

Financial Accounting



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Sixth Edition



Chapter 11

Reporting and Analyzing Equity

Conceptual Learning Objectives

- C1:** Identify characteristics of corporations and their organization.
- C2:** Explain characteristics of, and distribute dividends between, common and preferred stock.
- C3:** Explain the items reported in retained earnings.

Analytical Learning Objectives

- A1: Compute earnings per share and describe its use.
- A2: Compute price-earnings ratio and describe its use in analysis.
- A3: Compute dividend yield and explain its use in analysis.
- A4: Compute book value and explain its use in analysis.

Procedural Learning Objectives

- P1:** Record the issuance of corporate stock.
- P2:** Record transactions involving cash dividends, stock dividends, and stock splits.
- P3:** Record purchases and sales of treasury stock and the retirement of stock.

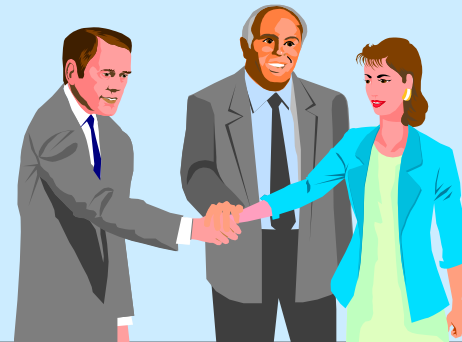
Characteristics of Corporations

Advantages

- Separate legal entity
- Limited liability of stockholders
- Transferable ownership rights
- Continuous life
- Lack of mutual agency for stockholders
- Ease of capital accumulation

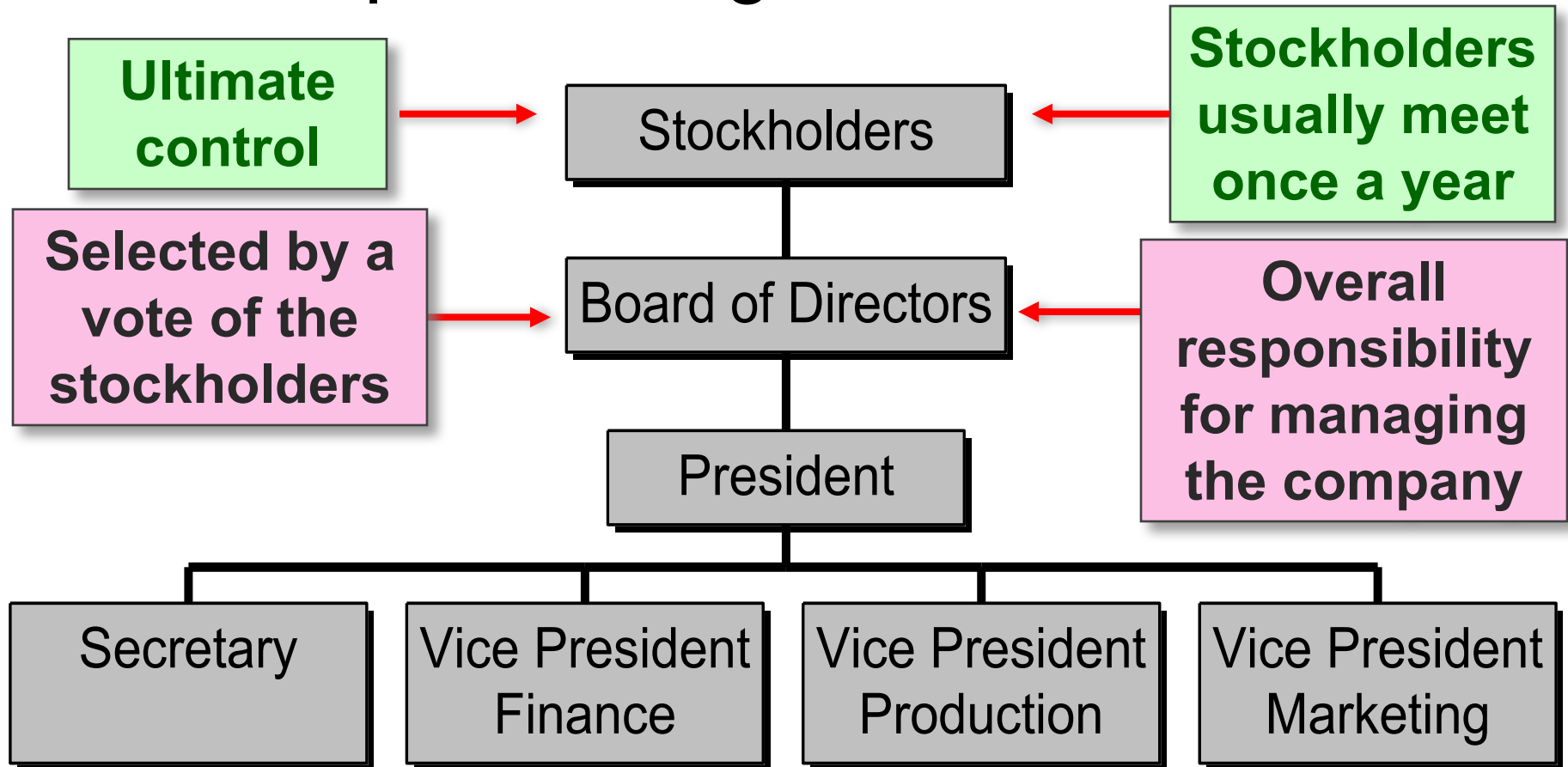
Disadvantages

- Governmental regulation
- Corporate taxation



Organizing and Managing a Corporation

Corporate Organization Chart



Basics of Capital Stock

Total amount of stock that a corporation's charter authorizes it to sell

Stockholders' Equity	2011	2010
Common stock, par value \$.01; authorized 250,000,000 shares; issued 92,556,295 shares in 2011; 111,015,133 shares in 2010	\$925,563	\$1,110,151

Total amount of stock that has been issued or sold to stockholders

C2

Classes of Stock

Par value

No-par value

Stated value



Issuing Par Value Stock

Par Value Stock

On September 1, Matrix, Inc. issued 100,000 shares of \$2 par value stock for \$25 per share. Let's record this transaction.

Record:

1. The cash received.
2. The number of shares issued \times the par value per share in the **Common Stock** account.
3. The remainder is assigned to **Paid-In Capital in Excess of Par Value, Common Stock**.





Issuing Par Value Stock



Par Value Stock

On September 1, Matrix, Inc. issued 100,000 shares of \$2 par value stock for \$25 per share. Let's record this transaction.

	Dr	Cr
Sept. 1 Cash	2,500,000	
Common stock, \$2 par value		200,000
Paid-In Capital in Excess of Par Value, Common Stock		2,300,000
<i>Sold and issued 100,000 shares of common stock</i>		



Issuing Par Value Stock

Stockholders' Equity with Common Stock

Stockholders' Equity

Common Stock - \$2 par value; 500,000 shares authorized; 100,000 shares issued and outstanding	\$ 200,000
Paid-In Capital in Excess of Par	2,300,000
Retained earnings	650,000
Total stockholders' equity	<u><u>\$ 3,150,000</u></u>

Issuing Stock for Noncash Assets

Par Value Stock

On September 1, Matrix, Inc. issued 100,000 shares of \$2 par value stock for land valued at \$2,500,000. Let's record this transaction.

Record:

1. The asset received at its market value.
2. The number of shares issued \times the par value per share in the **Common Stock** account.
3. The remainder is assigned to **Paid-In Capital in Excess of Par, Common Stock**.



P1

Issuing Stock for Noncash Assets

Par Value Stock

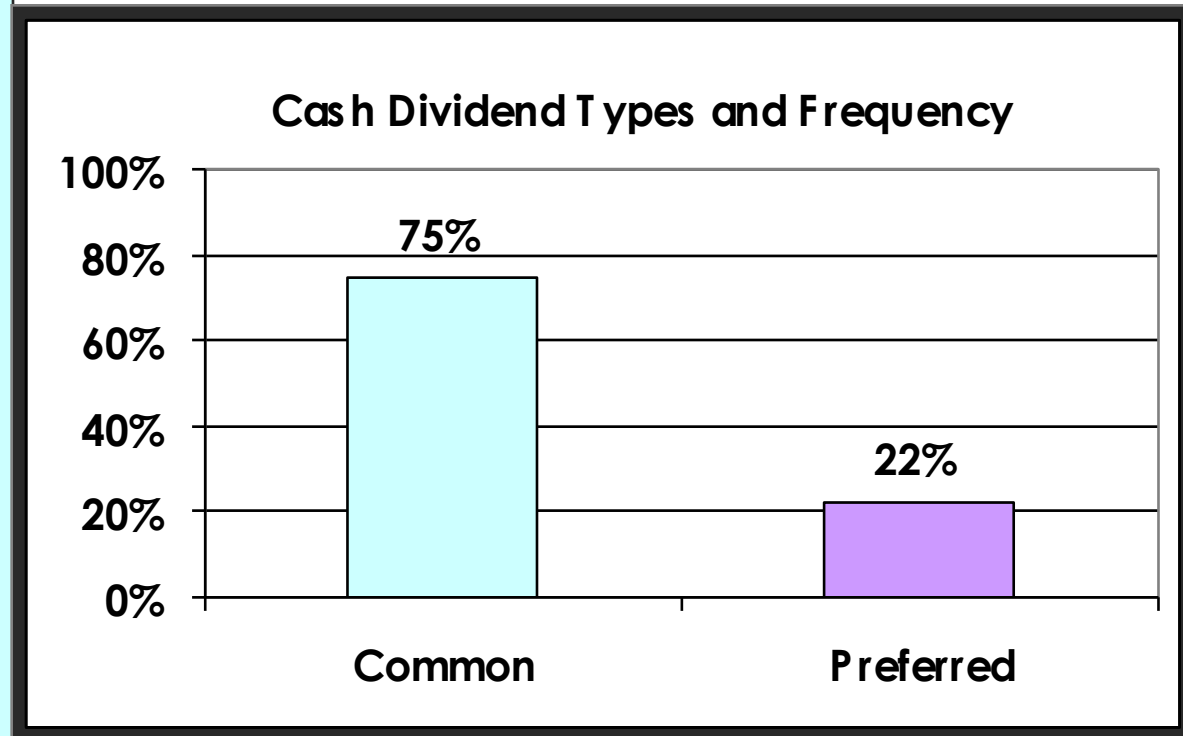
On September 1, Matrix, Inc. issued 100,000 shares of \$2 par value stock for land valued at \$2,500,000. Let's record this transaction.

Sept. 1	Land	2,500,000	
	Common stock, \$2 par value		200,000
	Paid-In Capital in		
	Excess of Par Value,		2,300,000
	Common Stock		
	<i>Exchanged 100,000 common shares for land</i>		

Cash Dividends

To pay a cash dividend the corporation must have:

1. A sufficient balance in retained earnings and
2. The cash necessary to pay the dividend.



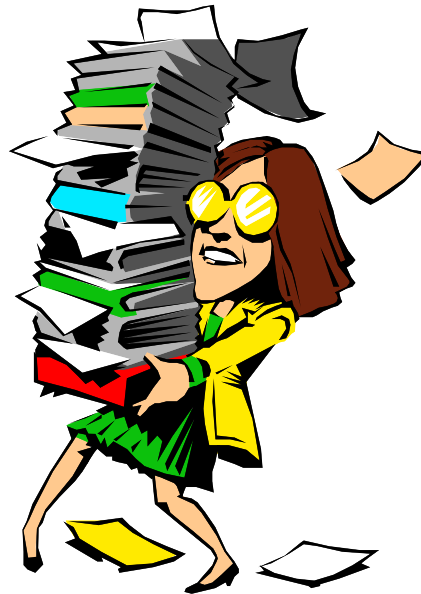
Cash Dividends

Three important dates



Date of Declaration

**Record liability
for dividend.**



Date of Record

**No entry
required.**



Date of Payment

**Record payment of
cash to stockholders.**

Entries for Cash Dividends

On January 19, a \$1 per share cash dividend is declared on Dana, Inc.'s 10,000 common shares outstanding. The dividend will be paid on March 19 to stockholders of record on February 19.



	Dr	Cr
Jan. 19 Retained Earnings	10,000	
Common Dividend Payable		10,000
<i>Declared \$1 per share cash dividend</i>		

Date of Declaration

**Record liability
for dividend.**

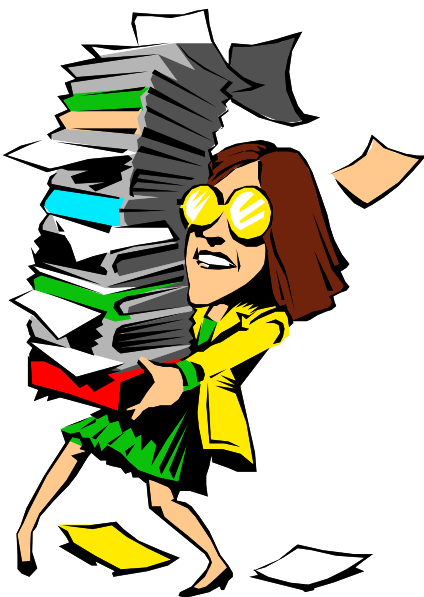
Entries for Cash Dividends

On January 19, a \$1 per share cash dividend is declared on Dana, Inc.'s 10,000 common shares outstanding. The dividend will be paid on March 19 to stockholders of record on February 19.

**No entry required on
February 19.**

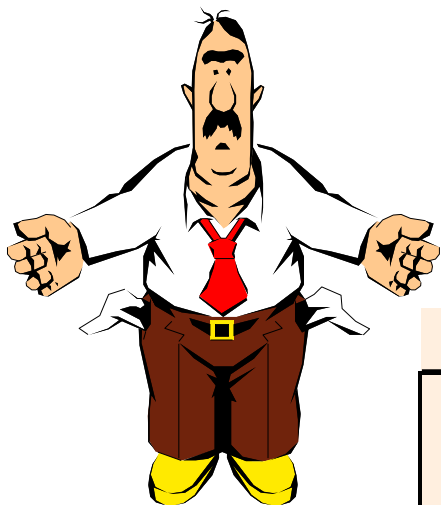
Date of Record

**No entry
required.**



Entries for Cash Dividends

On January 19, a \$1 per share cash dividend is declared on Dana, Inc.'s 10,000 common shares outstanding. The dividend will be paid on March 19 to stockholders of record on February 19.



		Dr	Cr
Mar. 19	Common Dividend Payable	10,000	
	Cash		10,000
	<i>Paid \$1 per share cash dividend</i>		

Date of Payment

Record payment of cash to stockholders.

Stock Dividends

The corporation distributes additional shares of its own stock to its stockholders without receiving any payment in return.



Why a stock dividend?

- Can be used to keep the market price on the stock affordable.
- Can provide evidence of management's confidence that the company is doing well.

Stock Dividends

Small Stock Dividend

- Distribution is $\leq 25\%$ of the previously outstanding shares.
- Capitalize retained earnings for the market value of the shares to be distributed.

Large Stock Dividend

- Distribution is $> 25\%$ of the previously outstanding shares.
- Capitalize retained earnings for the minimum amount required by state law, usually par or stated value of the shares.

Recording a Small Stock Dividend

Here is the stockholders' equity section of Quest's balance sheet prior to the declaration of a **small** stock dividend.

Quest, Inc.
Stockholders' Equity
December 31, 2011

Common stock - \$1 par value, 250,000 shares authorized, 100,000 shares issued and outstanding	\$ 100,000
Paid-In capital in excess of par value	8,000
Total paid-in capital	\$ 108,000
Retained earnings	35,000
Total stockholders' equity	\$ 143,000

Recording a Small Stock Dividend

On December 31, 2011, Quest declared a 2% stock dividend, when the stock was selling for \$10 per share. The stock will be distributed to stockholders on January 20, 2012. Let's make the December 31 entry.

Dec. 31	Retained Earnings	20,000	
	Common Stock Dividend Distributable		2,000
	Paid-In Capital in Excess of Par Value		18,000
	<i>Declared a 2,000 share (2%) stock dividend</i>		


$$100,000 \times 2\% = 2,000 \times \$10 = \$20,000$$

$$2,000 \times \$1 \text{ par} = \$2,000$$



P2

Before the
stock
dividend.



Quest, Inc. Balance Sheet (Stockholders' Equity Section) December 31, 2011	
Common stock - \$1 par value, 250,000 shares authorized, 100,000 shares issued and outstanding	\$ 100,000
Paid-in capital in excess of par value	8,000
Total paid-in capital	\$ 108,000
Retained earnings	35,000
Total stockholders' equity	\$ 143,000

Quest, Inc. Balance Sheet (Stockholders' Equity Section) December 31, 2011	
Common stock - \$1 par value, 250,000 shares authorized, 100,000 shares issued and outstanding	\$ 100,000
Common stock dividend distributable, 2,000 shares	2,000
Total common stock issued and to be issued	\$ 102,000
Paid-in capital in excess of par value	26,000
Total Paid-in capital	\$ 128,000
Retained earnings	15,000
Total stockholders' equity	\$ 143,000

After the
stock
dividend.



Recording a Large Stock Dividend

Router, Inc. shows the following stockholders' equity section just prior to issuing a **large** stock dividend.

Router, Inc.
Balance Sheet (Stockholders' Equity Section)
December 31, 2011

Common stock - \$1 par value, 200,000 shares authorized, 50,000 shares issued and outstanding	\$ 50,000
Paid-in capital in excess of par value	75,000
Retained earnings	100,000
Total stockholders' equity	\$ 225,000

Recording a Large Stock Dividend

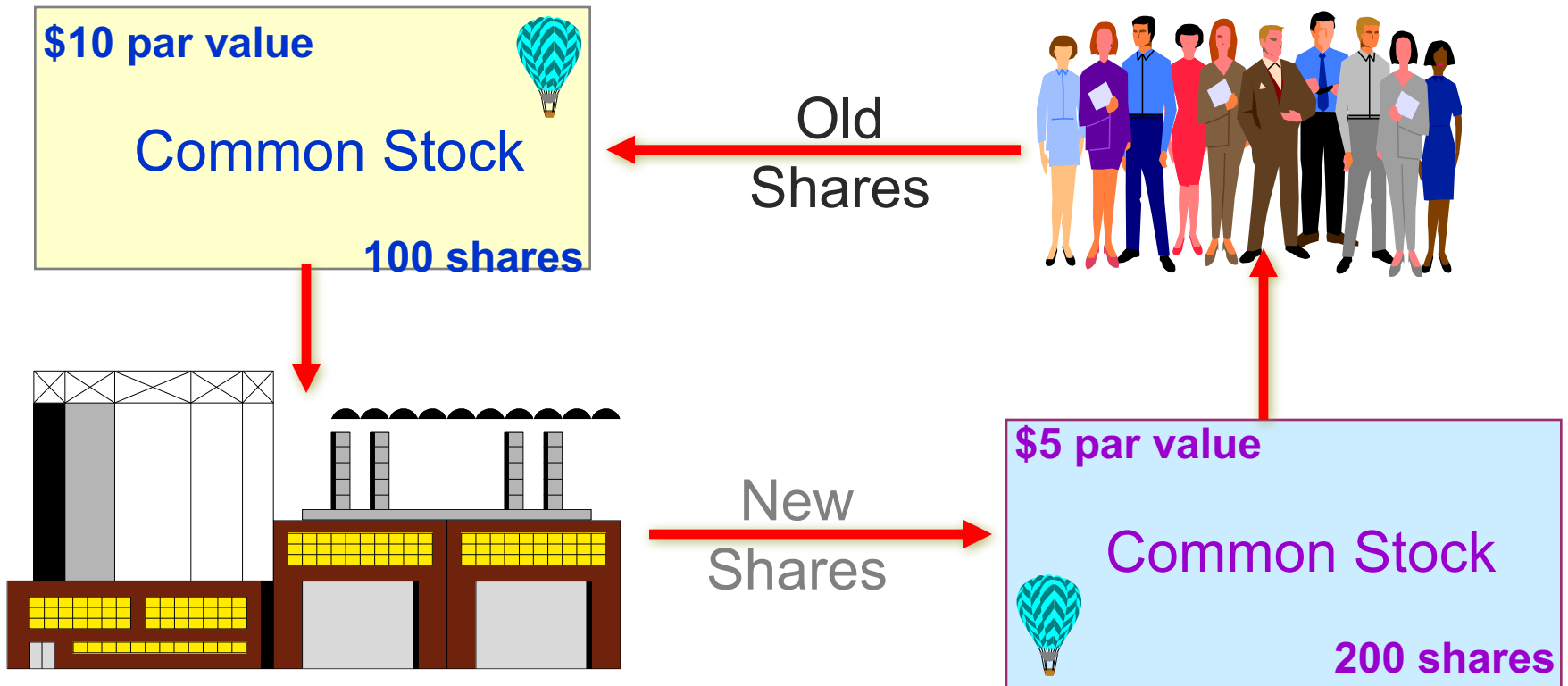
On December 31, 2011, Router declared a 40% stock dividend, when the stock was selling for \$8 per share. State law requires that large stock dividends be capitalized at par value per share.

	Dr	Cr
Dec. 31 Retained Earnings	20,000	
Common Stock Dividend Distributable		20,000
<i>Declared a 20,000 share (40%) stock dividend</i>		

$$50,000 \times 40\% = 20,000 \text{ shares} \times \$1 \text{ par value} = \$20,000$$

Stock Splits

A distribution of additional shares of stock to stockholders according to their percent ownership.



Stock Splits

After the 2-for-1 split the stockholders' equity section of the balance sheet looks like this .

Thomas, Inc. Stockholders' Equity June 30, 2011

No accounting entry is made.

Common stock - \$5 par value, 100,000 shares authorized, 50,000 shares issued and outstanding	\$ 250,000
Paid-in capital in excess of par value	300,000
Total paid-in capital	<u>550,000</u>
Retained earnings	775,000
Total stockholders' equity	<u><u>\$ 1,325,000</u></u>

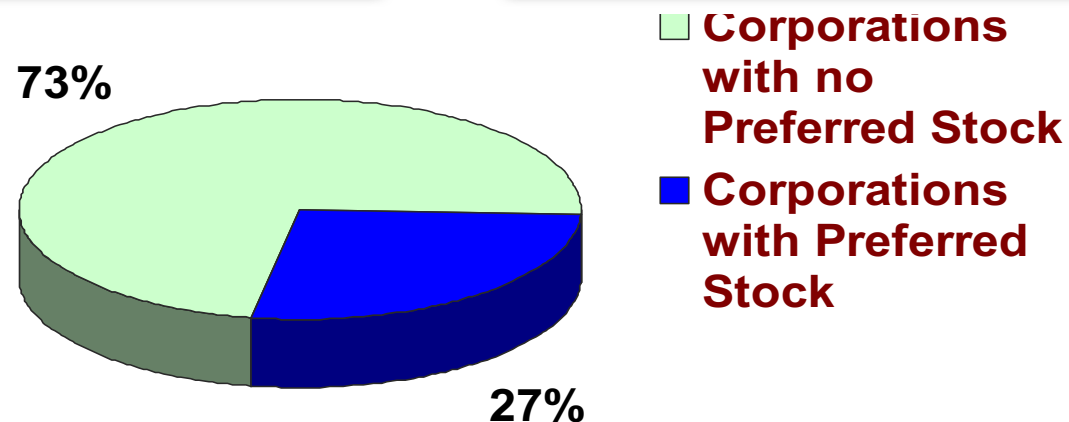
Preferred Stock

A separate class of stock, typically having priority over common shares in . . .

- Dividend distributions
- Distribution of assets in case of liquidation

Usually has a stated dividend rate

Normally has no voting rights



Cumulative or Noncumulative Dividend

Cumulative

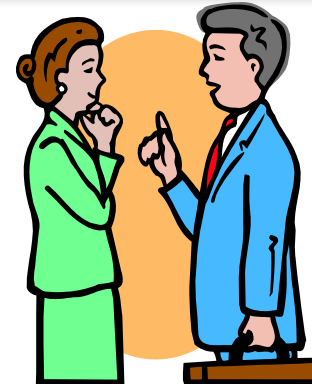
Vs.

Noncumulative

Dividends in arrears must be paid before dividends may be paid on common stock.

Undeclared dividends from current and prior years do not have to be paid in future years.

Most preferred stock is **cumulative**.



Cumulative or Noncumulative Dividend

Example: Consider the following stockholders' equity section of the balance sheet

Common stock, \$5 par value; 40,000 shares authorized, issued and outstanding	\$ 200,000
Preferred stock, 9%, \$100 par value; 1,000 shares authorized, issued and outstanding	100,000
Total Paid-In capital	<u>\$ 300,000</u>

The board of directors did not declare or pay dividends in 2011. In 2012, the board of directors declare and pay cash dividends of \$42,000.

Cumulative or Noncumulative Dividend

If Preferred Stock is **Noncumulative**:

Year 2011: No dividends paid.

Year 2012:

1. Pay 2012 preferred dividend.
2. Remainder goes to common.

Preferred	Common
\$ -	\$ -
<u>\$ 9,000</u>	<u>\$ 33,000</u>

If Preferred Stock is **Cumulative**:

Year 2011: No dividends paid.

Year 2012:

1. Pay 2011 preferred dividend in arrears.
2. Pay 2012 preferred dividend.
3. Remainder goes to common.

Totals

Preferred	Common
\$ -	\$ -
\$ 9,000	
9,000	
	\$ 24,000
<u>\$ 18,000</u>	<u>\$ 24,000</u>

Reasons for Issuing Preferred Stock

- To raise capital without sacrificing control
- To boost the return earned by common stockholders through **financial leverage**
- To appeal to investors who may believe the common stock is too risky or that the expected return on common stock is too low



Purchasing Treasury Stock

On May 8, Whitt, Inc. purchased 2,000 of its own shares of stock in the open market for \$8,000.

		Dr	Cr
May 8	Treasury Stock, Common	8,000	
	Cash		8,000
	<i>Purchase 2,000 treasury shares at \$4 per share</i>		

Treasury stock is shown as a reduction in total stockholders' equity on the balance sheet.

 P3

Selling Treasury Stock at Cost

On June 30, Whitt sold 100 shares of its treasury stock for \$4 per share.

		Dr	Cr
June 30	Cash	400	
	Treasury Stock, Common		400
	<i>Sold 100 shares of treasury for \$4 per share</i>		

Selling Treasury Stock Above Cost

On July 19, Whitt, Inc. sold an additional 500 shares of its treasury stock for \$8 per share.

		Dr	Cr
July 19	Cash	4,000	
	Treasury Stock, Common		2,000
	Paid-In Capital, Treasury Stock		2,000
	<i>Sold 500 treasury shares for \$8 per share</i>		

	Shares	per Share	Total
Sale	500	\$ 8.00	\$ 4,000
Cost	500	4.00	2,000
Paid-In Capital			<u>\$ 2,000</u>

Selling Treasury Stock Below Cost

P3

On August 27, Whitt sold an additional 400 shares of its treasury stock for \$1.50 per share.

		Dr	Cr
Aug. 27	Cash	600	
	Paid-in Capital, Treasury Stock	1,000	
	Treasury Stock, Common		1,600
	<i>Sold 500 treasury shares for \$1.50 per share</i>		

	Shares	per Share	Total
Cost	400	\$ 4.00	\$ 1,600
Sale	400	1.50	600
Difference			<u>\$ 1,000</u>

Statement of Retained Earnings

Total cumulative amount of reported net income less any net losses and dividends declared since the company started operating.

Reed, Inc.

Statement of Retained Earnings For Year Ended December 31, 2011

Retained earnings, 1/1/11	\$ 875,000
Plus: net income	155,600
Less: dividends declared	<u>(80,000)</u>
Retained earnings, 12/31/11	<u><u>\$ 950,600</u></u>

Restricted Retained Earnings

Legal

Most states restrict the amount of treasury stock purchases to the amount of retained earnings.

Contractual

Loan agreements can include restrictions on paying dividends below a certain amount of retained earnings.

Appropriated Retained Earnings

A corporation's directors can voluntarily limit dividends because of a special need for cash such as the purchase of new facilities.

Reed, Inc.	
Statement of Retained Earnings	
For Year Ended December 31, 2011	
Retained earnings, 1/1/11	\$ 875,000
Plus: net income	155,600
Less: dividends declared	(80,000)
Retained earnings, 12/31/11	\$ 950,600
Appropriated retained earnings	(450,000)
Unappropriated retained earnings	\$ 500,600

Prior Period Adjustments

Correction of material errors in past years' financial statements. If an amount is incorrectly expensed, add amount to retained earnings.

Reed, Inc.

Statement of Retained Earnings For Year Ended December 31, 2011

Retained earnings, 12/31/10, as previously reported	\$ 875,000
Prior period adjustment: Cost of equipment incorrectly expensed (net of \$28,000 income taxes)	72,000
Retained earnings, 12/31/10, as adjusted	947,000
Plus: net income for 2011	155,600
Less: dividends declared	(80,000)
Retained earnings, 12/31/11	<u><u>\$ 1,022,600</u></u>

Statement of Stockholders' Equity

Matrix, Inc.

Statement of Stockholders' Equity For the Year Ended December 31, 2011

(In millions)	Common Stock and Capital in Excess of Par		Retained Earnings	Total
	Shares	Amount		
Balance at January 1, 2011	821	\$ 2,500	\$ 9,500	\$ 12,000
Stock sales	17	500		500
Stock repurchases and retirement	(17)	(260)	(925)	(1,185)
Cash dividends declared			(150)	(150)
Other, net			70	70
Net income			5,100	5,100
Balance at December 31, 2011	<u>821</u>	<u>\$ 2,740</u>	<u>\$ 13,595</u>	<u>\$ 16,335</u>

This is a more inclusive statement than the statement of retained earnings.

Stock Options

Options are given to key employees to motivate them to:

- focus on company performance;
- take a long-run perspective; and
- remain with the company.



Earnings per Share

Earnings per share is one of the most widely cited items of accounting information.

$$\text{Basic earnings per share} = \frac{\text{Net income} - \text{Preferred dividends}}{\text{Weighted-average common shares outstanding}}$$

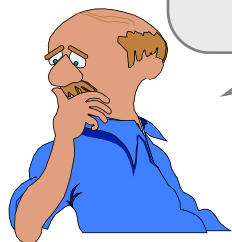


Price-Earnings

This ratio reveals information about the stock market's expectations for a company's future growth in earnings, dividends, and opportunities.

$$\text{Price-earnings ratio} = \frac{\text{Market value per share}}{\text{Earnings per share}}$$

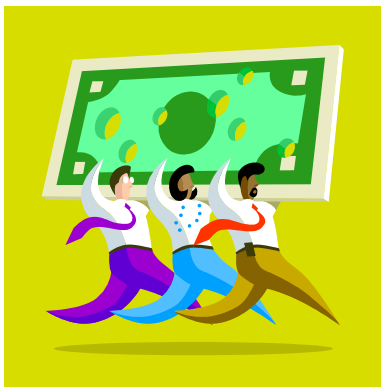
If earnings go up,
will the market price
of my stock follow?



Dividend Yield

Tells us the annual amount of cash dividends distributed to common stockholders relative to the stock's market price.

$$\text{Dividend yield} = \frac{\text{Annual cash dividends per share}}{\text{Market value per share}}$$



Book Value per Share—Common

Records amount of stockholders' equity applicable to **common** shares on a per share basis.

$$\text{Book value per common share} = \frac{\text{Stockholders' equity applicable to common shares}}{\text{Number of common shares outstanding}}$$



A4

Book Value per Share—Preferred

Records amount of stockholders' equity applicable to **preferred** shares on a per share basis.

$$\text{Book value per preferred share} = \frac{\text{Stockholders' equity applicable to preferred shares}}{\text{Number of preferred shares outstanding}}$$



End of Chapter 11

