# Corporate Equity Accounting

## Part 3

Your goals for this "corporate" chapter are to learn about:

- Characteristics of the corporate form of organization.
- Common and preferred stock.
- Treasury stock.
- Stock splits and stock dividends.
- The statement of stockholders' equity.

# 12. The Corporate Form of Organization

Corporations are separate legal entities having existence separate and distinct from their owners (i.e., stockholders). In essence, they are artificial beings existing only in contemplation of law. In the United States, a corporation is typically created when one or more individuals file “articles of incorporation” with a Secretary of State in the particular home state in which they choose to become domiciled. The articles of incorporation will generally specify a number of important features about the purpose of the corporate entity and how general governance of ongoing operations will be structured. After reviewing the articles of incorporation, the Secretary of State will issue a charter (or certificate of incorporation) authorizing the corporate entity to “come into being.” The persons who initiated the filing (the “incorporators”) will then call a meeting to collect the shareholders’ initial investment (this start-up money will be placed into the corporate accounts) in exchange for the “stock” of the corporation (the “stock” is the financial instrument evidencing a person’s ownership interest in the corporation). Once the initial stock is issued, a shareholders’ meeting will be convened to adopt bylaws and elect a board of directors. These directors will then appoint the corporate officers who will be responsible for commencing the operations of the business. Of course, in a small start-up venture, the initial incorporators may become the shareholders, then elect themselves to the board, and finally appoint themselves to become the officers. Which leads one to wonder why go to all the trouble of incorporating?

The reasons for incorporating can vary, but there are certain unique advantages of this form of organization that have led to its popularity:

Perhaps the first and most obvious advantage of the corporate form of organization is that it permits otherwise unaffiliated persons to join together in mutual ownership of a business entity. This objective can be accomplished in other ways like a partnership, but the corporate form of organization is arguably one of the better vehicles. Large amounts of venture capital can be drawn together from many individuals and concentrated into one entity under shared ownership. The stock of the corporation provides a clear and unambiguous point of reference to identify who owns the business and in what proportion. Further, the democratic process associated with shareholder voting rights (typically one vote per share of stock) permits a shareholder’s “say so” in selecting the board of directors to be commensurate with the number of shares held. In addition to electing the board, shareholders may vote on other matters such as selection of an independent auditor, stock option plans, and corporate mergers. The voting “ballot” is usually referred to as a “proxy.”

A great feature of corporate stock is transferability of ownership. Corporate stock is easily transferable from one “person” to another. In this context, a “person” can be an individual or another corporation. Transferability provides liquidity to stockholders as it enables them to quickly enter or exit an ownership position in a corporate entity. And, although a corporation may become very complex (e.g., buying real estate, entering contracts, etc.), the ability of one shareholder to step out and allow a successor to take their place can be done quite simply; there is not a need for the holdings and agreements of the corporate entity to be revised.

As a corporation grows, it may bring in additional shareholders by issuing even more stock. At some point, the entity may become sufficiently large that its shares will become "listed" on a stock exchange and the shareholder group expanded to become large and dispersed. You have probably heard of an "IPO," which is the "initial public offering" of the stock of a corporation. Rules require that such IPOs be accompanied by regulatory registrations and filings, and that potential shareholders be furnished with a "prospectus" detailing corporate information. The pricing of IPOs can vary based on market conditions, and sometimes get "wild" for a hot company that seemingly everyone wants to own. "Publicly traded" (in contrast to "closely held") corporate entities are subject to a number of continuing regulatory registration and reporting requirements that are aimed at ensuring full and fair disclosure.

Another benefit of a corporation is its perpetual existence. A corporate entity is typically of unlimited duration enabling it to effectively outlive its shareholders. Changes in stock ownership do not cause operations to cease even when the change in ownership is brought about by the death of a shareholder. Many corporate entities are over one-hundred years old. What would cause a corporation to cease to exist? At some point, a corporation may be acquired by another and merged in with the successor. Or, a corporation may become a business failure and cease operations (typically accompanied by a request to the Secretary of State to "dissolve" the legal existence). Of course, not all dissolutions are the result of failure. Some businesses may find that liquidating operating assets and distributing substantial residual monies to the creditors and shareholders is a preferable strategy to continued operation.

Not to be overlooked in considering why a corporation is desirable is the feature of limited liability for stockholders. If you buy the stock of a corporation, you normally do so with the understanding that you can lose the amount of your investment, but no more. Stockholders are not liable for debts and losses of the company beyond the amount of their investment. There are exceptions to this rule. In some cases, shareholders may be called upon to sign a separate guarantee for corporate debt. And, shareholders in closely held companies can inadvertently get drawn into having to satisfy corporate debts where they commingle their personal finances with those of the company or fail to satisfy the necessary legal procedures to maintain a valid corporate existence.

Corporations are not without certain notable disadvantages:

Corporations in the United States are taxable entities, and their income is subject to taxation. This "income tax" is problematic as it oftentimes produces double taxation. This effect occurs, because when shareholders receive cash dividends on their corporate investments, they must include the dividends in their own calculation of taxable income. Thus, a dollar earned at the corporate level is reduced by corporate income taxes (at a rate that is likely about 35%); to the extent the remaining after-tax profit is distributed to shareholders as dividends, it is again subject to taxes at the shareholder level (at a rate that will vary in the 15% to 35% range). So, as much as half or more of the profits of a dividend-paying corporation are apt to be shared with governmental entities because of this double taxation effect. Governments are aware that this double-taxation outcome can limit corporate investment and be potentially damaging to the economic wealth of their nation. Within the United States, various measures of relief are sometimes available, depending on the prevailing political climate (including "dividends received deductions" for dividends paid between affiliated companies, lower shareholder tax rates on dividends, and S-Corporation provisions that permit closely held corporations to attribute their income to the shareholders thereby avoiding one level of tax). Outside of the United States, some countries adopt "tax holidays" that permit newer companies to be exempt from income taxes, or utilize different approaches to taxing the value additive components of production by an entity.

Another burden on the corporate form of organization is costly regulation. Larger (usually public) companies are under scrutiny of federal (The Securities and Exchange Commission (SEC) and other public oversight bodies) and state regulatory bodies. History tells us that the absence or failure of these regulators will quickly foster an environment where rogue business persons will launch all manner of stock fraud schemes (not the least of which is inflated profits to attract and rob unsuspecting investors). Worse, these frauds quickly corrupt public confidence in stock investments and destroy wealth and opportunity for everyone. Without a willingness on the part of investors to join together via a corporate vehicle, new ideas, products, and innovations go undeveloped. Therefore, it seems almost unavoidable that governmental regulation must be a part of the corporate scene. However, the cost of compliance with such regulation is heavy indeed. Public companies must prepare and file quarterly and annual reports with the SEC, along with a myriad of other documents. And, many of these documents must be certified or subjected to independent audit. Further, requirements are in place that requires companies to have strong internal controls and even ethical training. As a result, one cannot simply dismiss this regulatory cost as a nuisance; indeed, it must be considered as a potential barrier to opting to become a public company. Historic events (the stock market crash of 1929 and the Enron/WorldCom debacles of 2001 and 2002, are two USA examples of precipitating events) have been catalysts for significant legislation intended to protect public investors.