the cost at date of reissuance.
Chapter 15 Stockholders’ Equity

Pacific subtracts the cost of the treasury stock from the total of common stock, additional paid-in capital, and retained earnings. It therefore reduces stockholders’ equity. Many states require a corporation to restrict retained earnings for the cost of treasury stock purchased. The restriction keeps intact the corporation’s legal capital that it temporarily holds as treasury stock. When the corporation sells the treasury stock, it lifts the restriction.

Pacific discloses both the number of shares issued (100,000) and the number in the treasury (10,000). The difference is the number of shares of stock outstanding (90,000). The term *outstanding stock* means the number of shares of issued stock that stockholders own.

Illustration 15-4 shows the stockholders’ equity section for Pacific after purchase of the treasury stock.

![Illustration 15-4 Stockholders’ Equity with Treasury Stock](image)

<table>
<thead>
<tr>
<th>Stockholders’ equity</th>
<th>Paid-in capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock, $1 par value, 100,000 shares issued and 90,000 outstanding</td>
<td>$100,000</td>
</tr>
<tr>
<td>Additional paid-in-capital</td>
<td>900,000</td>
</tr>
<tr>
<td>Total paid-in-capital</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>300,000</td>
</tr>
<tr>
<td>Total paid-in-capital and retained earnings</td>
<td>1,300,000</td>
</tr>
<tr>
<td>Less: Cost of treasury stock (10,000 shares)</td>
<td>110,000</td>
</tr>
<tr>
<td>Total stockholders’ equity</td>
<td>$1,190,000</td>
</tr>
</tbody>
</table>

Pacific subtracts the cost of the treasury stock from the total of common stock, additional paid-in capital, and retained earnings. It therefore reduces stockholders’ equity. Many states require a corporation to restrict retained earnings for the cost of treasury stock purchased. The restriction keeps intact the corporation’s legal capital that it temporarily holds as treasury stock. When the corporation sells the treasury stock, it lifts the restriction.

Pacific discloses both the number of shares issued (100,000) and the number in the treasury (10,000). The difference is the number of shares of stock outstanding (90,000). The term *outstanding stock* means the number of shares of issued stock that stockholders own.

Sale of Treasury Stock

Companies usually reissue or retire treasury stock. When selling treasury shares, the accounting for the sale depends on the price. If the selling price of the treasury stock equals its cost, the company records the sale of the shares by debiting Cash and crediting Treasury Stock. In cases where the selling price of the treasury stock is not equal to cost, then accounting for treasury stock sold above cost differs from the accounting for treasury stock sold below cost. However, the sale of treasury stock either above or below cost increases both total assets and stockholders’ equity.

Sale of Treasury Stock above Cost. When the selling price of shares of treasury stock exceeds its cost, a company credits the difference to Paid-in Capital from Treasury Stock. To illustrate, assume that Pacific acquired 10,000 shares of its treasury stock at $11 per share. It now sells 1,000 shares at $15 per share on March 10. Pacific records the entry as follows.

**March 10, 2012**

<table>
<thead>
<tr>
<th>Cash</th>
<th>15,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treasury Stock</td>
<td>11,000</td>
</tr>
<tr>
<td>Paid-in Capital from Treasury Stock</td>
<td>4,000</td>
</tr>
</tbody>
</table>

There are two reasons why Pacific does not credit $4,000 to Gain on Sale of Treasury Stock: (1) Gains on sales occur when selling assets; treasury stock is not an asset. (2) A gain or loss should not be recognized from stock transactions with its own stockholders. Thus, Pacific should not include paid-in capital arising from the sale of treasury stock in the measurement of net income. Instead, it lists paid-in capital from treasury stock separately on the balance sheet, as a part of paid-in capital.

Sale of Treasury Stock below Cost. When a corporation sells treasury stock below its cost, it usually debits the excess of the cost over selling price to Paid-in Capital from Treasury Stock. Thus, if Pacific sells an additional 1,000 shares of treasury stock on March 21 at $8 per share, it records the sale as follows.
We can make several observations based on the two sale entries (sale above cost and sale below cost): (1) Pacific credits Treasury Stock at cost in each entry. (2) Pacific uses Paid-in Capital from Treasury Stock for the difference between the cost and the resale price of the shares. (3) Neither entry affects the original paid-in capital account, Common Stock.

After eliminating the credit balance in Paid-in Capital from Treasury Stock, the corporation debits any additional excess of cost over selling price to Retained Earnings. To illustrate, assume that Pacific sells an additional 1,000 shares at $8 per share on April 10. Illustration 15-5 shows the balance in the Paid-in Capital from Treasury Stock account (before the April 10 purchase).

<table>
<thead>
<tr>
<th>Paid-in Capital from Treasury Stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mar. 21 3,000</td>
</tr>
<tr>
<td>Balance 1,000</td>
</tr>
</tbody>
</table>

In this case, Pacific debits $1,000 of the excess to Paid-in Capital from Treasury Stock. It debits the remainder to Retained Earnings. The entry is:

<table>
<thead>
<tr>
<th>April 10, 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash 8,000</td>
</tr>
<tr>
<td>Paid-in Capital from Treasury Stock 1,000</td>
</tr>
<tr>
<td>Retained Earnings 2,000</td>
</tr>
<tr>
<td>Treasury Stock 11,000</td>
</tr>
</tbody>
</table>

Retiring Treasury Stock
The board of directors may approve the retirement of treasury shares. This decision results in cancellation of the treasury stock and a reduction in the number of shares of issued stock. Retired treasury shares have the status of authorized and unissued shares. The accounting effects are similar to the sale of treasury stock except that corporations debit the paid-in capital accounts applicable to the retired shares instead of cash. For example, if a corporation originally sells the shares at par, it debits Common Stock for the par value per share. If it originally sells the shares at $3 above par value, it also debits Paid-in Capital in Excess of Par—Common Stock for $3 per share at retirement.

Volatility in the markets can lead to wide swings in share repurchase activity. For example, share buybacks—following a long run of high buyback activity—tumbled 66 percent in a recent quarter from a year earlier among companies in the S&P 500 Index. Specifically, buybacks fell 42 percent in all of 2008 from the record that $589.1 billion members spent on buybacks in 2007. Why the pullback in buybacks? One experienced analyst reasoned that many companies have eliminated buybacks in a bid to boost liquidity and preserve cash in the face of tight credit markets and as many incur huge losses or have debt coming due that they are unable to refinance. Indeed, cash levels recently hit a record among index members as they cut spending in a host of areas. The reluctance of U.S. companies to spend money on share repurchases reflects what another analyst called a “storm-center mentality.” Financial officers, watching companies teeter because of arid credit conditions and slowing business, have prioritized cash preservation above all else. And share repurchases are considered more “discretionary” than quarterly dividends from a corporate perspective.

Chapter 15 Stockholders’ Equity

PREFERRED STOCK

As noted earlier, preferred stock is a special class of shares that possesses certain preferences or features not possessed by the common stock. The following features are those most often associated with preferred stock issues.

1. Preference as to dividends.
2. Preference as to assets in the event of liquidation.
3. Convertible into common stock.
4. Callable at the option of the corporation.
5. Nonvoting.

The features that distinguish preferred from common stock may be of a more restrictive and negative nature than preferences. For example, the preferred stock may be nonvoting, noncumulative, and nonparticipating.

Companies usually issue preferred stock with a par value, expressing the dividend preference as a percentage of the par value. Thus, holders of 8 percent preferred stock with a $100 par value are entitled to an annual dividend of $8 per share. This stock is commonly referred to as 8 percent preferred stock. In the case of no-par preferred stock, a corporation expresses a dividend preference as a specific dollar amount per share, for example, $7 per share. This stock is commonly referred to as $7 preferred stock.

A preference as to dividends does not assure the payment of dividends. It merely assures that the corporation must pay the stated dividend rate or amount applicable to the preferred stock before paying any dividends on the common stock.

A company often issues preferred stock (instead of debt) because of a high debt-to-equity ratio. In other instances, it issues preferred stock through private placements with other corporations at a lower-than-market dividend rate because the acquiring corporation receives largely tax-free dividends (owing to the IRS’s 70 percent or 80 percent dividends received deduction).

Features of Preferred Stock

A corporation may attach whatever preferences or restrictions, in whatever combination it desires, to a preferred stock issue, as long as it does not specifically violate its state incorporation law. Also, it may issue more than one class of preferred stock. We discuss the most common features attributed to preferred stock below.

Cumulative Preferred Stock

Cumulative preferred stock requires that if a corporation fails to pay a dividend in any year, it must make it up in a later year before paying any dividends to common stockholders. If the directors fail to declare a dividend at the normal date for dividend action, the dividend is said to have been “passed.” Any passed dividend on cumulative preferred stock constitutes a dividend in arrears. Because no liability exists until the board of directors declares a dividend, a corporation does not record a dividend in arrears as a liability but discloses it in a note to the financial statements. A corporation seldom issues noncumulative preferred stock because a passed dividend is lost forever to the preferred stockholder. As a result, this stock issue would be less marketable.

Participating Preferred Stock

Holders of participating preferred stock share ratably with the common stockholders in any profit distributions beyond the prescribed rate. That is, 5 percent preferred stock,

9Accounting Trends and Techniques—2010 reports that of its 500 surveyed companies, 39 had one class of preferred stock, and 8 had two or more classes. Of these companies, just 36 had preferred stock outstanding.
if fully participating, will receive not only its 5 percent return, but also dividends at the same rates as those paid to common stockholders if paying amounts in excess of 5 percent of par or stated value to common stockholders. Note that participating preferred stock may be only partially participating. Although seldom used, examples of companies that have issued participating preferred stock are LTV Corporation, Southern California Edison, and Allied Products Corporation.

Convertible Preferred Stock
Convertible preferred stock allows stockholders, at their option, to exchange preferred shares for common stock at a predetermined ratio. The convertible preferred stockholder not only enjoys a preferred claim on dividends but also has the option of converting into a common stockholder with unlimited participation in earnings.

Callable Preferred Stock
Callable preferred stock permits the corporation at its option to call or redeem the outstanding preferred shares at specified future dates and at stipulated prices. Many preferred issues are callable. The corporation usually sets the call or redemption price slightly above the original issuance price and commonly states it in terms related to the par value. The callable feature permits the corporation to use the capital obtained through the issuance of such stock until the need has passed or it is no longer advantageous.

The existence of a call price or prices tends to set a ceiling on the market value of the preferred shares unless they are convertible into common stock. When a corporation redeems preferred stock, it must pay any dividends in arrears.

Redeemable Preferred Stock
Recently, more and more issuances of preferred stock have features that make the security more like debt (legal obligation to pay) than an equity instrument. For example, redeemable preferred stock has a mandatory redemption period or a redemption feature that the issuer cannot control.

Previously, public companies were not permitted to report these debt-like preferred stock issues in equity, but they were not required to report them as a liability either. There were concerns about classification of these debt-like securities, which may have been reported as equity or in the “mezzanine” section of balance sheets between debt and equity. There also was diversity in practice as to how dividends on these securities were reported. The FASB now requires debt-like securities, like redeemable preferred stock, to be classified as liabilities and be measured and accounted for similar to liabilities. [1]

Accounting for and Reporting Preferred Stock
The accounting for preferred stock at issuance is similar to that for common stock. A corporation allocates proceeds between the par value of the preferred stock and additional paid-in capital. To illustrate, assume that Bishop Co. issues 10,000 shares of $10 par value preferred stock for $12 cash per share. Bishop records the issuance as follows.

\[
\begin{align*}
\text{Cash} & : 120,000 \\
\text{Preferred Stock} & : 100,000 \\
\text{Paid-in Capital in Excess of Par—Preferred Stock} & : 20,000
\end{align*}
\]

Thus, Bishop maintains separate accounts for these different classes of shares.

In contrast to convertible bonds (recorded as a liability on the date of issue) corporations consider convertible preferred stock as a part of stockholders’ equity. In addition, when exercising convertible preferred stock, there is no theoretical justification for recognition of a gain or loss. A company recognizes no gain or loss when dealing with stockholders in their capacity as business owners. Instead, the company employs the book value method: debit Preferred Stock, along with any related Paid-in Capital in Excess of Par—Preferred Stock; credit Common Stock and Paid-in Capital in Excess of Par—Common Stock (if an excess exists).

See the FASB Codification section (page 876).
Preferred stock generally has no maturity date. Therefore, no legal obligation exists to pay the preferred stockholder. As a result, companies classify preferred stock as part of stockholders’ equity. Companies generally report preferred stock at par value as the first item in the stockholders’ equity section. They report any excess over par value as part of additional paid-in capital. They also consider dividends on preferred stock as a distribution of income and not an expense. Companies must disclose the pertinent rights of the preferred stock outstanding.

DIVIDEND POLICY

Dividend payouts can be important signals to the market. The practice of paying dividends declined sharply in the 1980s and 1990s as companies focused on growth and plowed profits back into the business. A resurgence in dividend payouts is due in large part to the dividend tax cut of 2003, which reduced the rate of tax on dividends to 15 percent (quite a bit lower than the ordinary income rate charged in the past). In addition, investors who were burned by accounting scandals in recent years began demanding higher payouts in the form of dividends. Why? A dividend check provides proof that at least some portion of a company’s profits is genuine.

Determining the proper amount of dividends to pay is a difficult financial management decision. Companies that are paying dividends are extremely reluctant to reduce or eliminate their dividend. They fear that the securities market might negatively view this action. As a consequence, companies that have been paying cash dividends will make every effort to continue to do so. In addition, the type of shareholder the company has (taxable or nontaxable, retail investor or institutional investor) plays a large role in determining dividend policy.

Very few companies pay dividends in amounts equal to their legally available retained earnings. The major reasons are as follows.

1. To maintain agreements (bond covenants) with specific creditors, to retain all or a portion of the earnings, in the form of assets, to build up additional protection against possible loss.
2. To meet state corporation requirements, that earnings equivalent to the cost of treasury shares purchased be restricted against dividend declarations.
3. To retain assets that would otherwise be paid out as dividends, to finance growth or expansion. This is sometimes called internal financing, reinvesting earnings, or “plowing” the profits back into the business.
4. To smooth out dividend payments from year to year by accumulating earnings in good years and using such accumulated earnings as a basis for dividends in bad years.
5. To build up a cushion or buffer against possible losses or errors in the calculation of profits.

The reasons above are self-explanatory except for the second. The laws of some states require that the corporation restrict its legal capital from distribution to stockholders, to protect against loss for creditors. The applicable state law determines the legality of a dividend.


11If the corporation buys its own outstanding stock, it reduces its legal capital and distributes assets to stockholders. If permitted, the corporation could, by purchasing treasury stock at any price desired, return to the stockholders their investments and leave creditors with little or no protection against loss.
Financial Condition and Dividend Distributions

Effective management of a company requires attention to more than the legality of dividend distributions. Management must also consider economic conditions, most importantly, liquidity. Assume an extreme situation as shown in Illustration 15-6.

**ILLUSTRATION 15-6**
Balance Sheet, Showing a Lack of Liquidity

<table>
<thead>
<tr>
<th>BALANCE SHEET</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plant assets</td>
</tr>
<tr>
<td>Capital stock</td>
</tr>
<tr>
<td>Retained earnings</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>

The depicted company has a retained earnings credit balance. Unless restricted, it can declare a dividend of $100,000. But because all its assets are plant assets used in operations, payment of a cash dividend of $100,000 would require the sale of plant assets or borrowing.

Even if a balance sheet shows current assets, as in Illustration 15-7, the question remains as to whether the company needs its cash for other purposes.

**ILLUSTRATION 15-7**
Balance Sheet, Showing Cash but Minimal Working Capital

<table>
<thead>
<tr>
<th>BALANCE SHEET</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>Plant assets</td>
</tr>
<tr>
<td>Current liabilities</td>
</tr>
<tr>
<td>Capital stock</td>
</tr>
<tr>
<td>Retained earnings</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>

The existence of current liabilities strongly implies that the company needs some of the cash to meet current debts as they mature. In addition, day-to-day cash requirements for payrolls and other expenditures not included in current liabilities also require cash.

Thus, before declaring a dividend, management must consider **availability of funds to pay the dividend**. A company should not pay a dividend unless both the present and future financial position warrant the distribution.

The SEC encourages companies to disclose their dividend policy in their annual report, especially those that (1) have earnings but fail to pay dividends, or (2) do not expect to pay dividends in the foreseeable future. In addition, the SEC encourages companies that consistently pay dividends to indicate whether they intend to continue this practice in the future.

Types of Dividends

Companies generally base dividend distributions either on accumulated profits (that is, retained earnings) or on some other capital item such as additional paid-in capital. Dividends are of the following types.

1. Cash dividends.
2. Property dividends.
3. Liquidating dividends.
4. Stock dividends.
Although commonly paid in cash, companies occasionally pay dividends in stock or some other asset.\(^{12}\) All dividends, except for stock dividends, reduce the total stockholders’ equity in the corporation. When declaring a stock dividend, the corporation does not pay out assets or incur a liability. It issues additional shares of stock to each stockholder and nothing more.

The natural expectation of any stockholder who receives a dividend is that the corporation has operated successfully. As a result, he or she is receiving a share of its profits. A company should disclose a liquidating dividend—that is, a dividend not based on retained earnings—to the stockholders so that they will not misunderstand its source.

**Cash Dividends**

The board of directors votes on the declaration of cash dividends. Upon approval of the resolution, the board declares a dividend. Before paying it, however, the company must prepare a current list of stockholders. For this reason, there is usually a time lag between declaration and payment. For example, the board of directors might approve a resolution at the January 10 (date of declaration) meeting, and declare it payable February 5 (date of payment) to all stockholders of record January 25 (date of record).\(^{13}\) In this example, the period from January 10 to January 25 gives time for the company to complete and register any transfers in process. The time from January 25 to February 5 provides an opportunity for the transfer agent or accounting department, depending on who does this work, to prepare a list of stockholders as of January 25 and to prepare and mail dividend checks.

A declared cash dividend is a liability. Because payment is generally required very soon, it is usually a current liability. Companies use the following entries to record the declaration and payment of an ordinary dividend payable in cash. For example, Roadway Freight Corp. on June 10 declared a cash dividend of 50 cents a share on 1.8 million shares payable July 16 to all stockholders of record June 24.

\[
\begin{align*}
\text{At date of declaration (June 10)} & \\
\text{Retained Earnings (Cash Dividends Declared)} & 900,000 \\
\text{Dividends Payable} & 900,000 \\
\text{At date of record (June 24)} & \\
\text{No entry} & \\
\text{At date of payment (July 16)} & \\
\text{Dividends Payable} & 900,000 \\
\text{Cash} & 900,000 \\
\end{align*}
\]

To set up a ledger account that shows the amount of dividends declared during the year, Roadway Freight might debit Cash Dividends Declared instead of Retained Earnings at the time of declaration. It then closes this account to Retained Earnings at year-end.

A company may declare dividends either as a certain percent of par, such as a 6 percent dividend on preferred stock, or as an amount per share, such as 60 cents per share on no-par common stock. In the first case, the rate multiplied by the par value of

\(^{12}\) *Accounting Trends and Techniques—2010* reported that of its 500 surveyed companies, 328 paid a cash dividend on common stock, 22 paid a cash dividend on preferred stock, none issued stock dividends, and 3 issued or paid dividends in kind. Some companies declare more than one type of dividend in a given year.

\(^{13}\) Theoretically, the ex-dividend date is the day after the date of record. However, to allow time for transfer of the shares, the stock exchanges generally advance the ex-dividend date two to four days. Therefore, the party who owns the stock on the day prior to the expressed ex-dividend date receives the dividends. The party who buys the stock on and after the ex-dividend date does not receive the dividend. Between the declaration date and the ex-dividend date, the market price of the stock includes the dividend.
outstanding shares equals the total dividend. In the second, the dividend equals the amount per share multiplied by the number of shares outstanding. **Companies do not declare or pay cash dividends on treasury stock.**

Dividend policies vary among corporations. Some companies, such as JP Morgan Chase, Clorox Co., and Tootsie Roll Industries, take pride in a long, unbroken string of quarterly dividend payments. They would lower or pass the dividend only if forced to do so by a sustained decline in earnings or a critical shortage of cash.

“Growth” companies, on the other hand, pay little or no cash dividends because their policy is to expand as rapidly as internal and external financing permit. For example, Questcor Pharmaceuticals Inc. has never paid cash dividends to its common stockholders. These investors hope that the price of their shares will appreciate in value. The investors will then realize a profit when they sell their shares. Many companies focus more on increasing share price, stock repurchase programs, and corporate earnings than on dividend payout.

**Property Dividends**

Dividends payable in assets of the corporation other than cash are called **property dividends** or **dividends in kind.** Property dividends may be merchandise, real estate, or investments, or whatever form the board of directors designates. Ranchers Exploration and Development Corp. reported one year that it would pay a fourth-quarter dividend in gold bars instead of cash. Because of the obvious difficulties of divisibility of units and delivery to stockholders, the usual property dividend is in the form of securities of other companies that the distributing corporation holds as an investment.

For example, after ruling that DuPont’s 23 percent stock interest in General Motors (GM) violated antitrust laws, the Supreme Court ordered DuPont to divest itself of the GM stock within 10 years. The stock represented 63 million shares of GM’s 281 million shares then outstanding. DuPont could not sell the shares in one block of 63 million. Further, it could not sell 6 million shares annually for the next 10 years without severely depressing the value of the GM stock. DuPont solved its problem by declaring a property dividend and distributing the GM shares as a dividend to its own stockholders.

When declaring a property dividend, the corporation should declare at fair value the property it will distribute, recognizing any gain or loss as the difference between the property’s fair value and carrying value at date of declaration. The corporation may then record the declared dividend as a debit to Retained Earnings (or Property Dividends Declared) and a credit to Property Dividends Payable, at an amount equal to the fair value of the distributed property. Upon distribution of the dividend, the corporation debits Property Dividends Payable and credits the account containing the distributed asset (restated at fair value).

For example, Trendler, Inc. transferred to stockholders some of its equity investments costing $1,250,000 by declaring a property dividend on December 28, 2011, to be distributed on January 30, 2012, to stockholders of record on January 15, 2012. At the date of declaration, the securities have a market price of $2,000,000. Trendler makes the following entries.

**At date of declaration (December 28, 2011)**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Investments</td>
<td>750,000</td>
</tr>
<tr>
<td>Unrealized Holding Gain or Loss—Income</td>
<td>750,000</td>
</tr>
<tr>
<td>Retained Earnings (property dividends declared)</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Property Dividends Payable</td>
<td></td>
</tr>
</tbody>
</table>

**At date of distribution (January 30, 2012)**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property Dividends Payable</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Equity Investments</td>
<td>2,000,000</td>
</tr>
</tbody>
</table>
Liquidating Dividends
Some corporations use paid-in capital as a basis for dividends. Without proper disclosure of this fact, stockholders may erroneously believe the corporation has been operating at a profit. To avoid this type of deception, intentional or unintentional, a clear statement of the source of every dividend should accompany the dividend check.

Dividends based on other than retained earnings are sometimes described as liquidating dividends. This term implies that such dividends are a return of the stockholder’s investment rather than of profits. In other words, any dividend not based on earnings reduces corporate paid-in capital and to that extent, it is a liquidating dividend. Companies in the extractive industries may pay dividends equal to the total of accumulated income and depletion. The portion of these dividends in excess of accumulated income represents a return of part of the stockholder’s investment.

For example, McChesney Mines Inc. issued a “dividend” to its common stockholders of $1,200,000. The cash dividend announcement noted that stockholders should consider $900,000 as income and the remainder a return of capital. McChesney Mines records the dividend as follows.

\[
\begin{align*}
\text{At date of declaration} & \\
\text{Retained Earnings} & 900,000 \\
\text{Paid-in Capital in Excess of Par—Common Stock} & 300,000 \\
\text{Dividends Payable} & 1,200,000
\end{align*}
\]

\[
\begin{align*}
\text{At date of payment} & \\
\text{Dividends Payable} & 1,200,000 \\
\text{Cash} & 1,200,000
\end{align*}
\]

In some cases, management simply decides to cease business and declares a liquidating dividend. In these cases, liquidation may take place over a number of years to ensure an orderly and fair sale of assets. For example, when Overseas National Airways dissolved, it agreed to pay a liquidating dividend to its stockholders over a period of years equivalent to $8.60 per share. Each liquidating dividend payment in such cases reduces paid-in capital.

Stock Dividends
If management wishes to “capitalize” part of the earnings (i.e., reclassify amounts from earned to contributed capital), and thus retain earnings in the business on a permanent basis, it may issue a stock dividend. In this case, the company distributes no assets. Each stockholder maintains exactly the same proportionate interest in the corporation and the same total book value after the company issues the stock dividend. Of course, the book value per share is lower because each stockholder holds more shares.

A stock dividend therefore is the issuance by a corporation of its own stock to its stockholders on a pro rata basis, without receiving any consideration. In recording a stock dividend, some believe that the company should transfer the par value of the stock issued as a dividend from retained earnings to capital stock. Others believe that it should transfer the fair value of the stock issued—it’s market value at the declaration date—from retained earnings to capital stock and additional paid-in-capital.

The fair value position was adopted, at least in part, in order to influence the stock dividend policies of corporations. Evidently in 1941, both the New York Stock Exchange and many in the accounting profession regarded periodic stock dividends as objectionable. They believed that the term dividend when used with a distribution of additional stock was misleading because investors’ net assets did not increase as a result of this “dividend.” As a result, these groups decided to make it more difficult...
for corporations to sustain a series of such stock dividends out of their accumulated earnings, by requiring the use of fair value when it substantially exceeded book value.  

When the stock dividend is less than 20–25 percent of the common shares outstanding at the time of the dividend declaration, the company is therefore required to transfer the fair value of the stock issued from retained earnings. Stock dividends of less than 20–25 percent are often referred to as small (ordinary) stock dividends. This method of handling stock dividends is justified on the grounds that “many recipients of stock dividends look upon them as distributions of corporate earnings and usually in an amount equivalent to the fair value of the additional shares received.” [3] We consider this argument unconvincing. It is generally agreed that stock dividends are not income to the recipients. Therefore, sound accounting should not recommend procedures simply because some recipients think they are income.  

To illustrate a small stock dividend, assume that Vine Corporation has outstanding 1,000 shares of $100 par value capital stock and retained earnings of $50,000. If Vine declares a 10 percent stock dividend, it issues 100 additional shares to current stockholders. If the fair value of the stock at the time of the stock dividend is $130 per share, the entry is:

<table>
<thead>
<tr>
<th>At date of declaration</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained Earnings</td>
<td>13,000</td>
</tr>
<tr>
<td>Common Stock Dividend Distributable</td>
<td>10,000</td>
</tr>
<tr>
<td>Paid-in Capital in Excess of Par—Common Stock</td>
<td>3,000</td>
</tr>
</tbody>
</table>

Note that the stock dividend does not affect any asset or liability. The entry merely reflects a reclassification of stockholders’ equity. If Vine prepares a balance sheet between the dates of declaration and distribution, it should show the common stock dividend distributable in the stockholders’ equity section as an addition to capital stock (whereas it shows cash or property dividends payable as current liabilities).

When issuing the stock, the entry is:

<table>
<thead>
<tr>
<th>At date of distribution</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Stock Dividend Distributable</td>
<td>10,000</td>
</tr>
<tr>
<td>Common Stock</td>
<td>10,000</td>
</tr>
</tbody>
</table>

No matter what the fair value is at the time of the stock dividend, each stockholder retains the same proportionate interest in the corporation.

Some state statutes specifically prohibit the issuance of stock dividends on treasury stock. In those states that permit treasury shares to participate in the distribution accompanying a stock dividend or stock split, the planned use of the treasury shares influences corporate practice. For example, if a corporation issues treasury shares in connection with employee stock options, the treasury shares may participate in the distribution because the corporation usually adjusts the number of shares under option for any stock dividends or splits. But no useful purpose is served by issuing additional shares to the treasury stock without a specific purpose, since they are essentially equivalent to authorized but unissued shares.

To continue with our example of the effect of the small stock dividend, note in Illustration 15-8 (on page 864) that the stock dividend does not change the total

---


15One study concluded that small stock dividends do not always produce significant amounts of extra value on the date after issuance (ex date) and that large stock dividends almost always fail to generate extra value on the ex-dividend date. Taylor W. Foster III and Don Vickrey, “The Information Content of Stock Dividend Announcements,” The Accounting Review, Vol. LIII, No. 2 (April 1978), pp. 360–370.
stockholders’ equity. Also note that it does not change the proportion of the total shares outstanding held by each stockholder.

**Stock Split**

If a company has undistributed earnings over several years, and accumulates a sizable balance in retained earnings, the market value of its outstanding shares likely increases. Stock issued at prices less than $50 a share can easily attain a market price in excess of $200 a share. The higher the market price of a stock, however, the less readily some investors can purchase it.

The managements of many corporations believe that better public relations depend on wider ownership of the corporation stock. They therefore target a market price sufficiently low to be within range of the majority of potential investors. To reduce the market price of shares, they use the common device of a **stock split**. For example, after its stock price increased by 25-fold, Qualcomm Inc. split its stock 4-for-1. Qualcomm’s stock had risen above $500 per share, raising concerns that Qualcomm could not meet an analyst target of $1,000 per share. The split reduced the analysts’ target to $250, which it could better meet with wider distribution of shares at lower trading prices.

From an accounting standpoint, Qualcomm **records no entry for a stock split**. However, it enters a memorandum note to indicate the changed par value of the shares and the increased number of shares. Illustration 15-9 shows the lack of change in stockholders’ equity for a 2-for-1 stock split on 1,000 shares of $100 par value stock with the par being halved upon issuance of the additional shares.

---

**ILLUSTRATION 15-8**

Effects of a Small (10%) Stock Dividend

<table>
<thead>
<tr>
<th>Before dividend</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock, 1,000 shares of $100 par</td>
<td>$100,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>50,000</td>
</tr>
<tr>
<td><strong>Total stockholders’ equity</strong></td>
<td><strong>$150,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Stockholders’ interests:</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. 400 shares, 40% interest, book value</td>
</tr>
<tr>
<td>B. 500 shares, 50% interest, book value</td>
</tr>
<tr>
<td>C. 100 shares, 10% interest, book value</td>
</tr>
<tr>
<td><strong>$150,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>After declaration but before distribution of 10% stock dividend</th>
</tr>
</thead>
<tbody>
<tr>
<td>If fair value ($130) is used as basis for entry:</td>
</tr>
<tr>
<td>Common stock, 1,000 shares at $100 par</td>
</tr>
<tr>
<td>Common stock distributable, 100 shares at $100 par</td>
</tr>
<tr>
<td>Paid-in capital in excess of par</td>
</tr>
<tr>
<td>Retained earnings ($50,000 – $13,000)</td>
</tr>
<tr>
<td><strong>Total stockholders’ equity</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>After declaration and distribution of 10% stock dividend</th>
</tr>
</thead>
<tbody>
<tr>
<td>If fair value ($130) is used as basis for entry:</td>
</tr>
<tr>
<td>Common stock, 1,100 shares at $100 par</td>
</tr>
<tr>
<td>Paid-in capital in excess of par</td>
</tr>
<tr>
<td>Retained earnings ($50,000 – $13,000)</td>
</tr>
<tr>
<td><strong>Total stockholders’ equity</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Stockholders’ interest:</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. 440 shares, 40% interest, book value</td>
</tr>
<tr>
<td>B. 550 shares, 50% interest, book value</td>
</tr>
<tr>
<td>C. 110 shares, 10% interest, book value</td>
</tr>
<tr>
<td><strong>$150,000</strong></td>
</tr>
</tbody>
</table>
Stock splits were all the rage in the booming stock market of the 1990s. Of major companies on the New York Stock Exchange, fewer than 80 companies split shares in 1990. By 1998, with stock prices soaring, over 200 companies split shares. Although the split does not increase a stockholder’s proportionate ownership of the company, studies show that split shares usually outperform those that don’t split, as well as the market as a whole, for several years after the split. In addition, the splits help the company keep the shares in more attractive price ranges.

What about when the market “turns south”? A number of companies who split their shares in the boom markets of the 1990s have since seen their share prices decline to a point considered too low. For example, since Ameritrade’s 12-for-1 split in 1999, its stock price declined over 74 percent, so that it was trading around $6 per share in March 2002. Lucent traded at less than $5 a share following a 4-for-1 split. For some investors, these low-priced stocks are unattractive because some brokerage commissions rely on the number of shares traded, not the dollar amount. Others are concerned that low-priced shares are easier for would-be scamsters to manipulate. And if a company’s per share price falls below $1 for 30 consecutive days, it is a violation of stock exchange listing requirements. Some companies are considering reverse stock splits in which, say, 5 shares are consolidated into one. Thus, a stock previously trading at $5 per share would be part of an unsplit share trading at $25. Unsplitting might thus avoid some of the negative consequences of a low trading price. The downside to this strategy is that analysts might view reverse splits as additional bad news about the direction of the stock price. For example, Webvan, a failed Internet grocer, did a 1-for-25 reverse split just before it entered bankruptcy. And struggling banking giant Citigroup has contemplated a 1-for-30 reverse stock split in an attempt to get its price into a favorable trading range.


Stock Split and Stock Dividend Differentiated

From a legal standpoint, a stock split differs from a stock dividend. How? A stock split increases the number of shares outstanding and decreases the par or stated value per share. A stock dividend, although it increases the number of shares outstanding, does not decrease the par value; thus, it increases the total par value of outstanding shares.

The reasons for issuing a stock dividend are numerous and varied. Stock dividends can be primarily a publicity gesture because many consider stock dividends as dividends. Another reason is that the corporation may simply wish to retain profits in the business by capitalizing a part of retained earnings. In such a situation, it makes a transfer on declaration of a stock dividend from earned capital to contributed capital.

A corporation may also use a stock dividend, like a stock split, to increase the marketability of the stock, although marketability is often a secondary consideration. If the stock dividend is large, it has the same effect on market price as a stock split. Whenever corporations issue additional shares for the purpose of reducing the unit market price, then the distribution more closely resembles a stock split than a stock dividend. This effect usually results only if the number of shares issued is more than 20–25 percent of the number of shares previously outstanding. A stock dividend of more than 20–25 percent of the number of shares previously outstanding is called a

ILLUSTRATION 15-9
Effects of a Stock Split

<table>
<thead>
<tr>
<th>Stockholders’ Equity before 2-for-1 Split</th>
<th>Stockholders’ Equity after 2-for-1 Split</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock, 1,000 shares at $100 par</td>
<td>Common stock, 2,000 shares at $50 par</td>
</tr>
<tr>
<td></td>
<td>$100,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>50,000</td>
</tr>
<tr>
<td></td>
<td>$150,000</td>
</tr>
<tr>
<td>$150,000</td>
<td>$150,000</td>
</tr>
</tbody>
</table>

What do the numbers mean?
large stock dividend. Such a distribution should not be called a stock dividend but instead “a split-up effected in the form of a dividend” or “stock split.”

Also, since a split-up effected in the form of a dividend does not alter the par value per share, companies generally are required to transfer the par value amount from retained earnings. In other words, companies transfer from retained earnings to capital stock the par value of the stock issued, as opposed to a transfer of the market price of the shares issued as in the case of a small stock dividend. For example, Brown Group, Inc. at one time authorized a 2-for-1 split, effected in the form of a stock dividend. As a result of this authorization, it distributed approximately 10.5 million shares, and transferred more than $39 million representing the par value of the shares issued from Retained Earnings to the Common Stock account.

To illustrate a large stock dividend (stock split-up effected in the form of a dividend), Rockland Steel, Inc. declared a 30 percent stock dividend on November 20, payable December 29 to stockholders of record December 12. At the date of declaration, 1,000,000 shares, par value $10, are outstanding and with a fair value of $200 per share. The entries are:

At date of declaration (November 20)

<table>
<thead>
<tr>
<th>Retained Earnings</th>
<th>3,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Stock Dividend Distributable</td>
<td>3,000,000</td>
</tr>
</tbody>
</table>

Computation:

\[
\begin{align*}
1,000,000 & \times 0.30 \times 10 \\
300,000 & \times 3,000,000 \\
\end{align*}
\]

At date of distribution (December 29)

<table>
<thead>
<tr>
<th>Common Stock Dividend Distributable</th>
<th>3,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Stock</td>
<td>3,000,000</td>
</tr>
</tbody>
</table>

Illustration 15-10 summarizes and compares the effects in the balance sheet and related items of various types of dividends and stock splits.
Recently, the number of companies paying dividends is down—really down. As indicated in the chart below, for the first time in at least half a century, companies announced more dividend cuts than increases in 2009. But by the end of the year, positive actions were beginning to predominate.

![chart](chart.png)

What do the numbers mean?

In a normal year, companies announce 10 to 20 times more favorable than unfavorable dividend changes, but the last two years have been anything but normal. Why? Well, it appears the financial crisis forced many financial companies to cut or suspend payments, and the credit crisis and recession led many other companies to cut back wherever they could. Thus, this has not been a good time to be an investor hoping to get a return on your shares through dividends.

However, just as dividends can go down, they can recover. Indeed, by the end of the year, there were indications that the recession was over and the number of negative dividend decisions began to decline. As one analyst noted, “The fourth quarter was in no way a good period for dividends, but compared to recent history it marks a significant improvement, and when added to the stabilization in increases, the worst may be over.”

In fact, the sheer rapidity of the plunge could provide an indication that the dividend recovery will be fast. It is possible that some companies made cuts fearing much worse conditions than actually arrived and will therefore be able to raise payouts even without much improvement in business.


Disclosure of Restrictions on Retained Earnings

Many corporations restrict retained earnings or dividends, without any formal journal entries. Such restrictions are best disclosed by note. Parenthetical notations are sometimes used, but restrictions imposed by bond indentures and loan agreements commonly require an extended explanation. Notes provide a medium for more complete explanations and free the financial statements from abbreviated notations. The note disclosure should reveal the source of the restriction, pertinent provisions, and the amount of retained earnings subject to restriction, or the amount not restricted.
Restrictions may be based on the retention of a certain retained earnings balance, the ability to maintain certain working capital requirements, additional borrowing, and other considerations. The example from the annual report of *Alberto-Culver Company* in Illustration 15-11 shows a note disclosing potential restrictions on retained earnings and dividends.

**ILLUSTRATION 15-11**

**Disclosure of Restrictions on Retained Earnings and Dividends**

**Note 3 (in part):** The $200 million revolving credit facility, the term note, and the receivables agreement impose restrictions on such items as total debt, working capital, dividend payments, treasury stock purchases, and interest expense. At year-end, the company was in compliance with these arrangements, and $220 million of consolidated retained earnings was not restricted as to the payment of dividends.

**PRESENTATION AND ANALYSIS OF STOCKHOLDERS’ EQUITY**

**Presentation**

Illustration 15-12 shows a comprehensive stockholders’ equity section from the balance sheet of *Frost Company* that includes most of the equity items we discussed in this chapter.

**ILLUSTRATION 15-12**

**Comprehensive Stockholders’ Equity Presentation**

<table>
<thead>
<tr>
<th>FROST COMPANY</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>STOCKHOLDERS’ EQUITY</strong></td>
</tr>
<tr>
<td><strong>DECEMBER 31, 2012</strong></td>
</tr>
<tr>
<td><strong>Capital stock</strong></td>
</tr>
<tr>
<td>Preferred stock, $100 par value, 7% cumulative, 100,000 shares authorized, 30,000 shares issued and outstanding</td>
</tr>
<tr>
<td>Common stock, no-par, stated value $10 per share, 500,000 shares authorized, 400,000 shares issued</td>
</tr>
<tr>
<td>Common stock dividend distributable, 20,000 shares</td>
</tr>
<tr>
<td><strong>Total capital stock</strong></td>
</tr>
<tr>
<td><strong>Additional paid-in capital</strong></td>
</tr>
<tr>
<td>Excess over par—preferred</td>
</tr>
<tr>
<td>Excess over stated value—common</td>
</tr>
<tr>
<td><strong>Total paid-in capital</strong></td>
</tr>
<tr>
<td><strong>Retained earnings</strong></td>
</tr>
<tr>
<td><strong>Total paid-in capital and retained earnings</strong></td>
</tr>
<tr>
<td>Less: Cost of treasury stock (2,000 shares, common)</td>
</tr>
<tr>
<td>Accumulated other comprehensive loss</td>
</tr>
<tr>
<td><strong>Total stockholders’ equity</strong></td>
</tr>
</tbody>
</table>

---

18 Accounting Trends and Techniques—2010 reports that of its 500 surveyed companies, 452 had additional paid-in capital, 285 used the caption “Additional paid-in capital,” 76 used “Capital in excess of par or stated value” as the caption, 65 used “Paid-in capital” or “Additional capital,” and 26 used other captions.

19 Companies may include a number of items in the “Accumulated other comprehensive loss.” Among these items are “Foreign currency translation adjustments” (covered in advanced accounting), “Unrealized holding gains and losses for available-for-sale securities” (covered in Chapter 17), “Guarantees of employee stock option plan (ESOP) debt,” “Unearned or deferred compensation related to employee stock award plans,” and others.

Accounting Trends and Techniques—2010 reports that of its 500 surveyed companies, 23 reported cumulative translation adjustments, 23 reported defined benefit postretirement plan adjustments, 13 reported changes in the fair value of derivatives, and 14 reported unrealized losses/gains on certain investments. A number of companies had more than one item.
Frost should disclose the pertinent rights and privileges of the various securities outstanding. For example, companies must disclose all of the following: dividend and liquidation preferences, participation rights, call prices and dates, conversion or exercise prices and pertinent dates, sinking fund requirements, unusual voting rights, and significant terms of contracts to issue additional shares. Liquidation preferences should be disclosed in the equity section of the balance sheet, rather than in the notes to the financial statements, to emphasize the possible effect of this restriction on future cash flows. [5]

**Statement of Stockholders’ Equity**

The statement of stockholders’ equity is frequently presented in the following basic format.

1. Balance at the beginning of the period.
2. Additions.
3. Deductions.
4. Balance at the end of the period.

Companies must disclose changes in the separate accounts comprising stockholders’ equity, to make the financial statements sufficiently informative. [20] Such changes may be disclosed in separate statements or in the basic financial statements or notes thereto. [21]

A columnar format for the presentation of changes in stockholders’ equity items in published annual reports is gaining in popularity. An example is Kellogg Company’s statement of stockholders’ equity, shown in Illustration 15-13.

---

**Kellogg Company and Subsidiaries**

Consolidated Statement of Shareholders’ Equity

<table>
<thead>
<tr>
<th>(millions)</th>
<th>Common Stock</th>
<th>Capital in Excess of Par Value</th>
<th>Retained Earnings</th>
<th>Treasury Stock</th>
<th>Accumulated Other Comprehensive Income/(loss)</th>
<th>Total Shareholders’ Equity</th>
<th>Total Comprehensive Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, January 3, 2009</td>
<td>419 $105</td>
<td>$438</td>
<td>$4,836</td>
<td>37 $(1,790)</td>
<td>$(2,141)</td>
<td>$1,448</td>
<td>$(168)</td>
</tr>
<tr>
<td>Common stock repurchases</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income (loss)</td>
<td>4</td>
<td>(187)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other comprehensive income (loss)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stock compensation</td>
<td>175</td>
<td>175</td>
<td>175</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stock options exercised and other</td>
<td>37</td>
<td>37</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance, January 2, 2010</td>
<td>419</td>
<td>$105</td>
<td>$472</td>
<td>$5,481</td>
<td>$(1,820)</td>
<td>$1,966</td>
<td>$2,272</td>
</tr>
</tbody>
</table>

**ILLUSTRATION 15-13**

Columnar Format for Statement of Stockholders’ Equity

---

[20] If a company has other comprehensive income, and computes total comprehensive income only in the statement of stockholders’ equity, it must display the statement of stockholders’ equity with the same prominence as other financial statements. [6]

[21] Accounting Trends and Techniques—2010 reports that of the 500 companies surveyed, 490 presented statements of stockholders’ equity, 2 presented separate statements of retained earnings only, 2 presented combined statements of income and retained earnings, and 6 presented changes in equity items in the notes only.
Chapter 15  Stockholders’ Equity

Analysis

Analysts use stockholders’ equity ratios to evaluate a company’s profitability and long-term solvency. We discuss and illustrate the following three ratios below.

1. Rate of return on common stock equity.
2. Payout ratio.
3. Book value per share.

Rate of Return on Common Stock Equity

The rate of return on common stock equity measures profitability from the common stockholders’ viewpoint. This ratio shows how many dollars of net income the company earned for each dollar invested by the owners. Return on equity (ROE) also helps investors judge the worthiness of a stock when the overall market is not doing well. For example, Best Buy shares dropped nearly 40 percent, along with the broader market in 2001–2002. But a review of its return on equity during this period and since shows a steady return of 20 to 22 percent while the overall market ROE declined from 16 percent to 8 percent. More importantly, Best Buy and other stocks, such as 3M and Procter & Gamble, recovered their lost market value, while other stocks with less robust ROEs stayed in the doldrums.

Return on equity equals net income less preferred dividends, divided by average common stockholders’ equity. For example, assume that Gerber’s Inc. had net income of $360,000, declared and paid preferred dividends of $54,000, and average common stockholders’ equity of $2,550,000. Illustration 15-14 shows how to compute Gerber’s ratio.

ILLUSTRATION 15-14
Computation of Rate of Return on Common Stock Equity

| Rate of Return on Common Stock Equity = Net income − Preferred dividends |
|-------------------------------|-----------------|
| Average common stockholders’ equity |
| $360,000 − $54,000 |
| $2,550,000 |
| = 12% |

As shown in Illustration 15-14, when preferred stock is present, income available to common stockholders equals net income less preferred dividends. Similarly, the amount of common stock equity used in this ratio equals total stockholders’ equity less the par value of preferred stock.

A company can improve its return on common stock equity through the prudent use of debt or preferred stock financing. Trading on the equity describes the practice of using borrowed money or issuing preferred stock in hopes of obtaining a higher rate of return on the money used. Shareholders win if return on the assets is higher than the cost of financing these assets. When this happens, the rate of return on common stock equity will exceed the rate of return on total assets. In short, the company is “trading on the equity at a gain.” In this situation, the money obtained from bondholders or preferred stockholders earns enough to pay the interest or preferred dividends and leaves a profit for the common stockholders. On the other hand, if the cost of the financing is higher that the rate earned on the assets, the company is trading on equity at a loss and stockholders lose.

Payout Ratio

Another ratio of interest to investors, the payout ratio, is the ratio of cash dividends to net income. If preferred stock is outstanding, this ratio equals cash dividends paid to
common stockholders, divided by net income available to common stockholders. For example, assume that Troy Co. has cash dividends of $100,000 and net income of $500,000, and no preferred stock outstanding. Illustration 15-15 shows the payout ratio computation.

\[
Payout\ ratio = \frac{\text{Cash dividends}}{\text{Net income} - \text{Preferred dividends}}
\]

\[
= \frac{100,000}{500,000 - 20%} = 20\%
\]

Recently, the payout ratio has plummeted. In 1982, more than half of earnings were converted to dividends. In the second quarter of 2007, just 29 percent of the earnings of the S&P 500 was distributed via dividends.²²

**Book Value per Share**
A much-used basis for evaluating net worth is found in the book value or equity value per share of stock. **Book value per share** of stock is the amount each share would receive if the company were liquidated on the basis of amounts reported on the balance sheet. However, the figure loses much of its relevance if the valuations on the balance sheet fail to approximate fair value of the assets. Book value per share equals common stockholders’ equity divided by outstanding common shares. Assume that Chen Corporation’s common stockholders’ equity is $1,000,000 and it has 100,000 shares of common stock outstanding, Illustration 15-16 shows its book value per share computation.

\[
\text{Book value per share} = \frac{\text{Common stockholders' equity}}{\text{Outstanding shares}}
\]

\[
= \frac{1,000,000}{100,000} = 10\ \text{per share}
\]

KEY TERMS
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SUMMARY OF LEARNING OBJECTIVES

1. Discuss the characteristics of the corporate form of organization. Among the specific characteristics of the corporate form that affect accounting are the: (1) influence of state corporate law, (2) use of the capital stock or share system, and (3) development of a variety of ownership interests. In the absence of restrictive provisions, each share of stock carries the right to share proportionately in: (1) profits and losses; (2) management (the right to vote for directors); (3) corporate assets upon liquidation; (4) any new issues of stock of the same class (called the preemptive right).

2. Identify the key components of stockholders’ equity. Stockholders’ or owners’ equity is classified into two categories: contributed capital and earned capital. Contributed capital (paid-in capital) describes the total amount paid in on capital stock. Put another way, it is the amount that stockholders advance to the corporation for use in the business. Contributed capital includes items such as the par value of all outstanding capital stock and premiums less any discounts on issuance. Earned capital is the capital that develops if the business operates profitably; it consists of all undistributed income that remains invested in the company.

3. Explain the accounting procedures for issuing shares of stock. Accounts are kept for the following different types of stock: Par value stock: (a) preferred stock or common stock; (b) paid-in capital in excess of par or additional paid-in capital; and (c) discount on stock. No-par stock: common stock or common stock and additional paid-in capital, if stated value used. Stock issued in combination with other securities (lump-sum sales): The two methods of allocation available are (a) the proportional method; and (b) the incremental method. Stock issued in noncash transactions: When issuing stock for services or property other than cash, the company should record the property or services at either the fair value of the stock issued, or the fair value of the noncash consideration received, whichever is more clearly determinable.

4. Describe the accounting for treasury stock. The cost method is generally used in accounting for treasury stock. This method derives its name from the fact that a company maintains the Treasury Stock account at the cost of the shares purchased. Under the cost method, a company debits the Treasury Stock account for the cost of the shares acquired and credits it for this same cost upon reissuance. The price received for the stock when originally issued does not affect the entries to record the acquisition and reissuance of the treasury stock.

5. Explain the accounting and reporting of preferred stock. Preferred stock is a special class of shares that possesses certain preferences or features not possessed by the common stock. The features that are most often associated with preferred stock issues are: (1) preference as to dividends; (2) preference as to assets in the event of liquidation; (3) convertible into common stock; (4) callable at the option of the corporation; (5) nonvoting. At issuance, the accounting for preferred stock is similar to that for common stock. When convertible preferred stock is converted, a company uses the book value method: It debits Preferred Stock, along with any related Paid-in Capital in Excess of Par—Preferred Stock and credits Common Stock and Paid-in Capital in Excess of Par—Common Stock (if an excess exists).

6. Describe the policies used in distributing dividends. The state incorporation laws normally provide information concerning the legal restrictions related to the payment of dividends. Corporations rarely pay dividends in an amount equal to the legal limit. This is due, in part, to the fact that companies use assets represented by undistributed earnings to finance future operations of the business. If a company is considering declaring a dividend, it must ask two preliminary questions: (1) Is the condition of the
corporation such that the dividend is legally permissible? (2) Is the condition of the corporation such that a dividend is economically sound?

7 Identify the various forms of dividend distributions. Dividends are of the following types: (1) cash dividends, (2) property dividends, (3) liquidating dividends (dividends based on other than retained earnings), (4) stock dividends (the issuance by a corporation of its own stock to its stockholders on a pro rata basis, but without receiving consideration).

8 Explain the accounting for small and large stock dividends, and for stock splits. Generally accepted accounting principles require that the accounting for small stock dividends (less than 20 or 25 percent) rely on the fair value of the stock issued. When declaring a stock dividend, a company debits Retained Earnings at the fair value of the stock it distributes. The entry includes a credit to Common Stock Dividend Distributable at par value times the number of shares, with any excess credited to Paid-in Capital in Excess of Par. If the number of shares issued exceeds 20 or 25 percent of the shares outstanding (large stock dividend), it debits Retained Earnings at par value and credits Common Stock Distributable—there is no additional paid-in capital.

A stock dividend is a capitalization of retained earnings that reduces retained earnings and increases certain contributed capital accounts. The par value per share and total stockholders’ equity remain unchanged with a stock dividend, and all stockholders retain their same proportionate share of ownership. A stock split results in an increase or decrease in the number of shares outstanding, with a corresponding decrease or increase in the par or stated value per share. No accounting entry is required for a stock split.

9 Indicate how to present and analyze stockholders’ equity. The stockholders’ equity section of a balance sheet includes capital stock, additional paid-in capital, and retained earnings. A company might also present additional items such as treasury stock and accumulated other comprehensive income. Companies often provide a statement of stockholders’ equity. Common ratios that use stockholders’ equity amounts are: rate of return on common stock equity, payout ratio, and book value per share.

DIVIDEND PREFERENCES

Illustrations 15A-1 to 15A-4 indicate the effects of various dividend preferences on dividend distributions to common and preferred stockholders. Assume that in 2012, Mason Company is to distribute $50,000 as cash dividends, its outstanding common stock has a par value of $400,000, and its 6 percent preferred stock has a par value of $100,000. Mason would distribute dividends to each class, employing the assumptions given, as follows.

1. If the preferred stock is noncumulative and nonparticipating:

<table>
<thead>
<tr>
<th></th>
<th>Preferred</th>
<th>Common</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>6% of $100,000</td>
<td>$6,000</td>
<td></td>
<td>$ 6,000</td>
</tr>
<tr>
<td>The remainder to common</td>
<td></td>
<td>$44,000</td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>$6,000</td>
<td>$44,000</td>
<td>$50,000</td>
</tr>
</tbody>
</table>
2. If the preferred stock is cumulative and nonparticipating, and Mason Company did not pay dividends on the preferred stock in the preceding two years:

**ILLUSTRATION 15A-2**
Dividend Distribution, Cumulative and Nonparticipating Preferred, with Dividends in Arrears

<table>
<thead>
<tr>
<th></th>
<th>Preferred</th>
<th>Common</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends in arrears, 6% of $100,000 for 2 years</td>
<td>$12,000</td>
<td></td>
<td>$12,000</td>
</tr>
<tr>
<td>Current year’s dividend, 6% of $100,000</td>
<td>6,000</td>
<td></td>
<td>6,000</td>
</tr>
<tr>
<td>The remainder to common</td>
<td></td>
<td>$32,000</td>
<td>32,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$18,000</td>
<td>$32,000</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

3. If the preferred stock is noncumulative and is fully participating:

**ILLUSTRATION 15A-3**
Dividend Distribution, Noncumulative and Fully Participating Preferred

<table>
<thead>
<tr>
<th></th>
<th>Preferred</th>
<th>Common</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current year’s dividend, 6%</td>
<td>$  6,000</td>
<td>$24,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>Participating dividend of 4%</td>
<td>4,000</td>
<td>16,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$10,000</td>
<td>$40,000</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

The participating dividend was determined as follows.

Current year’s dividend:
- Preferred, 6% of $100,000 = $  6,000
- Common, 6% of $400,000 = 24,000
  Total = $30,000

Amount available for participation ($50,000 – $30,000) = $20,000
Par value of stock that is to participate ($100,000 + $400,000) = $500,000
Rate of participation ($20,000 / $500,000) = 4%

Participating dividend:
- Preferred, 4% of $100,000 = 4,000
- Common, 4% of $400,000 = 16,000
  Total = $20,000

4. If the preferred stock is cumulative and is fully participating, and Mason Company did not pay dividends on the preferred stock in the preceding two years:

**ILLUSTRATION 15A-4**
Dividend Distribution, Cumulative and Fully Participating Preferred, with Dividends in Arrears

<table>
<thead>
<tr>
<th></th>
<th>Preferred</th>
<th>Common</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends in arrears, 6% of $100,000 for 2 years</td>
<td>$12,000</td>
<td></td>
<td>$12,000</td>
</tr>
<tr>
<td>Current year’s dividend, 6%</td>
<td>1,600</td>
<td>$24,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Participating dividend, 1.6% ($8,000 – $500,000)</td>
<td>6,400</td>
<td>8,000</td>
<td>14,400</td>
</tr>
<tr>
<td>Totals</td>
<td>$19,600</td>
<td>$30,400</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

**BOOK VALUE PER SHARE**

Book value per share in its simplest form is computed as net assets divided by outstanding shares at the end of the year. The computation of book value per share becomes more complicated if a company has preferred stock in its capital structure. For example,

When preferred stock is participating, there may be different agreements as to how the participation feature is to be executed. However, in the absence of any specific agreement the following procedure is recommended:

a. After the preferred stock is assigned its current year’s dividend, the common stock will receive a “like” percentage of par value outstanding. In example (3), this amounts to 6 percent of $400,000.

b. In example (3), shown in Illustration 15A-3, the remainder of the declared dividend is $20,000. We divide this amount by total par value ($500,000) to find the rate of participation to be applied to each class of stock. In this case, the rate of participation is 4% ($20,000 / $500,000), which we then multiply by the par value of each class of stock to determine the amount of participation.
if preferred dividends are in arrears, if the preferred stock is participating, or if preferred stock has a redemption or liquidating value higher than its carrying amount, the company must allocate retained earnings between the preferred and common stockholders in computing book value.

To illustrate, assume that the following situation exists.

### Illustration 15A-5

<table>
<thead>
<tr>
<th>Stockholders’ equity</th>
<th>Preferred</th>
<th>Common</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred stock, 5%</td>
<td>$300,000</td>
<td></td>
</tr>
<tr>
<td>Common stock</td>
<td></td>
<td>$400,000</td>
</tr>
<tr>
<td>Excess of issue price over par of common stock</td>
<td>37,500</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td></td>
<td>162,882</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>$300,000</strong></td>
<td><strong>$600,082</strong></td>
</tr>
<tr>
<td>Shares outstanding</td>
<td>4,000</td>
<td></td>
</tr>
<tr>
<td><strong>Book value per share</strong></td>
<td><strong>$150.02</strong></td>
<td></td>
</tr>
</tbody>
</table>

The situation in Illustration 15A-5 assumes that no preferred dividends are in arrears and that the preferred is not participating. Now assume that the same facts exist except that the 5 percent preferred is cumulative, participating up to 8 percent, and that dividends for three years before the current year are in arrears. Illustration 15A-6 shows how to compute the book value of the common stock, assuming that no action has yet been taken concerning dividends for the current year.

### Illustration 15A-6

<table>
<thead>
<tr>
<th>Stockholders’ equity</th>
<th>Preferred</th>
<th>Common</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred stock, 5%</td>
<td>$300,000</td>
<td></td>
</tr>
<tr>
<td>Common stock</td>
<td></td>
<td>$400,000</td>
</tr>
<tr>
<td>Excess of issue price over par of common stock</td>
<td>37,500</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td></td>
<td>162,882</td>
</tr>
<tr>
<td><strong>Dividends in arrears (3 years at 5% a year)</strong></td>
<td>45,000</td>
<td></td>
</tr>
<tr>
<td><strong>Current year requirement at 5%</strong></td>
<td>15,000</td>
<td>20,000</td>
</tr>
<tr>
<td><strong>Participating—additional 3%</strong></td>
<td>9,000</td>
<td>12,000</td>
</tr>
<tr>
<td>Remainder to common</td>
<td>61,582</td>
<td></td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>$369,000</strong></td>
<td><strong>$531,082</strong></td>
</tr>
<tr>
<td>Shares outstanding</td>
<td>4,000</td>
<td></td>
</tr>
<tr>
<td><strong>Book value per share</strong></td>
<td><strong>$132.77</strong></td>
<td></td>
</tr>
</tbody>
</table>

In connection with the book value computation, the analyst must know how to handle the following items: the number of authorized and unissued shares; the number of treasury shares on hand; any commitments with respect to the issuance of unissued shares or the reissuance of treasury shares; and the relative rights and privileges of the various types of stock authorized. As an example, if the liquidating value of the preferred stock is higher than its carrying amount, the liquidating amount should be used in the book value computation.

### Summary of Learning Objective for Appendix 15A

10. **Explain the different types of preferred stock dividends and their effect on book value per share.** The dividend preferences of preferred stock affect the dividends paid to stockholders. Preferred stock can be (1) cumulative or noncumulative, and (2) fully participating, partially participating, or nonparticipating. If preferred dividends
are in arrears, if the preferred stock is participating, or if preferred stock has a redemption or liquidation value higher than its carrying amount, allocate retained earnings between preferred and common stockholders in computing book value per share.

**FASB CODIFICATION**

**FASB Codification References**


**Exercises**

If your school has a subscription to the FASB Codification, go to [http://aaahq.org/ascLogin.cfm](http://aaahq.org/ascLogin.cfm) to log in and prepare responses to the following. Provide Codification references for your responses.

**CE15-1** Access the glossary (“Master Glossary”) to answer the following.

(a) What is a “convertible security”?  
(b) What is a “stock dividend”?  
(c) What is a “stock split”?

(d) What are “participation rights”?

**CE15-2** At what percentage point can the issuance of additional shares still qualify as a stock dividend, as opposed to a stock split?

**CE15-3** A company plans to issue shares and wants to know the SEC’s stance on the accounting treatment for the costs of issuing stock. Can these costs be deferred, or must they be expensed immediately?

**CE15-4** If a company chooses to purchase its own shares and then either (1) retires the repurchased shares and issues additional shares, or (2) resells the repurchased shares, can a gain or loss be recognized by the company? Why or why not?

An additional Codification case can be found in the Using Your Judgment section, on page 894.

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**Be sure to check the book’s companion website for a Review and Analysis Exercise, with solution.**

**WILEY PLUS** Questions, Brief Exercises, Exercises, Problems, and many more resources are available for practice in WileyPLUS.
1. In the absence of restrictive provisions, what are the basic rights of stockholders of a corporation?

2. Why is a preemptive right important?

3. Distinguish between common and preferred stock.

4. Why is the distinction between paid-in capital and retained earnings important?

5. Explain each of the following terms: authorized capital stock, unissued capital stock, issued capital stock, outstanding capital stock, and treasury stock.

6. What is meant by par value, and what is its significance to stockholders?

7. Describe the accounting for the issuance for cash of no-par value common stock at a price in excess of the stated value of the common stock.

8. Explain the difference between the proportional method and the incremental method of allocating the proceeds of lump-sum sales of capital stock.

9. What are the different bases for stock valuation when assets other than cash are received for issued shares of stock?

10. Explain how underwriting costs and accounting and legal fees associated with the issuance of stock should be recorded.

11. For what reasons might a corporation purchase its own stock?

12. Discuss the propriety of showing:
   (a) Treasury stock as an asset.
   (b) “Gain” or “loss” on sale of treasury stock as additions to or deductions from income.
   (c) Dividends received on treasury stock as income.

13. What features or rights may alter the character of preferred stock?

14. Dagwood Inc. recently noted that its 4% preferred stock and 4% participating preferred stock, which are both cumulative, have priority as to dividends up to 4% of their par value. Its participating preferred stock participates equally with the common stock in any dividends in excess of 4%. What is meant by the term participating? Cumulative?

15. Where in the financial statements is preferred stock normally reported?

16. List possible sources of additional paid-in capital.

17. Satchel Inc. purchases 10,000 shares of its own previously issued $10 par common stock for $290,000. Assuming the shares are held in the treasury with intent to reissue, what effect does this transaction have on (a) net income, (b) total assets, (c) total paid-in capital, and (d) total stockholders’ equity?

18. Indicate how each of the following accounts should be classified in the stockholders’ equity section.
   (a) Common Stock
   (b) Retained Earnings
   (c) Paid-in Capital in Excess of Par—Common Stock
   (d) Treasury Stock
   (e) Paid-in Capital from Treasury Stock
   (f) Paid-in Capital in Excess of Stated Value—Common Stock
   (g) Preferred Stock

19. What factors influence the dividend policy of a company?

20. What are the principal considerations of a board of directors in making decisions involving dividend declarations? Discuss briefly.

21. Dividends are sometimes said to have been paid “out of retained earnings.” What is the error, if any, in that statement?

22. Distinguish among: cash dividends, property dividends, liquidating dividends, and stock dividends.

23. Describe the accounting entry for a stock dividend, if any. Describe the accounting entry for a stock split, if any.

24. Stock splits and stock dividends may be used by a corporation to change the number of shares of its stock outstanding.
   (a) What is meant by a stock split effected in the form of a dividend?
   (b) From an accounting viewpoint, explain how the stock split effected in the form of a dividend differs from an ordinary stock dividend.
   (c) How should a stock dividend that has been declared but not yet issued be classified in a balance sheet? Why?

25. The following comment appeared in the notes of Colorado Corporation’s annual report: “Such distributions, representing proceeds from the sale of Sarazan, Inc., were paid in the form of partial liquidating dividends and were in lieu of a portion of the Company’s ordinary cash dividends.” How would a partial liquidating dividend be accounted for in the financial records?

26. This comment appeared in the annual report of MacCloud Inc.: “The Company could pay cash or property dividends on the Class A common stock without paying cash or property dividends on the Class B common stock. But if the Company pays any cash or property dividends on the
Class B common stock, it would be required to pay at least the same dividend on the Class A common stock.” How is a property dividend accounted for in the financial records?

27. For what reasons might a company restrict a portion of its retained earnings?

28. How are restrictions of retained earnings reported?

29. McNabb Corp. had $100,000 of 7%, $20 par value preferred stock and 12,000 shares of $25 par value common stock outstanding throughout 2012.

(a) Assuming that total dividends declared in 2012 were $64,000, and that the preferred stock is not cumulative but is fully participating, common stockholders should receive 2012 dividends of what amount?

(b) Assuming that total dividends declared in 2012 were $64,000, and that the preferred stock is fully participating and cumulative with preferred dividends in arrears for 2011, preferred stockholders should receive 2012 dividends totaling what amount?

(c) Assuming that total dividends declared in 2012 were $30,000, that the preferred stock is cumulative, nonparticipating, and was issued on January 1, 2011, and that $5,000 of preferred dividends were declared and paid in 2011, the common stockholders should receive 2012 dividends totaling what amount?

BRIEF EXERCISES

3 BE15-1 Buttercup Corporation issued 300 shares of $10 par value common stock for $4,500. Prepare Buttercup’s journal entry.

3 BE15-2 Swarten Corporation issued 600 shares of no-par common stock for $8,200. Prepare Swarten’s journal entry if (a) the stock has no stated value, and (b) the stock has a stated value of $2 per share.

9 BE15-3 Wilco Corporation has the following account balances at December 31, 2012.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock, $5 par value</td>
<td>$510,000</td>
</tr>
<tr>
<td>Treasury stock</td>
<td>90,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>2,340,000</td>
</tr>
<tr>
<td>Paid-in capital in excess of par—common stock</td>
<td>1,320,000</td>
</tr>
</tbody>
</table>

Prepare Wilco’s December 31, 2012, stockholders’ equity section.

3 BE15-4 Ravonette Corporation issued 300 shares of $10 par value common stock and 100 shares of $50 par value preferred stock for a lump sum of $13,500. The common stock has a market price of $20 per share, and the preferred stock has a market price of $90 per share. Prepare the journal entry to record the issuance.

3 BE15-5 On February 1, 2012, Buffalo Corporation issued 3,000 shares of its $5 par value common stock for land worth $31,000. Prepare the February 1, 2012, journal entry.

3 BE15-6 Moonwalker Corporation issued 2,000 shares of its $10 par value common stock for $60,000. Moonwalker also incurred $1,500 of costs associated with issuing the stock. Prepare Moonwalker’s journal entry to record the issuance of the company’s stock.

4 BE15-7 Sprinkle Inc. has outstanding 10,000 shares of $10 par value common stock. On July 1, 2012, Sprinkle reacquired 100 shares at $87 per share. On September 1, Sprinkle reissued 60 shares at $90 per share. On November 1, Sprinkle reissued 40 shares at $83 per share. Prepare Sprinkle’s journal entries to record these transactions using the cost method.

4 BE15-8 Arantxa Corporation has outstanding 20,000 shares of $5 par value common stock. On August 1, 2012, Arantxa reacquired 200 shares at $80 per share. On November 1, Arantxa reissued the 200 shares at $70 per share. Arantxa had no previous treasury stock transactions. Prepare Arantxa’s journal entries to record these transactions using the cost method.

5 BE15-9 Hinges Corporation issued 500 shares of $100 par value preferred stock for $61,500. Prepare Hinges’s journal entry.

6 BE15-10 Woolford Inc. declared a cash dividend of $1.00 per share on its 2 million outstanding shares. The dividend was declared on August 1, payable on September 9 to all stockholders of record on August 15. Prepare all journal entries necessary on those three dates.

7 BE15-11 Cole Inc. owns shares of Marlin Corporation stock classified as available-for-sale securities. At December 31, 2012, the available-for-sale securities were carried in Cole’s accounting records at their cost of $875,000, which equals their fair value. On September 21, 2013, when the fair value of the securities was
$1,200,000, Cole declared a property dividend whereby the Marlin securities are to be distributed on October 23, 2013, to stockholders of record on October 8, 2013. Prepare all journal entries necessary on those three dates.

BE15-12 Graves Mining Company declared, on April 20, a dividend of $500,000 payable on June 1. Of this amount, $125,000 is a return of capital. Prepare the April 20 and June 1 entries for Graves.

BE15-13 Green Day Corporation has outstanding 400,000 shares of $10 par value common stock. The corporation declares a 5% stock dividend when the fair value of the stock is $65 per share. Prepare the journal entries for Green Day Corporation for both the date of declaration and the date of distribution.

BE15-14 Use the information from BE15-13, but assume Green Day Corporation declared a 100% stock dividend rather than a 5% stock dividend. Prepare the journal entries for both the date of declaration and the date of distribution.

BE15-15 Nottebart Corporation has outstanding 10,000 shares of $100 par value, 6% preferred stock and 60,000 shares of $10 par value common stock. The preferred stock was issued in January 2012, and no dividends were declared in 2012 or 2013. In 2014, Nottebart declares a cash dividend of $300,000. How will the dividend be shared by common and preferred stockholders if the preferred is (a) noncumulative and (b) cumulative?

**EXERCISES**

E15-1 (Recording the Issuances of Common Stock) During its first year of operations, Sitwell Corporation had the following transactions pertaining to its common stock.

Jan. 10 Issued 80,000 shares for cash at $6 per share.
Mar. 1 Issued 5,000 shares to attorneys in payment of a bill for $35,000 for services rendered in helping the company to incorporate.
July 1 Issued 30,000 shares for cash at $8 per share.
Sept. 1 Issued 60,000 shares for cash at $10 per share.

Instructions
(a) Prepare the journal entries for these transactions, assuming that the common stock has a par value of $3 per share.
(b) Prepare the journal entries for these transactions, assuming that the common stock is no-par with a stated value of $2 per share.

E15-2 (Recording the Issuance of Common and Preferred Stock) Abernathy Corporation was organized on January 1, 2012. It is authorized to issue 10,000 shares of 8%, $50 par value preferred stock, and 500,000 shares of no-par common stock with a stated value of $2 per share. The following stock transactions were completed during the first year.

Jan. 10 Issued 80,000 shares of common stock for cash at $5 per share.
Mar. 1 Issued 5,000 shares of preferred stock for cash at $108 per share.
Apr. 1 Issued 24,000 shares of common stock for land. The asking price of the land was $90,000; the fair value of the land was $80,000.
May 1 Issued 80,000 shares of common stock for cash at $7 per share.
Aug. 1 Issued 10,000 shares of common stock to attorneys in payment of their bill of $50,000 for services rendered in helping the company organize.
Sept. 1 Issued 10,000 shares of common stock for cash at $9 per share.
Nov. 1 Issued 1,000 shares of preferred stock for cash at $112 per share.

Instructions
Prepare the journal entries to record the above transactions.

E15-3 (Stock Issued for Land) Twenty-five thousand shares reacquired by Pierce Corporation for $48 per share were exchanged for undeveloped land that has an appraised value of $1,700,000. At the time of the exchange, the common stock was trading at $60 per share on an organized exchange.

Instructions
(a) Prepare the journal entry to record the acquisition of land assuming that the purchase of the stock was originally recorded using the cost method.
(b) Briefly identify the possible alternatives (including those that are totally unacceptable) for quantifying the cost of the land and briefly support your choice.
Chapter 15 Stockholders’ Equity

3  E15-4 (Lump-Sum Sale of Stock with Bonds) Fogelberg Corporation is a regional company which is an SEC registrant. The corporation’s securities are thinly traded on NASDAQ (National Association of Securities Dealers Quotes). Fogelberg has issued 10,000 units. Each unit consists of a $500 par, 12% subordinated debenture and 10 shares of $5 par common stock. The investment banker has retained 400 units as the underwriting fee. The other 9,600 units were sold to outside investors for cash at $850 per unit. Prior to this sale the 2-week ask price of common stock was $40 per share. Twelve percent is a reasonable market yield for the debentures, and therefore the par value of the bonds is equal to the fair value.

Instructions
(a) Prepare the journal entry to record Fogelberg’s transaction, under the following conditions.
(i) Employing the incremental method.
(ii) Employing the proportional method, assuming the recent price quote on the common stock reflects fair value.
(b) Briefly explain which method is, in your opinion, the better method.

5  E15-5 (Lump-Sum Sales of Stock with Preferred Stock) Hartman Inc. issues 500 shares of $10 par value common stock and 100 shares of $100 par value preferred stock for a lump sum of $100,000.

Instructions
(a) Prepare the journal entry for the issuance when the market price of the common shares is $168 each and market price of the preferred is $210 each. (Round to nearest dollar.)
(b) Prepare the journal entry for the issuance when only the market price of the common stock is known and it is $170 per share.

4  E15-6 (Stock Issuances and Repurchase) Loxley Corporation is authorized to issue 50,000 shares of $10 par value common stock. During 2012, Loxley took part in the following selected transactions.
1. Issued 5,000 shares of stock at $45 per share, less costs related to the issuance of the stock totaling $7,000.
2. Issued 1,000 shares of stock for land appraised at $50,000. The stock was actively traded on a national stock exchange at approximately $46 per share on the date of issuance.
3. Purchased 500 shares of treasury stock at $44 per share. The treasury shares purchased were issued in 2008 at $40 per share.

Instructions
(a) Prepare the journal entry to record item 1.
(b) Prepare the journal entry to record item 2.
(c) Prepare the journal entry to record item 3 using the cost method.

4  E15-7 (Effect of Treasury Stock Transactions on Financials) Sanborn Company has outstanding 40,000 shares of $5 par common stock which had been issued at $30 per share. Sanborn then entered into the following transactions.
1. Purchased 5,000 treasury shares at $45 per share.
2. Resold 500 of the treasury shares at $40 per share.
3. Resold 2,000 of the treasury shares at $49 per share.

Instructions
Use the following code to indicate the effect each of the three transactions has on the financial statement categories listed in the table below, assuming Sanborn Company uses the cost method: I = Increase; D = Decrease; NE = No effect.

<table>
<thead>
<tr>
<th></th>
<th>Assets</th>
<th>Liabilities</th>
<th>Stockholders’ Equity</th>
<th>Paid-in Capital</th>
<th>Retained Earnings</th>
<th>Net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

5  E15-8 (Preferred Stock Entries and Dividends) Weisberg Corporation has 10,000 shares of $100 par value, 6% preferred stock and 50,000 shares of $10 par value common stock outstanding at December 31, 2012.

Instructions
Answer the questions in each of the following independent situations.
(a) If the preferred stock is cumulative and dividends were last paid on the preferred stock on December 31, 2009, what are the dividends in arrears that should be reported on the December 31, 2012, balance sheet? How should these dividends be reported?
(b) If the preferred stock is convertible into seven shares of $10 par value common stock and 3,000 shares are converted, what entry is required for the conversion assuming the preferred stock was issued at par value?

(c) If the preferred stock was issued at $107 per share, how should the preferred stock be reported in the stockholders' equity section?

3 4 E15-9 (Correcting Entries for Equity Transactions) Davison Inc. recently hired a new accountant with extensive experience in accounting for partnerships. Because of the pressure of the new job, the accountant was unable to review what he had learned earlier about corporation accounting. During the first month, he made the following entries for the corporation's capital stock.

May 2  Cash  192,000
Common Stock  192,000
(Issued 12,000 shares of $10 par value common stock at $16 per share)

10  Cash  600,000
Common Stock  600,000
(Issued 10,000 shares of $30 par value preferred stock at $60 per share)

15  Common Stock  14,000
Cash  14,000
(Purchased 1,000 shares of common stock for the treasury at $14 per share)

31  Cash  8,500
Common Stock  5,000
Gain on Sale of Stock  3,500
(Sold 500 shares of treasury stock at $17 per share)

Instructions
On the basis of the explanation for each entry, prepare the entries that should have been made for the transactions.

3 4 E15-10 (Analysis of Equity Data and Equity Section Preparation) For a recent 2-year period, the balance sheet of Franklin Company showed the following stockholders' equity data at December 31 in millions.

<table>
<thead>
<tr>
<th></th>
<th>2013</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paid-in capital in excess of par—common stock</td>
<td>$891</td>
<td>$817</td>
</tr>
<tr>
<td>Common stock</td>
<td>545</td>
<td>540</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>7,167</td>
<td>5,226</td>
</tr>
<tr>
<td>Treasury stock</td>
<td>1,428</td>
<td>918</td>
</tr>
<tr>
<td>Total stockholders’ equity</td>
<td>$7,175</td>
<td>$5,665</td>
</tr>
<tr>
<td>Common stock shares issued</td>
<td>218</td>
<td>216</td>
</tr>
<tr>
<td>Common stock shares authorized</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td>Treasury stock shares</td>
<td>34</td>
<td>27</td>
</tr>
</tbody>
</table>

Instructions
(a) Answer the following questions.
1. What is the par value of the common stock?
2. What is the cost per share of treasury stock at December 31, 2013, and at December 31, 2012?
(b) Prepare the stockholders’ equity section at December 31, 2013.

7 8 E15-11 (Equity Items on the Balance Sheet) The following are selected transactions that may affect stockholders’ equity.

1. Recorded accrued interest earned on a note receivable.
2. Declared and distributed a stock split.
3. Declared a cash dividend.
4. Recorded a retained earnings restriction.
5. Recorded the expiration of insurance coverage that was previously recorded as prepaid insurance.
6. Paid the cash dividend declared in item 3 above.
7. Recorded accrued interest expense on a note payable.
8. Declared a stock dividend.
9. Distributed the stock dividend declared in item 8.
Chapter 15 Stockholders’ Equity

Instructions
In the following table, indicate the effect each of the nine transactions has on the financial statement elements listed. Use the following code:

<table>
<thead>
<tr>
<th>Item</th>
<th>Assets</th>
<th>Liabilities</th>
<th>Stockholders' Equity</th>
<th>Paid-in Capital</th>
<th>Retained Earnings</th>
<th>Net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>Increase</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>D</td>
<td>Decrease</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NE</td>
<td>No effect</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

E15-12 (Cash Dividend and Liquidating Dividend) Addison Corporation has 10 million shares of common stock issued and outstanding. On June 1, the board of directors voted a 60 cents per share cash dividend to stockholders of record as of June 14, payable June 30.

Instructions
(a) Prepare the journal entry for each of the dates above assuming the dividend represents a distribution of earnings.
(b) How would the entry differ if the dividend were a liquidating dividend?

E15-13 (Stock Split and Stock Dividend) The common stock of Warner Inc. is currently selling at $110 per share. The directors wish to reduce the share price and increase share volume prior to a new issue. The per share par value is $10; book value is $70 per share. Five million shares are issued and outstanding.

Instructions
Prepare the necessary journal entries assuming the following.
(a) The board votes a 2-for-1 stock split.
(b) The board votes a 100% stock dividend.
(c) Briefly discuss the accounting and securities market differences between these two methods of increasing the number of shares outstanding.

E15-14 (Entries for Stock Dividends and Stock Splits) The stockholders’ equity accounts of Lawrence Company have the following balances on December 31, 2012.

- Common stock, $10 par, 200,000 shares issued and outstanding: $2,000,000
- Paid-in capital in excess of par—common stock: $1,200,000
- Retained earnings: $5,600,000

Shares of Lawrence Company stock are currently selling on the Midwest Stock Exchange at $37.

Instructions
Prepare the appropriate journal entries for each of the following cases.
(a) A stock dividend of 5% is declared and issued.
(b) A stock dividend of 100% is declared and issued.
(c) A 2-for-1 stock split is declared and issued.

E15-15 (Dividend Entries) The following data were taken from the balance sheet accounts of Wickham Corporation on December 31, 2012.

- Current assets: $540,000
- Debt investments: 624,000
- Common stock (par value $10): 600,000
- Paid-in capital in excess of par—common stock: 150,000
- Retained earnings: 840,000
**Instructions**
Prepare the required journal entries for the following unrelated items.

(a) A 5% stock dividend is declared and distributed at a time when the market price is $39 per share.
(b) The par value of the capital stock is reduced to $2 with a 5-for-1 stock split.
(c) A dividend is declared January 5, 2013, and paid January 25, 2013, in bonds held as an investment. The bonds have a book value of $90,000 and a fair value of $125,000.

### E15-16 (Computation of Retained Earnings)

The following information has been taken from the ledger accounts of Sampras Corporation.

- Total income since incorporation: $287,000
- Total cash dividends paid: $60,000
- Total value of stock dividends distributed: $40,000
- Gains on treasury stock transactions: $18,000
- Unamortized discount on bonds payable: $32,000

### Instructions

Determine the current balance of retained earnings.

### E15-17 (Stockholders’ Equity Section)

Teller Corporation’s post-closing trial balance at December 31, 2012, was as follows.

<table>
<thead>
<tr>
<th>TELLER CORPORATION</th>
<th>POST-CLOSING TRIAL BALANCE</th>
<th>DECEMBER 31, 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Dr.</td>
<td>Cr.</td>
</tr>
<tr>
<td>Accounts Payable</td>
<td></td>
<td>$ 310,000</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>$ 480,000</td>
<td></td>
</tr>
<tr>
<td>Accumulated Depreciation—Buildings</td>
<td>185,000</td>
<td></td>
</tr>
<tr>
<td>Paid-in Capital in Excess of Par—Common Stock</td>
<td>1,000,000</td>
<td></td>
</tr>
<tr>
<td>Paid-in Capital from Treasury Stock</td>
<td>160,000</td>
<td></td>
</tr>
<tr>
<td>Allowance for Doubtful Accounts</td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td>Bonds Payable</td>
<td>700,000</td>
<td></td>
</tr>
<tr>
<td>Buildings</td>
<td>1,450,000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>190,000</td>
<td></td>
</tr>
<tr>
<td>Common Stock ($1 par value)</td>
<td>200,000</td>
<td></td>
</tr>
<tr>
<td>Dividends Payable (preferred stock)</td>
<td>4,000</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>560,000</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>400,000</td>
<td></td>
</tr>
<tr>
<td>Preferred Stock ($50 par value)</td>
<td>500,000</td>
<td></td>
</tr>
<tr>
<td>Prepaid Expenses</td>
<td>40,000</td>
<td></td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>201,000</td>
<td></td>
</tr>
<tr>
<td>Treasury Stock (common)</td>
<td>170,000</td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>$3,290,000</td>
<td>$3,290,000</td>
</tr>
</tbody>
</table>

At December 31, 2012, Teller had the following number of common and preferred shares.

<table>
<thead>
<tr>
<th></th>
<th>Common</th>
<th>Preferred</th>
</tr>
</thead>
<tbody>
<tr>
<td>Authorized</td>
<td>600,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Issued</td>
<td>200,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Outstanding</td>
<td>190,000</td>
<td>10,000</td>
</tr>
</tbody>
</table>

The dividends on preferred stock are $4 cumulative. In addition, the preferred stock has a preference in liquidation of $50 per share.

### Instructions

Prepare the stockholders’ equity section of Teller’s balance sheet at December 31, 2012.

(AICPA adapted)
Chapter 15 Stockholders’ Equity

E15-18 (Dividends and Stockholders’ Equity Section) Elizabeth Company reported the following amounts in the stockholders’ equity section of its December 31, 2012, balance sheet.

- Preferred stock, 8%, $100 par (10,000 shares authorized, 2,000 shares issued) $200,000
- Common stock, $5 par (100,000 shares authorized, 20,000 shares issued) 100,000
- Additional paid-in capital 125,000
- Retained earnings 450,000
- Total $875,000

During 2013, Elizabeth took part in the following transactions concerning stockholders’ equity.

1. Paid the annual 2012 $8 per share dividend on preferred stock and a $2 per share dividend on common stock. These dividends had been declared on December 31, 2012.
2. Purchased 2,700 shares of its own outstanding common stock for $40 per share. Elizabeth uses the cost method.
3. Reissued 700 treasury shares for land valued at $30,000.
4. Issued 500 shares of preferred stock at $105 per share.
5. Declared a 10% stock dividend on the outstanding common stock when the stock is selling for $45 per share.
6. Issued the stock dividend.
7. Declared the annual 2013 $8 per share dividend on preferred stock and the $2 per share dividend on common stock. These dividends are payable in 2014.

Instructions
(a) Prepare journal entries to record the transactions described above.
(b) Prepare the December 31, 2013, stockholders’ equity section. Assume 2013 net income was $330,000.

E15-19 (Comparison of Alternative Forms of Financing) Shown below is the liabilities and stockholders’ equity section of the balance sheet for Ingalls Company and Wilder Company. Each has assets totaling $4,200,000.

<table>
<thead>
<tr>
<th></th>
<th>Ingalls Co.</th>
<th>Wilder Co.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current liabilities</td>
<td>$ 300,000</td>
<td>$ 600,000</td>
</tr>
<tr>
<td>Long-term debt, 10%</td>
<td>1,200,000</td>
<td>2,900,000</td>
</tr>
<tr>
<td>Common stock ($20 par)</td>
<td>2,000,000</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>700,000</td>
<td>700,000</td>
</tr>
<tr>
<td>Total</td>
<td>$4,200,000</td>
<td>$4,200,000</td>
</tr>
</tbody>
</table>

For the year, each company has earned the same income before interest and taxes.

<table>
<thead>
<tr>
<th></th>
<th>Ingalls Co.</th>
<th>Wilder Co.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income before interest and taxes</td>
<td>$1,200,000</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>120,000</td>
<td>0</td>
</tr>
<tr>
<td>Income taxes (40%)</td>
<td>1,080,000</td>
<td>1,200,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$ 648,000</td>
<td>$ 720,000</td>
</tr>
</tbody>
</table>

At year-end, the market price of Ingalls’s stock was $101 per share, and Wilder’s was $63.50. Assume balance sheet amounts are representative for the entire year.

Instructions
(a) Which company is more profitable in terms of return on total assets?
(b) Which company is more profitable in terms of return on stockholders’ equity?
(c) Which company has the greater net income per share of stock? Neither company issued or reacquired shares during the year.
(d) From the point of view of net income, is it advantageous to the stockholders of Ingalls Co. to have the long-term debt outstanding? Why?
(e) What is the book value per share for each company?
E15-20 (Trading on the Equity Analysis) Presented below is information from the annual report of Potter Plastics, Inc.

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating income</td>
<td>$532,150</td>
</tr>
<tr>
<td>Bond interest expense</td>
<td>135,000</td>
</tr>
<tr>
<td>Income taxes</td>
<td>183,432</td>
</tr>
<tr>
<td>Net income</td>
<td>$213,718</td>
</tr>
<tr>
<td>Bonds payable</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>Common stock</td>
<td>875,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>575,000</td>
</tr>
</tbody>
</table>

**Instructions**

(a) Compute the return on common stock equity and the rate of interest paid on bonds. (Assume balances for debt and equity accounts approximate averages for the year.)

(b) Is Potter Plastics, Inc. trading on the equity successfully? Explain.

E15-21 (Preferred Dividends) The outstanding capital stock of Pennington Corporation consists of 2,000 shares of $100 par value, 6% preferred, and 5,000 shares of $50 par value common.

**Instructions**

Assuming that the company has retained earnings of $70,000, all of which is to be paid out in dividends, and that preferred dividends were not paid during the 2 years preceding the current year, determine how much each class of stock should receive under each of the following conditions.

(a) The preferred stock is noncumulative and nonparticipating.

(b) The preferred stock is cumulative and nonparticipating.

(c) The preferred stock is cumulative and participating. (Round dividend rate percentages to four decimal places.)

E15-22 (Preferred Dividends) Martinez Company’s ledger shows the following balances on December 31, 2012.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred Stock (5%; $10 par value, outstanding 20,000 shares)</td>
<td>$200,000</td>
</tr>
<tr>
<td>Common Stock ($100 par value, outstanding 30,000 shares)</td>
<td>3,000,000</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>630,000</td>
</tr>
</tbody>
</table>

**Instructions**

Assuming that the directors decide to declare total dividends in the amount of $266,000, determine how much each class of stock should receive under each of the conditions stated below. One year’s dividends are in arrears on the preferred stock.

(a) The preferred stock is cumulative and fully participating.

(b) The preferred stock is noncumulative and nonparticipating.

(c) The preferred stock is noncumulative and is participating in distributions in excess of a 7% dividend rate on the common stock.

E15-23 (Preferred Stock Dividends) Hagar Company has outstanding 2,500 shares of $100 par, 6% preferred stock and 15,000 shares of $10 par value common. The schedule below shows the amount of dividends paid out over the last 4 years.

**Instructions**

Allocate the dividends to each type of stock under assumptions (a) and (b). Express your answers in per share amounts using the format shown below.

<table>
<thead>
<tr>
<th>Year</th>
<th>Paid-out</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>$12,000</td>
</tr>
<tr>
<td>2012</td>
<td>$26,000</td>
</tr>
<tr>
<td>2013</td>
<td>$52,000</td>
</tr>
<tr>
<td>2014</td>
<td>$76,000</td>
</tr>
</tbody>
</table>

**Assumptions**

<table>
<thead>
<tr>
<th>Year</th>
<th>(a) Preferred, noncumulative, and nonparticipating</th>
<th>(b) Preferred, cumulative, and fully participating</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Preferred</td>
<td>Common</td>
</tr>
<tr>
<td>2011</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2012</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Chapter 15 Stockholders’ Equity

*E15-24 (Computation of Book Value per Share) Johnstone Inc. began operations in January 2011 and reported the following results for each of its 3 years of operations.

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Income/Net Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>$260,000 net loss</td>
</tr>
<tr>
<td>2012</td>
<td>$40,000 net loss</td>
</tr>
<tr>
<td>2013</td>
<td>$700,000 net income</td>
</tr>
</tbody>
</table>

At December 31, 2013, Johnstone Inc. capital accounts were as follows.

- 6% cumulative preferred stock, par value $100; authorized, issued, and outstanding 5,000 shares: $500,000
- Common stock, par value $1.00; authorized 1,000,000 shares; issued and outstanding 750,000 shares: $750,000

Johnstone Inc. has never paid a cash or stock dividend. There has been no change in the capital accounts since Johnstone began operations. The state law permits dividends only from retained earnings.

Instructions
(a) Compute the book value of the common stock at December 31, 2013.
(b) Compute the book value of the common stock at December 31, 2013, assuming that the preferred stock has a liquidating value of $106 per share.

See the book’s companion website, www.wiley.com/college/kieso, for a set of B Exercises.

PROBLEMS

**P15-1 (Equity Transactions and Statement Preparation)** On January 5, 2012, Phelps Corporation received a charter granting the right to issue 5,000 shares of $100 par value, 8% cumulative and nonparticipating preferred stock, and 50,000 shares of $10 par value common stock. It then completed these transactions.

<table>
<thead>
<tr>
<th>Date</th>
<th>Transaction Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan. 11</td>
<td>Issued 20,000 shares of common stock at $16 per share.</td>
</tr>
<tr>
<td>Feb. 1</td>
<td>Issued to Sanchez Corp. 4,000 shares of preferred stock for the following assets: equipment with a fair value of $50,000; a factory building with a fair value of $160,000; and land with an appraised value of $270,000.</td>
</tr>
<tr>
<td>July 29</td>
<td>Purchased 1,800 shares of common stock at $17 per share. (Use cost method.)</td>
</tr>
<tr>
<td>Aug. 10</td>
<td>Sold 1,800 treasury shares at $14 per share.</td>
</tr>
<tr>
<td>Dec. 31</td>
<td>Declared a $0.25 per share cash dividend on the common stock and declared the preferred dividend.</td>
</tr>
<tr>
<td>Dec. 31</td>
<td>Closed the Income Summary account. There was a $175,700 net income.</td>
</tr>
</tbody>
</table>

Instructions
(a) Record the journal entries for the transactions listed above.
(b) Prepare the stockholders’ equity section of Phelps Corporation’s balance sheet as of December 31, 2012.

**P15-2 (Treasury Stock Transactions and Presentation)** Clemson Company had the following stockholders’ equity as of January 1, 2012.

- Common stock, $5 par value, 20,000 shares issued: $100,000
- Paid-in capital in excess of par—common stock: $300,000
- Retained earnings: $320,000
- Total stockholders’ equity: $720,000

During 2012, the following transactions occurred.

<table>
<thead>
<tr>
<th>Date</th>
<th>Transaction Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Feb. 1</td>
<td>Clemson repurchased 2,000 shares of treasury stock at a price of $19 per share.</td>
</tr>
<tr>
<td>Mar. 1</td>
<td>800 shares of treasury stock repurchased above were reissued at $17 per share.</td>
</tr>
<tr>
<td>Mar. 18</td>
<td>500 shares of treasury stock repurchased above were reissued at $14 per share.</td>
</tr>
<tr>
<td>Apr. 22</td>
<td>600 shares of treasury stock repurchased above were reissued at $20 per share.</td>
</tr>
</tbody>
</table>
Instructions
(a) Prepare the journal entries to record the treasury stock transactions in 2012, assuming Clemson uses the cost method.
(b) Prepare the stockholders’ equity section as of April 30, 2012. Net income for the first 4 months of 2012 was $130,000.

P15-3 (Equity Transactions and Statement Preparation) Hatch Company has two classes of capital stock outstanding: 8%, $20 par preferred and $5 par common. At December 31, 2012, the following accounts were included in stockholders’ equity.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred Stock, 150,000 shares</td>
<td>$ 3,000,000</td>
</tr>
<tr>
<td>Common Stock, 2,000,000 shares</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Paid-in Capital in Excess of Par—Preferred Stock</td>
<td>$ 200,000</td>
</tr>
<tr>
<td>Paid-in Capital in Excess of Par—Common Stock</td>
<td>$27,000,000</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>$ 4,500,000</td>
</tr>
</tbody>
</table>

The following transactions affected stockholders’ equity during 2013.

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan. 1</td>
<td>Issued 30,000 shares of preferred stock at $22 per share.</td>
<td></td>
</tr>
<tr>
<td>Feb. 1</td>
<td>Issued 50,000 shares of common stock at $20 per share.</td>
<td></td>
</tr>
<tr>
<td>June 1</td>
<td>2-for-1 stock split (par value reduced to $2.50).</td>
<td></td>
</tr>
<tr>
<td>July 1</td>
<td>Purchased 30,000 shares of common treasury stock at $10 per share.</td>
<td>Hatch uses the cost method.</td>
</tr>
<tr>
<td>Sept. 15</td>
<td>Reissued 10,000 shares of treasury stock at $11 per share.</td>
<td></td>
</tr>
<tr>
<td>Dec. 31</td>
<td>The preferred dividend is declared, and a common dividend of 50¢ per share is declared.</td>
<td></td>
</tr>
<tr>
<td>Dec. 31</td>
<td>Net income is $2,100,000.</td>
<td></td>
</tr>
</tbody>
</table>

Instructions
Prepare the stockholders’ equity section for Hatch Company at December 31, 2013. Show all supporting computations.

P15-4 (Stock Transactions—Lump Sum) Seles Corporation’s charter authorized issuance of 100,000 shares of $10 par value common stock and 50,000 shares of $50 preferred stock. The following transactions involving the issuance of shares of stock were completed. Each transaction is independent of the others.

1. Issued a $10,000, 9% bond payable at par and gave as a bonus one share of preferred stock, which at that time was selling for $106 a share.
2. Issued 500 shares of common stock for equipment. The equipment had been appraised at $7,100; the seller’s book value was $6,200. The most recent market price of the common stock is $16 a share.
3. Issued 375 shares of common and 100 shares of preferred for a lump sum amounting to $10,800. The common had been selling at $14 and the preferred at $65.
4. Issued 200 shares of common and 50 shares of preferred for equipment. The common had a fair value of $16 per share; the equipment has a fair value of $6,500.

Instructions
Record the transactions listed above in journal entry form.

P15-5 (Treasury Stock—Cost Method) Before Gordon Corporation engages in the treasury stock transactions listed below, its general ledger reflects, among others, the following account balances (par value of its stock is $30 per share).

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paid-in Capital in Excess of Par—Common Stock</td>
<td>$99,000</td>
</tr>
<tr>
<td>Common Stock</td>
<td>$270,000</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>$ 80,000</td>
</tr>
</tbody>
</table>

Instructions
Record the treasury stock transactions (given below) under the cost method of handling treasury stock; use the FIFO method for purchase-sale purposes.

(a) Bought 380 shares of treasury stock at $40 per share.
(b) Bought 300 shares of treasury stock at $45 per share.
(c) Sold 350 shares of treasury stock at $42 per share.
(d) Sold 110 shares of treasury stock at $38 per share.
Chapter 15 Stockholders’ Equity

P15-6 (Treasury Stock—Cost Method—Equity Section Preparation) Washington Company has the following stockholders’ equity accounts at December 31, 2012.

<table>
<thead>
<tr>
<th>Account Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Stock ($100 par value, authorized 8,000 shares)</td>
<td>$480,000</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>294,000</td>
</tr>
</tbody>
</table>

Instructions
(a) Prepare entries in journal form to record the following transactions, which took place during 2013.
(1) 280 shares of outstanding stock were purchased at $97 per share. (These are to be accounted for using the cost method.)
(2) A $20 per share cash dividend was declared.
(3) The dividend declared in (2) above was paid.
(4) The treasury shares purchased in (1) above were resold at $102 per share.
(5) 500 shares of outstanding stock were purchased at $105 per share.
(6) 350 of the shares purchased in (5) above were resold at $96 per share.
(b) Prepare the stockholders’ equity section of Washington Company’s balance sheet after giving effect to these transactions, assuming that the net income for 2013 was $94,000. State law requires restriction of retained earnings for the amount of treasury stock.

P15-7 (Cash Dividend Entries) The books of Conchita Corporation carried the following account balances as of December 31, 2012.

<table>
<thead>
<tr>
<th>Account Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>195,000</td>
</tr>
<tr>
<td>Preferred Stock (6% cumulative, nonparticipating, $50 par)</td>
<td>300,000</td>
</tr>
<tr>
<td>Common Stock (no-par value, 300,000 shares issued)</td>
<td>1,500,000</td>
</tr>
<tr>
<td>Paid-in Capital in Excess of Par—Preferred Stock</td>
<td>150,000</td>
</tr>
<tr>
<td>Treasury Stock (common 2,800 shares at cost)</td>
<td>33,600</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>105,000</td>
</tr>
</tbody>
</table>

The company decided not to pay any dividends in 2012.
The board of directors, at their annual meeting on December 21, 2013, declared the following: “The current year dividends shall be 6% on the preferred and $.30 per share on the common. The dividends in arrears shall be paid by issuing 1,900 shares of treasury stock.” At the date of declaration, the preferred is selling at $80 per share, and the common at $12 per share. Net income for 2013 is estimated at $77,000.

Instructions
(a) Prepare the journal entries required for the dividend declaration and payment, assuming that they occur simultaneously.
(b) Could Conchita Corporation give the preferred stockholders 2 years’ dividends and common stockholders a 30 cents per share dividend, all in cash?

P15-8 (Dividends and Splits) Myers Company provides you with the following condensed balance sheet information.

<table>
<thead>
<tr>
<th>Account Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$ 40,000</td>
</tr>
<tr>
<td>Equity investments (ABC stock; 10,000 shares at cost)</td>
<td>60,000</td>
</tr>
<tr>
<td>Equipment (net)</td>
<td>250,000</td>
</tr>
<tr>
<td>Intangibles</td>
<td>60,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>$410,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Account Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current and long-term liabilities</td>
<td>$100,000</td>
</tr>
<tr>
<td>Stockholders’ equity</td>
<td></td>
</tr>
<tr>
<td>Common stock ($5 par)</td>
<td>$20,000</td>
</tr>
<tr>
<td>Paid-in capital in excess of par</td>
<td>110,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>180,000</td>
</tr>
<tr>
<td>Total liabilities and stockholders’ equity</td>
<td>310,000</td>
</tr>
</tbody>
</table>

Instructions
For each transaction below, indicate the dollar impact (if any) on the following five items: (1) total assets, (2) common stock, (3) paid-in capital in excess of par, (4) retained earnings, and (5) stockholders’ equity.
(Each situation is independent.)

(a) Myers declares and pays a $0.50 per share cash dividend.
(b) Myers declares and issues a 10% stock dividend when the market price of the stock is $14 per share.
(c) Myers declares and issues a 30% stock dividend when the market price of the stock is $15 per share.

(d) Myers declares and distributes a property dividend. Myers gives one share of ABC stock for every two shares of Myers Company stock held. ABC is selling for $10 per share on the date the property dividend is declared.

(e) Myers declares a 2-for-1 stock split and issues new shares.

### P15-9 (Stockholders’ Equity Section of Balance Sheet)

The following is a summary of all relevant transactions of Vicario Corporation since it was organized in 2012.

In 2012, 15,000 shares were authorized and 7,000 shares of common stock ($50 par value) were issued at a price of $57. In 2013, 1,000 shares were issued as a stock dividend when the stock was selling for $60. Three hundred shares of common stock were bought in 2014 at a cost of $64 per share. These 300 shares are still in the company treasury.

In 2013, 10,000 preferred shares were authorized and the company issued 5,000 of them ($100 par value) at $113. Some of the preferred stock was reacquired by the company and later reissued for $4,700 more than it cost the company.

The corporation has earned a total of $610,000 in net income after income taxes and paid out a total of $312,600 in cash dividends since incorporation.

#### Instructions

Prepare the stockholders’ equity section of the balance sheet in proper form for Vicario Corporation as of December 31, 2014. Account for treasury stock using the cost method.

### P15-10 (Stock Dividends and Stock Split)

Oregon Inc. $10 par common stock is selling for $110 per share. Four million shares are currently issued and outstanding. The board of directors wishes to stimulate interest in Oregon common stock before a forthcoming stock issue but does not wish to distribute capital at this time. The board also believes that too many adjustments to the stockholders’ equity section, especially retained earnings, might discourage potential investors.

The board has considered three options for stimulating interest in the stock:

1. A 20% stock dividend.
2. A 100% stock dividend.
3. A 2-for-1 stock split.

#### Instructions

Acting as financial advisor to the board, you have been asked to report briefly on each option and, considering the board’s wishes, make a recommendation. Discuss the effects of each of the foregoing options.

### P15-11 (Stock and Cash Dividends)

Earnhart Corporation has outstanding 3,000,000 shares of common stock of a par value of $10 each. The balance in its Retained Earnings account at January 1, 2012, was $24,000,000, and it then had Paid-in Capital in Excess of Par—Common Stock of $5,000,000. During 2012, the company’s net income was $4,700,000. A cash dividend of $0.60 a share was declared on May 5, 2012, and was paid June 30, 2012, and a 6% stock dividend was declared on November 30, 2012, and distributed to stockholders of record at the close of business on December 31, 2012. You have been asked to advise on the proper accounting treatment of the stock dividend.

The existing stock of the company is quoted on a national stock exchange. The market price of the stock has been as follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>Market Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>October 31, 2012</td>
<td>$31</td>
</tr>
<tr>
<td>November 30, 2012</td>
<td>$34</td>
</tr>
<tr>
<td>December 31, 2012</td>
<td>$38</td>
</tr>
</tbody>
</table>

#### Instructions

(a) Prepare the journal entry to record the declaration and payment of the cash dividend.

(b) Prepare the journal entry to record the declaration and distribution of the stock dividend.

(c) Prepare the stockholders’ equity section (including schedules of retained earnings and additional paid-in capital) of the balance sheet of Earnhart Corporation for the year 2012 on the basis of the foregoing information. Draft a note to the financial statements setting forth the basis of the accounting for the stock dividend, and add separately appropriate comments or explanations regarding the basis chosen.

### P15-12 (Analysis and Classification of Equity Transactions)

Penn Company was formed on July 1, 2010. It was authorized to issue 300,000 shares of $10 par value common stock and 100,000 shares of 8% $25 par value, cumulative and nonparticipating preferred stock. Penn Company has a July 1–June 30 fiscal year.
Chapter 15 Stockholders’ Equity

The following information relates to the stockholders’ equity accounts of Penn Company.

Common Stock
Prior to the 2012–13 fiscal year, Penn Company had 110,000 shares of outstanding common stock issued as follows.

1. 85,000 shares were issued for cash on July 1, 2010, at $31 per share.
2. On July 24, 2010, 5,000 shares were exchanged for a plot of land which cost the seller $70,000 in 2004 and had an estimated fair value of $220,000 on July 24, 2010.
3. 20,000 shares were issued on March 1, 2011, for $42 per share.

During the 2012–13 fiscal year, the following transactions regarding common stock took place.

November 30, 2012  Penn purchased 2,000 shares of its own stock on the open market at $39 per share. Penn uses the cost method for treasury stock.
December 15, 2012  Penn declared a 5% stock dividend for stockholders of record on January 15, 2013, to be issued on January 31, 2013. Penn was having a liquidity problem and could not afford a cash dividend at the time. Penn’s common stock was selling at $52 per share on December 15, 2012.
June 20, 2013  Penn sold 500 shares of its own common stock that it had purchased on November 30, 2012, for $21,000.

Preferred Stock
Penn issued 40,000 shares of preferred stock at $44 per share on July 1, 2011.

Cash Dividends
Penn has followed a schedule of declaring cash dividends in December and June, with payment being made to stockholders of record in the following month. The cash dividends which have been declared since inception of the company through June 30, 2013, are shown below.

<table>
<thead>
<tr>
<th>Declaration Date</th>
<th>Common Stock</th>
<th>Preferred Stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/15/11</td>
<td>$0.30 per share</td>
<td>$1.00 per share</td>
</tr>
<tr>
<td>6/15/12</td>
<td>$0.30 per share</td>
<td>$1.00 per share</td>
</tr>
<tr>
<td>12/15/12</td>
<td>—</td>
<td>$1.00 per share</td>
</tr>
</tbody>
</table>

No cash dividends were declared during June 2013 due to the company’s liquidity problems.

Retained Earnings
As of June 30, 2012, Penn’s retained earnings account had a balance of $690,000. For the fiscal year ending June 30, 2013, Penn reported net income of $40,000.

Instructions
Prepare the stockholders’ equity section of the balance sheet, including appropriate notes, for Penn Company as of June 30, 2013, as it should appear in its annual report to the shareholders. (CMA adapted)

CONCEPTS FOR ANALYSIS

CA15-1 (Preemptive Rights and Dilution of Ownership) Wallace Computer Company is a small, closely held corporation. Eighty percent of the stock is held by Derek Wallace, president. Of the remainder, 10% is held by members of his family and 10% by Kathy Baker, a former officer who is now retired. The balance sheet of the company at June 30, 2012, was substantially as shown below.

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities and Stockholders’ Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash $22,000</td>
<td>Current liabilities $50,000</td>
</tr>
<tr>
<td>Other $450,000</td>
<td>Capital stock $250,000</td>
</tr>
<tr>
<td>$472,000</td>
<td>Retained earnings $172,000</td>
</tr>
</tbody>
</table>

Additional authorized capital stock of $300,000 par value had never been issued. To strengthen the cash position of the company, Wallace issued capital stock with a par value of $100,000 to himself at par for cash. At the next stockholders’ meeting, Baker objected and claimed that her interests had been injured.
CA15-2 (Issuance of Stock for Land) Martin Corporation is planning to issue 3,000 shares of its own $10 par value common stock for two acres of land to be used as a building site.

Instructions
(a) What general rule should be applied to determine the amount at which the land should be recorded?
(b) Under what circumstances should this transaction be recorded at the fair value of the land?
(c) Under what circumstances should this transaction be recorded at the fair value of the stock issued?
(d) Assume Martin intentionally records this transaction at an amount greater than the fair value of the land and the stock. Discuss this situation.


Instructions
Answer the following questions based on SFAC No. 6.
(a) Define and discuss the term “equity.”
(b) What transactions or events change owners’ equity?
(c) Define “investments by owners” and provide examples of this type of transaction. What financial statement element other than equity is typically affected by owner investments?
(d) Define “distributions to owners” and provide examples of this type of transaction. What financial statement element other than equity is typically affected by distributions?
(e) What are examples of changes within owners’ equity that do not change the total amount of owners’ equity?

CA15-4 (Stock Dividends and Splits) The directors of Merchant Corporation are considering the issuance of a stock dividend. They have asked you to discuss the proposed action by answering the following questions.

Instructions
(a) What is a stock dividend? How is a stock dividend distinguished from a stock split (1) from a legal standpoint, and (2) from an accounting standpoint?
(b) For what reasons does a corporation usually declare a stock dividend? A stock split?
(c) Discuss the amount, if any, of retained earnings to be capitalized in connection with a stock dividend.

(AICPA adapted)

CA15-5 (Stock Dividends) Kulikowski Inc., a client, is considering the authorization of a 10% common stock dividend to common stockholders. The financial vice president of Kulikowski wishes to discuss the accounting implications of such an authorization with you before the next meeting of the board of directors.

Instructions
(a) The first topic the vice president wishes to discuss is the nature of the stock dividend to the recipient. Discuss the case against considering the stock dividend as income to the recipient.
(b) The other topic for discussion is the propriety of issuing the stock dividend to all “stockholders of record” or to “stockholders of record exclusive of shares held in the name of the corporation as treasury stock.” Discuss the case against issuing stock dividends on treasury shares.

(AICPA adapted)

CA15-6 (Stock Dividend, Cash Dividend, and Treasury Stock) Mask Company has 30,000 shares of $10 par value common stock authorized and 20,000 shares issued and outstanding. On August 15, 2012, Mask purchased 1,000 shares of treasury stock for $18 per share. Mask uses the cost method to account for treasury stock. On September 14, 2012, Mask sold 500 shares of the treasury stock for $20 per share.
Chapter 15 Stockholders’ Equity

In October 2012, Mask declared and distributed 1,950 shares as a stock dividend from unissued shares when the market price of the common stock was $21 per share.


Instructions
(a) How should Mask account for the purchase and sale of the treasury stock, and how should the treasury stock be presented in the balance sheet at December 31, 2012?
(b) How should Mask account for the stock dividend, and how would it affect the stockholders’ equity at December 31, 2012? Why?
(c) How should Mask account for the cash dividend, and how would it affect the balance sheet at December 31, 2012? Why?

(AICPA adapted)

CA15-7 (Treasury Stock—Ethics) Lois Kenseth, president of Sycamore Corporation, is concerned about several large stockholders who have been very vocal lately in their criticisms of her leadership. She thinks they might mount a campaign to have her removed as the corporation’s CEO. She decides that buying them out by purchasing their shares could eliminate them as opponents, and she is confident they would accept a “good” offer. Kenseth knows the corporation’s cash position is decent, so it has the cash to complete the transaction. She also knows the purchase of these shares will increase earnings per share, which should make other investors quite happy. (Earnings per share is calculated by dividing net income available for the common shareholders by the weighted-average number of shares outstanding. Therefore, if the number of shares outstanding is decreased by purchasing treasury shares, earnings per share increases.)

Instructions
Answer the following questions.
(a) Who are the stakeholders in this situation?
(b) What are the ethical issues involved?
(c) Should Kenseth authorize the transaction?

USING YOUR JUDGMENT

FINANCIAL REPORTING

Financial Reporting Problem
P&G The Procter & Gamble Company (P&G)
The financial statements of P&G are presented in Appendix 5B or can be accessed at the book’s companion website, www.wiley.com/college/kieso.

Instructions
Refer to these financial statements and the accompanying notes to answer the following questions.
(a) What is the par or stated value of P&G’s preferred stock?
(b) What is the par or stated value of P&G’s common stock?
(c) What percentage of P&G’s authorized common stock was issued at June 30, 2009?
(d) How many shares of common stock were outstanding at June 30, 2009, and June 30, 2008?
(e) What was the dollar amount effect of the cash dividends on P&G’s stockholders’ equity?
(f) What is P&G’s rate of return on common stock equity for 2009 and 2008?
(g) What is P&G’s payout ratio for 2009 and 2008?
(h) What was the market price range (high/low) of P&G’s common stock during the quarter ended June 30, 2009?
Using Your Judgment 893

Comparative Analysis Case
The Coca-Cola Company and PepsiCo, Inc.

Instructions
Go to the book’s companion website and use information found there to answer the following questions related to The Coca-Cola Company and PepsiCo, Inc.

(a) What is the par or stated value of Coca-Cola’s and PepsiCo’s common or capital stock?
(b) What percentage of authorized shares was issued by Coca-Cola at December 31, 2009, and by PepsiCo at December 26, 2009?
(c) How many shares are held as treasury stock by Coca-Cola at December 31, 2009, and by PepsiCo at December 26, 2009?
(d) How many Coca-Cola common shares are outstanding at December 31, 2009? How many PepsiCo shares of capital stock are outstanding at December 26, 2009?
(e) What amounts of cash dividends per share were declared by Coca-Cola and PepsiCo in 2009? What were the dollar amount effects of the cash dividends on each company’s shareholders’ equity?
(f) What are Coca-Cola’s and PepsiCo’s rate of return on common/capital stock equity for 2009 and 2008? Which company gets the higher return on the equity of its shareholders?
(g) What are Coca-Cola’s and PepsiCo’s payout ratios for 2009?
(h) What was the market price range (high/low) for Coca-Cola’s common stock and PepsiCo’s capital stock during the fourth quarter of 2009? Which company’s (Coca-Cola’s or PepsiCo’s) stock price increased more (%) during 2009?

Financial Statement Analysis Cases
Case 1 Kellogg Company
Kellogg Company is the world’s leading producer of ready-to-eat cereal products. In recent years, the company has taken numerous steps aimed at improving its profitability and earnings per share. Presented below are some basic facts for Kellogg.

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$12,575</td>
<td>$12,822</td>
</tr>
<tr>
<td>Net earnings</td>
<td>1,212</td>
<td>1,148</td>
</tr>
<tr>
<td>Total assets</td>
<td>11,200</td>
<td>10,946</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>8,925</td>
<td>9,491</td>
</tr>
<tr>
<td>Common stock, $0.25 par value</td>
<td>105</td>
<td>105</td>
</tr>
<tr>
<td>Capital in excess of par value</td>
<td>472</td>
<td>438</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>5,481</td>
<td>4,836</td>
</tr>
<tr>
<td>Treasury stock, at cost</td>
<td>1,820</td>
<td>1,790</td>
</tr>
<tr>
<td>Number of shares outstanding (in millions)</td>
<td>419</td>
<td>419</td>
</tr>
</tbody>
</table>

Instructions
(a) What are some of the reasons that management purchases its own stock?
(b) Explain how earnings per share might be affected by treasury stock transactions.
(c) Calculate the ratio of debt to total assets for 2008 and 2009, and discuss the implications of the change.

Case 2 Wiebold, Incorporated
The following note related to stockholders’ equity was reported in Wiebold, Inc.’s annual report.

On February 1, the Board of Directors declared a 3-for-2 stock split, distributed on February 22 to shareholders of record on February 10. Accordingly, all numbers of common shares, except unissued shares and treasury shares, and all per share data have been restated to reflect this stock split.

On the basis of amounts declared and paid, the annualized quarterly dividends per share were $0.80 in the current year and $0.75 in the prior year.
894 Chapter 15 Stockholders’ Equity

Instructions
(a) What is the significance of the date of record and the date of distribution?
(b) Why might Weibold have declared a 3-for-2 for stock split?
(c) What impact does Wiebold’s stock split have on (1) total stockholders’ equity, (2) total par value, (3) outstanding shares, and (4) book value per share?

Accounting, Analysis, and Principles
On January 1, 2012, Agassi Corporation had the following stockholders’ equity accounts.

- Common Stock ($10 par value, 60,000 shares issued and outstanding) $600,000
- Paid-in Capital in Excess of Par 500,000
- Retained Earnings 620,000

During 2012, the following transactions occurred.
- Jan. 15 Declared and paid a $1.05 cash dividend per share to stockholders.
- Apr. 15 Declared and paid a 10% stock dividend. The market price of the stock was $14 per share.
- May 15 Reacquired 2,000 common shares at a market price of $15 per share.
- Nov. 15 Reissued 1,000 shares held in treasury at a price of $18 per share.
- Dec. 31 Determined that net income for the year was $370,000.

Accounting
Journalize the above transactions. (Include entries to close net income to Retained Earnings.) Determine the ending balances for Paid-in Capital, Retained Earnings, and Stockholders’ Equity.

Analysis
Calculate the payout ratio and the return on common stock equity ratio.

Principles
R. Federer is examining Agassi’s financial statements and wonders whether the “gains” or “losses” on Agassi’s treasury stock transactions should be included in income for the year. Briefly explain whether, and the conceptual reasons why, gains or losses on treasury stock transactions should be recorded in income.

BRIDGE TO THE PROFESSION
Professional Research: FASB Codification
Recall from Chapter 13 that Hincapie Co. (a specialty bike-accessory manufacturer) is expecting growth in sales of some products targeted to the low-price market. Hincapie is contemplating a preferred stock issue to help finance this expansion in operations. The company is leaning toward participating preferred stock because ownership will not be diluted, but the investors will get an extra dividend if the company does well. The company management wants to be certain that its reporting of this transaction is transparent to its current shareholders and wants you to research the disclosure requirements related to its capital structure.

Instructions
If your school has a subscription to the FASB Codification, go to http://aahq.org/ascLogin.cfm to log in and prepare responses to the following. Provide Codification references for your responses.
(a) Identify the authoritative literature that addresses disclosure of information about capital structure.
(b) Find definitions of the following:
   (1) Securities.
   (2) Participation rights.
   (3) Preferred stock.
(c) What information about securities must companies disclose? Discuss how Hincapie should report the proposed preferred stock issue.
The primary IFRS related to stockholders’ equity are IAS 1 ("Presentation of Financial Statements"), IAS 32 ("Financial Instruments: Presentation"), and IAS 39 ("Financial Instruments: Recognition and Measurement"). The accounting for transactions related to stockholders’ equity, such as issuance of shares, purchase of treasury stock, and declaration and payment of dividends, are similar under both IFRS and GAAP. Major differences relate to terminology used, introduction of terms such as revaluation surplus, and presentation of stockholders’ equity information.

RELEVANT FACTS

- Many countries have different investor groups than the United States. For example, in Germany, financial institutions like banks are not only the major creditors but often are the largest shareholders as well. In the United States and the United Kingdom, many companies rely on substantial investment from private investors.
- The accounting for treasury share retirements differs between IFRS and GAAP. Under GAAP, a company has three options: (1) charge the excess of the cost of treasury shares over par value to retained earnings, (2) allocate the difference between paid-in capital
and retained earnings, or (3) charge the entire amount to paid-in capital. Under IFRS, the excess may have to be charged to paid-in capital, depending on the original transaction related to the issuance of the shares.

- The statement of changes in equity is usually referred to as the statement of stockholders’ equity (or shareholders’ equity) under GAAP.
- Both IFRS and GAAP use the term retained earnings. However, IFRS relies on the term “reserve” as a dumping ground for other types of equity transactions, such as other comprehensive income items as well as various types of unusual transactions related to convertible debt and share option contracts. GAAP relies on the account Accumulated Other Comprehensive Income (Loss). We also use this account in the discussion below, as it appears this account is gaining prominence within the IFRS literature.
- Under IFRS, it is common to report “Revaluation Surplus” related to increases or decreases in items such as property, plant, and equipment; mineral resources; and intangible assets. The term surplus is generally not used in GAAP. In addition, unrealized gains on the above items are not reported in the financial statements under GAAP.

### ABOUT THE NUMBERS

**Equity**

Equity is the residual interest in the assets of the company after deducting all liabilities. Equity is often referred to as shareholders’ equity, stockholders’ equity, or corporate capital. Equity is often subclassified on the statement of financial position (balance sheet) into the following categories (as discussed in Chapter 5).

1. Share capital.
2. Share premium.
3. Retained earnings.
4. Accumulated other comprehensive income.
5. Treasury shares.
6. Non-controlling interest (minority interest).

Such classifications help financial statement users to better understand the legal or other restrictions related to the ability of the company to pay dividends or otherwise use its equity for certain defined purposes. Companies often make a distinction between contributed capital (paid-in capital) and earned capital. Contributed capital (paid-in capital) is the total amount paid in on capital shares—the amount provided by shareholders to the corporation for use in the business. Contributed capital includes items such as the par value of all outstanding shares and premiums less discounts on issuance. Earned capital is the capital that develops from profitable operations. It consists of all undistributed income that remains invested in the company. Retained earnings represents the earned capital of the company.

As indicated above, equity is a residual interest and therefore its value is derived from the amount of the corporation’s assets and liabilities. Only in unusual cases will a company’s equity equal the total fair value of its shares. For example, BMW recently had total equity of €20,265 million and a market capitalization of €21,160 million. BMW’s equity represents the net contributions from shareholders (from both majority and minority shareholders) plus retained earnings and accumulated other comprehensive income. As a residual interest, its equity has no existence apart from the assets and liabilities of BMW—equity equals net assets. Equity is not a claim to specific assets but a claim against a portion of the total assets. Its amount is not specified or fixed; it depends on BMW’s profitability. Equity grows if it is profitable. It shrinks, or may disappear entirely, if BMW loses money.
ISSUANCE OF ORDINARY SHARES

Under IFRS, the accounting for share issuances is similar to GAAP. The primary difference is the account titles. GAAP uses an account, Common Stock, for the par value of shares, while IFRS uses an account labeled Share Capital. What about no-par shares? In some countries, as in the United States, the total issue price for no-par shares may be considered legal capital, which could reduce the flexibility in paying dividends. Corporations sell no-par shares, like par value shares, for whatever price they will bring. However, unlike par value shares, corporations issue them without a premium or a discount. The exact amount received represents the credit to ordinary or preference shares.

For example, Video Electronics Corporation is organized with 10,000 ordinary shares authorized without par value. Video Electronics makes only a memorandum entry for the authorization, inasmuch as no amount is involved. If Video Electronics then issues 500 shares for cash at $10 per share, it makes the following entry.

\[
\text{Cash} \quad 5,000 \\
\text{Share Capital—Ordinary} \quad 5,000
\]

If it issues another 500 shares for $11 per share, Video Electronics makes this entry.

\[
\text{Cash} \quad 5,500 \\
\text{Share Capital—Ordinary} \quad 5,500
\]

True no-par shares should be carried in the accounts at issue price without any share premium reported. But some countries require that no-par shares have a stated value. The stated value is a minimum value below which a company cannot issue it. Thus, instead of being no-par shares, such stated-value shares become, in effect, shares with a very low par value. It thus is open to all the criticism and abuses that first encouraged the development of no-par shares.

If no-par shares have a stated value of $5 per share but sell for $11, all such amounts in excess of $5 are recorded as share premium, which in many jurisdictions is fully or partially available for dividends. Thus, no-par value shares, with a low stated value, permit a new corporation to commence its operations with share premium that may exceed its stated capital. For example, if a company issued 1,000 of the shares with a $5 stated value at $15 per share for cash, it makes the following entry.

\[
\text{Cash} \quad 15,000 \\
\text{Share Capital—Ordinary} \quad 5,000 \\
\text{Share Premium—Ordinary} \quad 10,000
\]

Most corporations account for no-par shares with a stated value as if they were par value shares with par equal to the stated value.

ACCOUNTING FOR AND REPORTING PREFERENCE SHARES

The accounting for preference shares at issuance is similar to that for ordinary shares. A corporation allocates proceeds between the par value of the preference shares and share premium. To illustrate, assume that Bishop Co. issues 10,000 shares of $10 par value preference shares for $12 cash per share. Bishop records the issuance as follows.

\[
\text{Cash} \quad 120,000 \\
\text{Share Capital—Preference} \quad 100,000 \\
\text{Share Premium—Preference} \quad 20,000
\]

Thus, Bishop maintains separate accounts for these different classes of shares. Corporations consider convertible preference shares as a part of equity. In addition, when exercising convertible preference shares, there is no theoretical justification for recognition of a gain or loss. A company recognizes no gain or loss when dealing with shareholders in their capacity as business owners. Instead, the company employs the book value method: debit Share Capital—Preference, along with any related Share Premium—Preference; credit Share Capital—Ordinary and Share Premium—Ordinary (if an excess exists).
Preference shares generally have no maturity date. Therefore, no legal obligation exists to pay the preference shareholder. As a result, companies classify preference shares as part of equity. Companies generally report preference shares at par value as the first item in the equity section. They report any excess over par value as part of share premium. They also consider dividends on preference shares as a distribution of income and not an expense. Companies must disclose the pertinent rights of the preference shares outstanding.

Presentation of Equity
Statement of Financial Position

Illustration IFRS15-1 shows a comprehensive equity section from the statement of financial position of Frost Company that includes the equity items we discussed previously.

<table>
<thead>
<tr>
<th>FROST COMPANY</th>
<th>EQUITY</th>
<th>DECEMBER 31, 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share capital—preference, $100 par value, 7% cumulative, 100,000 shares authorized, 30,000 shares issued and outstanding</td>
<td>$3,000,000</td>
<td></td>
</tr>
<tr>
<td>Share capital—ordinary, no-par, stated value $10 per share, 500,000 shares authorized, 400,000 shares issued</td>
<td>4,000,000</td>
<td></td>
</tr>
<tr>
<td>Ordinary share dividend distributable</td>
<td>200,000</td>
<td>$  7,200,000</td>
</tr>
<tr>
<td>Share premium—preference</td>
<td>150,000</td>
<td></td>
</tr>
<tr>
<td>Share premium—ordinary</td>
<td>840,000</td>
<td>990,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>4,360,000</td>
<td></td>
</tr>
<tr>
<td>Treasury shares (2,000 ordinary shares)</td>
<td>(190,000)</td>
<td></td>
</tr>
<tr>
<td>Accumulated other comprehensive loss</td>
<td>(360,000)</td>
<td></td>
</tr>
<tr>
<td>Total equity</td>
<td>$12,000,000</td>
<td></td>
</tr>
</tbody>
</table>

Frost should disclose the pertinent rights and privileges of the various securities outstanding. For example, companies must disclose all of the following: dividend and liquidation preferences, participation rights, call prices and dates, conversion or exercise prices and pertinent dates, sinking fund requirements, unusual voting rights, and significant terms of contracts to issue additional shares. Liquidation preferences should be disclosed in the equity section of the statement of financial position, rather than in the notes to the financial statements, to emphasize the possible effect of this restriction on future cash flows.

Presentation of Statement of Changes in Equity

Companies are also required to present a statement of changes in equity. The statement of changes in equity includes the following.

1. Total comprehensive income for the period, showing separately the total amounts attributable to owners of the parent and to non-controlling interests.
2. For each component of equity, the effects of retrospective application or retrospective restatement.
3. For each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period, separately disclosing changes resulting from:
   (a) Profit or loss;
   (b) Each item of other comprehensive income; and
   (c) Transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners and changes in ownership interests in subsidiaries that do not result in a loss of control.

A typical statement of changes in equity is shown in Illustration IFRS15-2.
In addition, companies are required to present, either in the statement of changes in equity or in the notes, the amount of dividends recognized as distributions to owners during the period and the related amount per share.

ON THE HORIZON

As indicated in earlier discussions, the IASB and the FASB are currently working on a project related to financial statement presentation. An important part of this study is to determine whether certain line items, subtotals, and totals should be clearly defined and required to be displayed in the financial statements. For example, it is likely that the statement of changes in equity and its presentation will be examined closely. In addition, the options of how to present other comprehensive income under GAAP will change in any converged standard.

IFRS SELF-TEST QUESTIONS

1. Which of the following does not represent a pair of GAAP/IFRS-comparable terms?
   (a) Additional paid-in capital/Share premium.
   (b) Treasury stock/Repurchase reserve.
   (c) Common stock/Share capital—ordinary.
   (d) Preferred stock/Preference shares.

2. Under IFRS, the amount of capital received in excess of par value would be credited to:
   (a) Retained Earnings.
   (b) Contributed Capital.
   (c) Share Premium.
   (d) Par value is not used under IFRS.

3. The term reserves is used under IFRS with reference to all of the following except:
   (a) gains and losses on revaluation of property, plant, and equipment.
   (b) capital received in excess of the par value of issued shares.
   (c) retained earnings.
   (d) fair value differences.

4. Which of the following is false?
   (a) Under GAAP, companies cannot record gains on transactions involving their own shares.
   (b) Under IFRS, companies cannot record gains on transactions involving their own shares.
   (c) Under IFRS, the statement of stockholders’ equity is a required statement.
   (d) Under IFRS, a company records a revaluation surplus when it experiences an increase in the price of its common stock.

### Illustration

#### IFRS15-2
Statement of Changes in Equity

<table>
<thead>
<tr>
<th></th>
<th>Share Capital</th>
<th>Retained Earnings</th>
<th>Unrealized Holding Gain (Loss) on Non-Trading Equity Investments</th>
<th>Unrealized Holding Gain (Loss) on Property, Plant, and Equipment</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance—December 31, 2012</td>
<td>$600,000</td>
<td>$120,000</td>
<td>$22,000</td>
<td>$15,000</td>
<td>$757,000</td>
</tr>
<tr>
<td>Issue of Ordinary Shares</td>
<td>200,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Comprehensive Income</td>
<td>70,000</td>
<td>(20,000)</td>
<td>11,000</td>
<td>8,000</td>
<td>89,000</td>
</tr>
<tr>
<td>Dividends</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance—December 31, 2013</td>
<td>$800,000</td>
<td>$170,000</td>
<td>$33,000</td>
<td>$23,000</td>
<td>$1,026,000</td>
</tr>
</tbody>
</table>
5. Under IFRS, a purchase by a company of its own shares results in:
   (a) an increase in treasury shares.
   (b) a decrease in assets.
   (c) a decrease in equity.
   (d) All of the above.

IFRS CONCEPTS AND APPLICATION

IFRS15-1 Where can authoritative IFRS guidance related to stockholders’ equity be found?

IFRS15-2 Briefly describe some of the similarities and differences between GAAP and IFRS with respect to the accounting for stockholders’ equity.

IFRS15-3 Briefly discuss the implications of the financial statement presentation project for the reporting of stockholders’ equity.

IFRS15-4 Mary Tokar is comparing a GAAP-based company to a company that uses IFRS. Both companies report equity investments. The IFRS company reports unrealized losses on these investments under the heading “Reserves” in its equity section. However, Mary can find no similar heading in the GAAP-based company financial statements. Can Mary conclude that the GAAP-based company has no unrealized gains or losses on its non-trading equity investments? Explain.

IFRS15-5 Explain each of the following terms: authorized ordinary shares, unissued ordinary shares, issued ordinary shares, outstanding ordinary shares, and treasury shares.

IFRS15-6 Indicate how each of the following accounts should be classified in the equity section.

   (a) Share Capital—Ordinary
   (b) Retained Earnings
   (c) Share Premium—Ordinary
   (d) Treasury Shares
   (e) Share Premium—Treasury
   (f) Share Capital—Preference
   (g) Accumulated Other Comprehensive Income

IFRS15-7 Kaymer Corporation issued 300 shares of $10 par value ordinary shares for $4,500. Prepare Kaymer’s journal entry.

IFRS15-8 Wilco Corporation has the following account balances at December 31, 2012.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share capital—ordinary, $5 par value</td>
<td>$510,000</td>
</tr>
<tr>
<td>Treasury shares</td>
<td>90,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>2,340,000</td>
</tr>
<tr>
<td>Share premium—ordinary</td>
<td>1,320,000</td>
</tr>
</tbody>
</table>

Instructions
Prepare Wilco’s December 31, 2012, equity section.

IFRS15-9 Ravonette Corporation issued 300 shares of $10 par value ordinary shares and 100 shares of $50 par value preference shares for a lump sum of $13,500. The ordinary shares have a market price of $20 per share, and the preference shares have a market price of $90 per share.

Instructions
Prepare the journal entry to record the issuance.

IFRS15-10 Weisberg Corporation has 10,000 shares of $100 par value, 6%, preference shares and 50,000 ordinary shares of $10 par value outstanding at December 31, 2012.
Instructions

Answer the questions in each of the following independent situations.

(a) If the preference shares are cumulative and dividends were last paid on the preference shares on December 31, 2009, what are the dividends in arrears that should be reported on the December 31, 2012, statement of financial position? How should these dividends be reported?

(b) If the preference shares are convertible into seven shares of $10 par value ordinary shares and 3,000 shares are converted, what entry is required for the conversion, assuming the preference shares were issued at par value?

(c) If the preference shares were issued at $107 per share, how should the preference shares be reported in the equity section?

IFRS15-11 Teller Corporation’s post-closing trial balance at December 31, 2012, was as follows.

<table>
<thead>
<tr>
<th>TELLER CORPORATION POST-CLOSING TRIAL BALANCE DECEMBER 31, 2012</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>$ 310,000</td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>$ 480,000</td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation—building and equipment</td>
<td>185,000</td>
<td></td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td>Bonds payable</td>
<td>700,000</td>
<td></td>
</tr>
<tr>
<td>Building and equipment</td>
<td>1,450,000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>190,000</td>
<td></td>
</tr>
<tr>
<td>Dividends payable on preference shares—cash</td>
<td>4,000</td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>560,000</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>400,000</td>
<td></td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>40,000</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>201,000</td>
<td></td>
</tr>
<tr>
<td>Share capital—ordinary ($1 par value)</td>
<td>200,000</td>
<td></td>
</tr>
<tr>
<td>Share capital—preference ($50 par value)</td>
<td>500,000</td>
<td></td>
</tr>
<tr>
<td>Share premium—ordinary</td>
<td>1,000,000</td>
<td></td>
</tr>
<tr>
<td>Share premium—treasury</td>
<td>160,000</td>
<td></td>
</tr>
<tr>
<td>Treasury shares—ordinary at cost</td>
<td>170,000</td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>$3,290,000</td>
<td>$3,290,000</td>
</tr>
</tbody>
</table>

At December 31, 2012, Teller had the following number of ordinary and preference shares.

<table>
<thead>
<tr>
<th></th>
<th>Ordinary</th>
<th>Preference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Authorized</td>
<td>600,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Issued</td>
<td>200,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Outstanding</td>
<td>190,000</td>
<td>10,000</td>
</tr>
</tbody>
</table>

The dividends on preference shares are $4 cumulative. In addition, the preference shares have a preference in liquidation of $50 per share.

Instructions

Prepare the equity section of Teller’s statement of financial position at December 31, 2012.

Professional Research

IFRS15-12 Recall from Chapter 13 that Hincapie Co. (a specialty bike-accessory manufacturer) is expecting growth in sales of some products targeted to the low-price market. Hincapie is contemplating a preference share issue to help finance this expansion in
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operations. The company is leaning toward preference shares because ownership will not be diluted, but the investors will get an extra dividend if the company does well. The company management wants to be certain that its reporting of this transaction is transparent to its current shareholders and wants you to research the disclosure requirements related to its capital structure.

Instructions
Access the IFRS authoritative literature at the IASB website (http://eifrs.iasb.org/). When you have accessed the documents, you can use the search tool in your Internet browser to respond to the following questions. (Provide paragraph citations.)

(a) Identify the authoritative literature that addresses disclosure of information about capital structure.
(b) What information about share capital must companies disclose? Discuss how Hincapie should report the proposed preference share issue.

International Financial Reporting Problem:
Marks and Spencer plc

Instructions
Refer to M&S’s financial statements and the accompanying notes to answer the following questions.

(a) What is the par or stated value of M&S’s preference shares?
(b) What is the par or stated value of M&S’s ordinary shares?
(c) What percentage of M&S’s authorized ordinary shares was issued at April 3, 2010?
(d) How many ordinary shares were outstanding at December 31, 2010, and March 28, 2009?
(e) What was the pound amount effect of the cash dividends on M&S’s equity?
(f) What is M&S’s rate of return on ordinary share equity for 2010 and 2009?
(g) What is M&S’s payout ratio for 2010 and 2009?

ANSWERS TO IFRS SELF-TEST QUESTIONS
1. b 2. c 3. b 4. d 5. d

Remember to check the book’s companion website to find additional resources for this chapter.
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