

# CHAPTER 8

## Proprietorships, Partnerships, and Corporations

### LEARNING OBJECTIVES

**After you have mastered the material in this chapter, you will be able to:**

- 1 Identify the primary characteristics of sole proprietorships, partnerships, and corporations.
- 2 Analyze financial statements to identify the different types of business organizations.
- 3 Explain the characteristics of major types of stock issued by corporations.
- 4 Explain how to account for different types of stock issued by corporations.
- 5 Show how treasury stock transactions affect a company's financial statements.
- 6 Explain the effects of declaring and paying cash dividends on a company's financial statements.
- 7 Explain the effects of stock dividends and stock splits on a company's financial statements.
- 8 Show how the appropriation of retained earnings affects financial statements.
- 9 Explain some uses of accounting information in making stock investment decisions.

### CHAPTER OPENING

You want to start a business. How should you structure it? Should it be a sole proprietorship, partnership, or corporation? Each form of business structure presents advantages and disadvantages. For example, a sole proprietorship allows maximum independence and control while partnerships and corporations allow individuals to pool resources and talents with other people. This chapter discusses these and other features of the three primary forms of business structure.

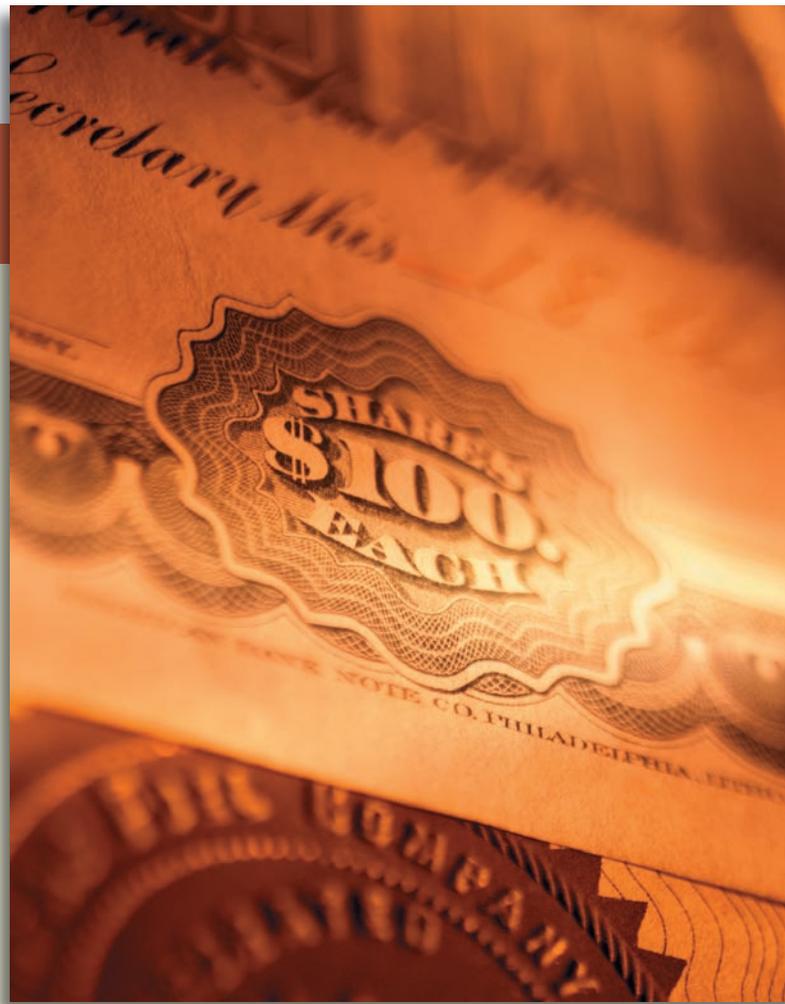
## The Curious Accountant

Imagine your rich uncle rewarded you for doing well in your first accounting course by giving you \$10,000 to invest in the stock of one company. After reviewing many recent annual reports, you narrowed your choice to two companies with the following characteristics:

**Mystery Company A:** This company began operations in 2003, but did not begin selling its stock to the public until April 16, 2009. In its first six years of operations it had total earnings of approximately \$1.6 million. By the time it went public it was already a leader in its field. At its current price of \$23 you could buy approximately 435 shares. A friend told you that a globally minded person like you would be crazy not to buy this stock.

**Mystery Company B:** This company has been in existence since 1837 and has made a profit most years. In the most recent five years, its net earnings totaled over \$51.8 *billion*, and it paid dividends of over \$21 *billion*. This stock is selling for about \$62 per share, so you can buy 161 shares of it. Your friend said “you would have to be goofy to buy this stock.”

The names of the real-world companies described above are disclosed later. Based on the information provided, which company’s stock would you buy? (Answer on page 290.)



## LO 1

Identify the primary characteristics of sole proprietorships, partnerships, and corporations.

## FORMS OF BUSINESS ORGANIZATIONS

**Sole proprietorships** are owned by a single individual who is responsible for making business and profit distribution decisions. If you want to be the absolute master of your destiny, you should organize your business as a proprietorship. Establishing a sole proprietorship is usually as simple as obtaining a business license from local government authorities. Usually no legal ownership agreement is required.

**Partnerships** allow persons to share their talents, capital, and the risks and rewards of business ownership. Because two or more individuals share ownership, partnerships require clear agreements about how authority, risks, and profits will be shared. Prudent partners minimize misunderstandings by hiring attorneys to prepare a **partnership agreement** which defines the responsibilities of each partner and describes how income or losses will be divided. Because the measurement of income affects the distribution of profits, partnerships frequently hire accountants to ensure that records are maintained in accordance with generally accepted accounting principles (GAAP). Partnerships (and sole proprietorships) also may need professional advice to deal with tax issues.

A **corporation** is a separate legal entity created by the authority of a state government. The paperwork to start a corporation is complex. For most laypersons, engaging professional attorneys and accountants to assist with the paperwork is well worth the fees charged.

Each state has separate laws governing establishing corporations. Many states follow the standard provisions of the Model Business Corporation Act. All states require the initial application to provide **articles of incorporation** which normally include the following information: (1) the corporation's name and proposed date of incorporation; (2) the purpose of the corporation; (3) the location of the business and its expected life (which can be *perpetuity*, meaning *endless*); (4) provisions for capital stock; and (5) the names and addresses of the members of the first board of directors, the individuals with the ultimate authority for operating the business. If the articles are in order, the state establishes the legal existence of the corporation by issuing a charter of incorporation. The charter and the articles are public documents.

## ADVANTAGES AND DISADVANTAGES OF DIFFERENT FORMS OF BUSINESS ORGANIZATION

Each form of business organization presents a different combination of advantages and disadvantages. Persons wanting to start a business or invest in one should consider the characteristics of each type of business structure.

### Regulation

Few laws specifically affect the operations of proprietorships and partnerships. Corporations, however, are usually heavily regulated. The extent of government regulation depends on the size and distribution of a company's ownership interests. Ownership interests in corporations are normally evidenced by **stock certificates**.

Ownership of corporations can be transferred from one individual to another through exchanging stock certificates. As long as the exchanges (buying and selling of shares of stock, often called *trading*) are limited to transactions between individuals, a company is defined as a **closely held corporation**. However, once a corporation reaches a certain size, it may list its stock on a stock exchange such as the **New York Stock Exchange** or the **American Stock Exchange**. Trading on a stock exchange is limited to the stockbrokers who are members of the exchange. These brokers represent buyers and sellers who are willing to pay the brokers commissions for exchanging stock certificates on their behalf. Although closely held corporations are relatively free from government regulation, companies whose stock is publicly traded on the exchanges by brokers are subject to extensive regulation.

The extensive regulation of trading on stock exchanges began in the 1930s. The stock market crash of 1929 and the subsequent Great Depression led Congress to pass the **Securities Act of 1933** and the **Securities Exchange Act of 1934** to regulate issuing stock and to govern the exchanges. The 1934 act also created the Securities and Exchange Commission (SEC) to enforce the securities laws. Congress gave the SEC legal authority to establish accounting principles for corporations that are registered on the exchanges. However, the SEC has generally deferred its rule-making authority to private sector accounting bodies such as the Financial Accounting Standards Board (FASB), effectively allowing the accounting profession to regulate itself.

A number of high-profile business failures around the turn of the last century raised questions about the effectiveness of self-regulation and the usefulness of audits to protect the public. The Sarbanes-Oxley Act of 2002 was adopted to address these concerns. The act creates a five-member Public Company Accounting Oversight Board (PCAOB) with the authority to set and enforce auditing, attestation, quality control, and ethics standards for auditors of public companies. The PCAOB is empowered to impose disciplinary and remedial sanctions for violations of its rules, securities laws, and professional auditing and accounting standards. Public corporations operate in a complex regulatory environment that requires the services of attorneys and professional accountants.

## Double Taxation

Corporations pay income taxes on their earnings and then owners pay income taxes on distributions (dividends) received from corporations. As a result, distributed corporate profits are taxed twice—first when income is reported on the corporation's income tax return and a second time when distributions are reported on individual owners' tax returns. This phenomenon is commonly called **double taxation** and is a significant disadvantage of the corporate form of business organization.

To illustrate, assume Glide Corporation earns pretax income of \$100,000. Glide is in a 30 percent tax bracket. The corporation itself will pay income tax of \$30,000 ( $\$100,000 \times 0.30$ ). If the corporation distributes the after-tax income of \$70,000 ( $\$100,000 - \$30,000$ ) to individual stockholders in 15 percent tax brackets,<sup>1</sup> the \$70,000 dividend will be reported on the individual tax returns, requiring tax payments of \$10,500 ( $\$70,000 \times .15$ ). Total income tax of \$40,500 ( $\$30,000 + \$10,500$ ) is due on \$100,000 of earned income. In contrast, consider a proprietorship that is owned by an individual in a 30 percent tax bracket. If the proprietorship earns and distributes \$100,000 profit, the total tax would be only \$30,000 ( $\$100,000 \times .30$ ).

Double taxation can be a burden for small companies. To reduce that burden, tax laws permit small closely held corporations to elect "S Corporation" status. S Corporations are taxed as proprietorships or partnerships. Also, many states have recently enacted laws permitting the formation of **limited liability companies (LLCs)** which offer many of the benefits of corporate ownership yet are in general taxed as partnerships. Because proprietorships and partnerships are not separate legal entities, company earnings are taxable to the owners rather than the company itself.

## Limited Liability

Given the disadvantages of increased regulation and double taxation, why would anyone choose the corporate form of business structure over a partnership or proprietorship? A major reason is that the corporate form limits an investor's potential liability as an owner of a business venture. Because a corporation is legally separate from its owners, creditors cannot claim owners' personal assets as payment for the company's debts. Also, plaintiffs

<sup>1</sup>As a result of the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003, dividends received in tax years after 2002 are taxed at a maximum rate of 15 percent for most taxpayers. Lower income individuals pay a 5 percent tax on dividends received on December 31, 2007, or earlier. This rate falls to zero in 2008. The provisions of JGTRRA are set to expire on December 31, 2008.

## Answers to The Curious Accountant

**Mystery Company A** is **Rosetta Stone, Inc.**, as of July 7, 2010. The company's main products provide computer-aided learning of over 30 languages.

The company has developed a visually based learning system that does not require much translation from one language to another. Therefore, the same product used by an English speaker to learn Spanish can, with only minimal changes, be used by a French speaker to learn Spanish. Some analysts believe this gives the company opportunities for large growth without a correspondingly large increase in investment.

**Mystery Company B** is **Procter & Gamble, Inc.** (as of July 7, 2010). Of course, only the future will tell which company is the better investment.

must sue the corporation, not its owners. The most that owners of a corporation can lose is the amount they have invested in the company (the value of the company's stock).

Unlike corporate stockholders, the owners of proprietorships and partnerships are *personally liable* for actions they take in the name of their companies. In fact, partners are responsible not only for their own actions but also for those taken by any other partner on behalf of the partnership. The benefit of **limited liability** is one of the most significant reasons the corporate form of business organization is so popular.

### Continuity

Unlike partnerships or proprietorships, which terminate with the departure of their owners, a corporation's life continues when a shareholder dies or sells his or her stock. Because of **continuity** of existence, many corporations formed in the 1800s still thrive today.

### Transferability of Ownership

The **transferability** of corporate ownership is easy. An investor simply buys or sells stock to acquire or give up an ownership interest in a corporation. Hundreds of millions of shares of stock are bought and sold on the major stock exchanges each day.

Transferring the ownership of proprietorships is much more difficult. To sell an ownership interest in a proprietorship, the proprietor must find someone willing to purchase the entire business. Because most proprietors also run their businesses, transferring ownership also requires transferring management responsibilities. Consider the difference in selling \$1 million of **Exxon** stock versus selling a locally owned gas station. The stock could be sold on the New York Stock Exchange within minutes. In contrast, it could take years to find a buyer who is financially capable of and interested in owning and operating a gas station.

Transferring ownership in partnerships can also be difficult. As with proprietorships, ownership transfers may require a new partner to make a significant investment and accept management responsibilities in the business. Further, a new partner must accept and be accepted by the other partners. Personality conflicts and differences in management style can cause problems in transferring ownership interests in partnerships.

### Management Structure

Partnerships and proprietorships are usually managed by their owners. Corporations, in contrast, have three tiers of management authority. The *owners (stockholders)* represent the highest level of organizational authority. The stockholders *elect* a **board of directors** to oversee company operations. The directors then *hire* professional executives to manage the

company on a daily basis. Because large corporations can offer high salaries and challenging career opportunities, they can often attract superior managerial talent.

While the management structure used by corporations is generally effective, it sometimes complicates dismissing incompetent managers. The chief executive officer (CEO) is usually a member of the board of directors and is frequently influential in choosing other board members. The CEO is also in a position to reward loyal board members. As a result, board members may be reluctant to fire the CEO or other top executives even if the individuals are performing poorly. Corporations operating under such conditions are said to be experiencing **entrenched management**.

### Ability to Raise Capital

Because corporations can have millions of owners (shareholders), they have the opportunity to raise huge amounts of capital. Few individuals have the financial means to build and operate a telecommunications network such as **AT&T** or a marketing distribution system such as **Walmart**. However, by pooling the resources of millions of owners through public stock and bond offerings, corporations generate the billions of dollars of capital needed for such massive investments. In contrast, the capital resources of proprietorships and partnerships are limited to a relatively small number of private owners. Although proprietorships and partnerships can also obtain resources by borrowing, the amount creditors are willing to lend them is usually limited by the size of the owners' net worth.

## APPEARANCE OF CAPITAL STRUCTURE IN FINANCIAL STATEMENTS

The ownership interest (equity) in a business is composed of two elements: (1) owner/investor contributions and (2) retained earnings. The way these two elements are reported in the financial statements differs for each type of business structure (proprietorship, partnership, or corporation).

### LO 2

Analyze financial statements to identify the different types of business organizations.

### Presentation of Equity in Proprietorships

Owner contributions and retained earnings are combined in a single Capital account on the balance sheets of proprietorships. To illustrate, assume that Worthington Sole Proprietorship was started on January 1, 2012, when it acquired a \$5,000 capital contribution from its owner, Phil Worthington. During the first year of operation, the company generated \$4,000 of cash revenues, incurred \$2,500 of cash expenses, and distributed \$1,000 cash to the owner. Exhibit 8.1 displays 2012 financial statements for Worthington's company. Note on the *capital statement* that distributions are called **withdrawals**. Verify that the \$5,500 balance in the Capital account on the balance sheet includes the \$5,000 owner contribution and the retained earnings of \$500 (\$1,500 net income – \$1,000 withdrawal).

#### EXHIBIT 8.1

### WORTHINGTON SOLE PROPRIETORSHIP Financial Statements As of December 31, 2012

Income Statement		Capital Statement		Balance Sheet	
Revenue	\$4,000	Beginning capital balance	\$ 0	Assets	
Expenses	<u>2,500</u>	Plus: Investment by owner	5,000	Cash	<u>\$5,500</u>
Net income	<u>\$1,500</u>	Plus: Net income	1,500	Equity	
		Less: Withdrawal by owner	<u>(1,000)</u>	Worthington, capital	<u>\$5,500</u>
		Ending capital balance	<u>\$5,500</u>		

 **CHECK YOURSELF 8.1**

Weiss Company was started on January 1, 2012, when it acquired \$50,000 cash from its owner(s). During 2012 the company earned \$72,000 of net income. Explain how the equity section of Weiss’s December 31, 2012, balance sheet would differ if the company were a proprietorship versus a corporation.

**Answer** *Proprietorship* records combine capital acquisitions from the owner and earnings from operating the business in a single capital account. In contrast, *corporation* records separate capital acquisitions from the owners and earnings from operating the business. If Weiss were a proprietorship, the equity section of the year-end balance sheet would report a single capital component of \$122,000. If Weiss were a corporation, the equity section would report two separate equity components, most likely common stock of \$50,000 and retained earnings of \$72,000.

**Presentation of Equity in Partnerships**

The financial statement format for reporting partnership equity is similar to that used for proprietorships. Contributed capital and retained earnings are combined. However, a separate capital account is maintained for each partner in the business to reflect each partner’s ownership interest.

To illustrate, assume that Sara Slater and Jill Johnson formed a partnership on January 1, 2012. The partnership acquired \$2,000 of capital from Slater and \$4,000 from Johnson. The partnership agreement called for each partner to receive an annual distribution equal to 10 percent of her capital contribution. Any further earnings were to be retained in the business and divided equally between the partners. During 2012, the company earned \$5,000 of cash revenue and incurred \$3,000 of cash expenses, for net income of \$2,000 (\$5,000 – \$3,000). As specified by the partnership agreement, Slater received a \$200 (\$2,000 × 0.10) cash withdrawal and Johnson received \$400 (\$4,000 × 0.10). The remaining \$1,400 (\$2,000 – \$200 – \$400) of income was retained in the business and divided equally, adding \$700 to each partner’s capital account.

Exhibit 8.2 displays financial statements for the Slater and Johnson partnership. Again, note that distributions are called *withdrawals*. Also find on the balance sheet a *separate capital account* for each partner. Each capital account includes the amount of the partner’s contributed capital plus her proportionate share of the retained earnings.

EXHIBIT 8.2					
SLATER AND JOHNSON PARTNERSHIP					
Financial Statements					
As of December 31, 2012					
Income Statement		Capital Statement		Balance Sheet	
Revenue	\$5,000	Beginning capital balance	\$ 0	Assets	
Expenses	<u>3,000</u>	Plus: Investment by owners	6,000	Cash	<u>\$7,400</u>
Net income	<u>\$2,000</u>	Plus: Net income	2,000	Equity	
		Less: Withdrawal by owners	<u>(600)</u>	Slater, capital	\$2,700
		Ending capital balance	<u>\$7,400</u>	Johnson, capital	<u>4,700</u>
				Total capital	<u>\$7,400</u>

## Presentation of Equity in Corporations

Corporations have more complex capital structures than proprietorships and partnerships. Explanations of some of the more common features of corporate capital structures and transactions follow.

## CHARACTERISTICS OF CAPITAL STOCK

Stock issued by corporations may have a variety of different characteristics. For example, a company may issue different classes of stock that grant owners different rights and privileges. Also, the number of shares a corporation can legally issue may differ from the number it actually has issued. Further, a corporation can even buy back its own stock. Finally, a corporation may assign different values to the stock it issues. Accounting for corporate equity transactions is discussed in the next section of the text.

### LO 3

Explain the characteristics of major types of stock issued by corporations.

### Par Value

Many states require assigning a **par value** to stock. Historically, par value represented the maximum liability of the investors. Par value multiplied by the number of shares of stock issued represents the minimum amount of assets that must be retained in the company as protection for creditors. This amount is known as **legal capital**. To ensure that the amount of legal capital is maintained in a corporation, many states require that purchasers pay at least the par value for a share of stock initially purchased from a corporation. To minimize the amount of assets that owners must maintain in the business, many corporations issue stock with very low par values, often \$1 or less. Therefore, *legal capital* as defined by par value has come to have very little relevance to investors or creditors. As a result, many states allow corporations to issue no-par stock.

### Stated Value

No-par stock may have a stated value. Like par value, **stated value** is an arbitrary amount assigned by the board of directors to the stock. It also has little relevance to investors and creditors. Stock with a par value and stock with a stated value are accounted for exactly the same way. When stock has no par or stated value, accounting for it is slightly different. These accounting differences are illustrated later in this chapter.

### Other Valuation Terminology

The price an investor must pay to purchase a share of stock is the **market value**. The sales price of a share of stock may be more or less than the par value. Another term analysts frequently associate with stock is *book value*. **Book value per share** is calculated by dividing total stockholders' equity (assets – liabilities) by the number of shares of stock owned by investors. Book value per share differs from market value per share because equity is measured in historical dollars and market value reflects investors' estimates of a company's current value.

### Stock: Authorized, Issued, and Outstanding

As part of the regulatory function, states approve the maximum number of shares of stock corporations are legally permitted to issue. This maximum number is called **authorized stock**. Authorized stock that has been sold to the public is called **issued stock**. When a corporation buys back some of its issued stock from the public, the repurchased stock is called **treasury stock**. Treasury stock is still considered to be issued stock, but it is no longer outstanding. **Outstanding stock** (total issued stock minus treasury stock) is stock owned by investors outside the corporation. For example, assume a company that is authorized to issue 150 shares of stock issues 100 shares to investors, and then buys back 20 shares of treasury stock. There are 150 shares authorized, 100 shares issued, and 80 shares outstanding.

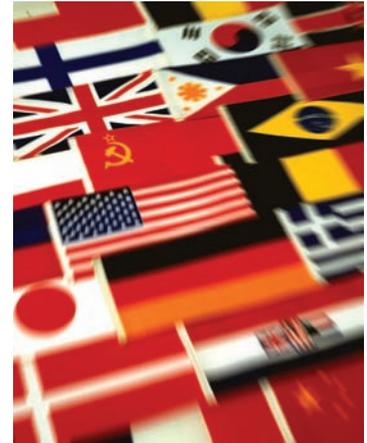
## FOCUS ON INTERNATIONAL ISSUES

### PICKY, PICKY, PICKY ...

Considering the almost countless number of differences that could exist between U.S. GAAP and IFRS, it is not surprising that some of those that do exist relate to very specific issues. Consider the case of the timing of stock splits.

Assume a company that ends its fiscal year on December 31, 2011, declares a 2-for-1 stock split on January 15, 2012, before it has issued its 2011 annual report. Should the company apply the effects of the stock split retroactively to its 2011 financial statements, or begin showing the effects of the split on its 2012 statements? Under U.S. GAAP the split must be applied retroactively to the 2011 statements since they had not been issued at the time of the split. Under IFRS the 2011 statements would not show the effects of the split, but the 2012 statements would. By the way, an event that occurs between a company's fiscal year-end and the date its annual report is released is called a *subsequent event* by accountants.

Obviously no one can know every GAAP rule, much less all of the differences between GAAP and IFRS. This is why it is important to learn how to find answers to specific accounting questions as well as to develop an understanding of the basic accounting rules. Most important, if you are not sure you know the answer, do not assume you do.



### Classes of Stock

The corporate charter defines the number of shares of stock authorized, the par value or stated value (if any), and the classes of stock that a corporation can issue. Most stock issued is either *common* or *preferred*.

#### Common Stock

All corporations issue **common stock**. Common stockholders bear the highest risk of losing their investment if a company is forced to liquidate. On the other hand, they reap the greatest rewards when a corporation prospers. Common stockholders generally enjoy several rights, including: (1) the right to buy and sell stock, (2) the right to share in the distribution of profits, (3) the right to share in the distribution of corporate assets in the case of liquidation, (4) the right to vote on significant matters that affect the corporate charter, and (5) the right to participate in the election of directors.

#### Preferred Stock

Many corporations issue **preferred stock** in addition to common stock. Holders of preferred stock receive certain privileges relative to holders of common stock. In exchange for special privileges in some areas, preferred stockholders give up rights in other areas. Preferred stockholders usually have no voting rights and the amount of their dividends is usually limited. Preferences granted to preferred stockholders include the following.

1. *Preference as to assets.* Preferred stock often has a liquidation value. In case of bankruptcy, preferred stockholders must be paid the liquidation value before any assets are distributed to common stockholders. However, preferred stockholder claims still fall behind creditor claims.
2. *Preference as to dividends.* Preferred shareholders are frequently guaranteed the right to receive dividends before common stockholders. The amount of the preferred dividend is normally stated on the stock certificate. It may be stated as a

dollar value (say, \$5) per share or as a percentage of the par value. Most preferred stock has **cumulative dividends**, meaning that if a corporation is unable to pay the preferred dividend in any year, the dividend is not lost but begins to accumulate. Cumulative dividends that have not been paid are called **dividends in arrears**. When a company pays dividends, any preferred stock arrearages must be paid before any other dividends are paid. Noncumulative preferred stock is not often issued because preferred stock is much less attractive if missed dividends do not accumulate.

To illustrate the effects of preferred dividends, consider Dillion, Incorporated, which has the following shares of stock outstanding.

Preferred stock, 4%, \$10 par, 10,000 shares  
Common stock, \$10 par, 20,000 shares

Assume the preferred stock dividend has not been paid for two years. If Dillion pays \$22,000 in dividends, how much will each class of stock receive? It depends on whether the preferred stock is cumulative.

Allocation of Distribution for Cumulative Preferred Stock		
	To Preferred	To Common
Dividends in arrears	\$ 8,000	\$ 0
Current year's dividends	<u>4,000</u>	<u>10,000</u>
Total distribution	<u>\$12,000</u>	<u>\$10,000</u>

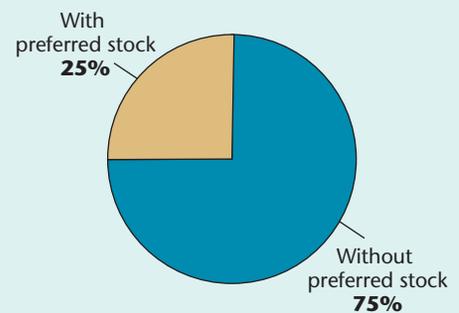
Allocation of Distribution for Noncumulative Preferred Stock		
	To Preferred	To Common
Dividends in arrears	\$ 0	\$ 0
Current year's dividends	<u>4,000</u>	<u>18,000</u>
Total distribution	<u>\$4,000</u>	<u>\$18,000</u>

The total annual dividend on the preferred stock is \$4,000 ( $0.04 \times \$10 \text{ par} \times 10,000 \text{ shares}$ ). If the preferred stock is cumulative, the \$8,000 in arrears must be paid first. Then \$4,000 for the current year's dividend is paid next. The remaining \$10,000 goes to common stockholders. If the preferred stock is noncumulative, the \$8,000 of dividends from past periods is ignored. This year's \$4,000 preferred dividend is paid first, with the remaining \$18,000 going to common.

Other features of preferred stock may include the right to participate in distributions beyond the established amount of the preferred dividend, the right to convert preferred stock to common stock or to bonds, and the potential for having the preferred stock called (repurchased) by the corporation. Detailed discussion of these topics is left to more advanced courses. Exhibit 8.3 indicates that roughly 25 percent of U.S. companies have preferred shares outstanding.

### EXHIBIT 8.3

#### Presence of Preferred Stock in the Capital Structure of U.S. Companies



Data source: AICPA, Accounting Trends and Techniques, 2006.

## LO 4

Explain how to account for different types of stock issued by corporations.

## ACCOUNTING FOR STOCK TRANSACTIONS ON THE DAY OF ISSUE

Issuing stock with a par or stated value is accounted for differently from issuing no-par stock. For stock with either a par or stated value, the total amount acquired from the owners is divided between two separate equity accounts. The amount of the par or stated value is recorded in the stock account. Any amount received above the par or stated value is recorded in an account called **Paid-in Capital in Excess of Par (or Stated) Value**.

### Issuing Par Value Stock

To illustrate the issue of common stock with a par value, assume that Nelson Incorporated is authorized to issue 250 shares of common stock. During 2012, Nelson issued 100 shares of \$10 par common stock for \$22 per share. The event increases assets and stockholders' equity by \$2,200 ( $\$22 \times 100$  shares). The increase in stockholders' equity is divided into two parts, \$1,000 of par value ( $\$10$  per share  $\times 100$  shares) and \$1,200 ( $\$2,200 - \$1,000$ ) received in excess of par value. The income statement is not affected. The \$2,200 cash inflow is reported in the financing activities section of the statement of cash flows. The effects on the financial statements follow.

Assets	=	Liab.	+	Equity	Rev.	-	Exp.	=	Net Inc.	Cash Flow
Cash	=			Com. Stk. + PIC in Excess						
2,200	=	NA	+	1,000 + 1,200	NA	-	NA	=	NA	2,200 FA

The *legal capital* of the corporation is \$1,000, the total par value of the issued common stock. The number of shares issued can be easily verified by dividing the total amount in the common stock account by the par value ( $\$1,000 \div \$10 = 100$  shares).

### Stock Classification

Assume Nelson Incorporated obtains authorization to issue 400 shares of Class B, \$20 par value common stock. The company issues 150 shares of this stock at \$25 per share. The event increases assets and stockholders' equity by \$3,750 ( $\$25 \times 150$  shares). The increase in stockholders' equity is divided into two parts, \$3,000 of par value ( $\$20$  per share  $\times 150$  shares) and \$750 ( $\$3,750 - \$3,000$ ) received in excess of par value. The income statement is not affected. The \$3,750 cash inflow is reported in the financing activities section of the statement of cash flows. The effects on the financial statements follow.

Assets	=	Liab.	+	Equity	Rev.	-	Exp.	=	Net Inc.	Cash Flow
Cash	=			Com. Stk. + PIC in Excess						
3,750	=	NA	+	3,000 + 750	NA	-	NA	=	NA	3,750 FA

As the preceding event suggests, companies can issue numerous classes of common stock. The specific rights and privileges for each class are described in the individual stock certificates.

### Stock Issued at Stated Value

Assume Nelson is authorized to issue 300 shares of a third class of stock, 7 percent cumulative preferred stock with a stated value of \$10 per share. Nelson issued 100 shares of the

preferred stock at a price of \$22 per share. The effects on the financial statements are identical to those described for the issue of the \$10 par value common stock.

Assets = Liab. + Equity					Rev. - Exp. = Net Inc.			Cash Flow
Cash	=		Pfd. Stk.	+ PIC in Excess				
2,200	=	NA	+ 1,000	+ 1,200	NA	- NA	= NA	2,200 FA

### Stock Issued with No Par Value

Assume that Nelson Incorporated is authorized to issue 150 shares of a fourth class of stock. This stock is no-par common stock. Nelson issues 100 shares of this no-par stock at \$22 per share. The entire amount received ( $\$22 \times 100 = \$2,200$ ) is recorded in the stock account. The effects on the financial statements follow.

Assets = Liab. + Equity					Rev. - Exp. = Net Inc.			Cash Flow
Cash	=		Com. Stk.	+ PIC in Excess				
2,200	=	NA	+ 2,200	+ NA	NA	- NA	= NA	2,200 FA

### Financial Statement Presentation

Exhibit 8.4 displays Nelson Incorporated's balance sheet after the four stock issuances described above. The exhibit assumes that Nelson earned and retained \$5,000 of cash income during 2012. The stock accounts are presented first, followed by the paid-in capital in excess of par (or stated) value accounts. A wide variety of reporting formats is used in practice. For example, another popular format is to group accounts by stock class, with the paid-in capital in excess accounts listed with their associated stock accounts. Alternatively, many companies combine the different classes of stock into a single amount and provide the detailed information in footnotes to the financial statements.

EXHIBIT 8.4	
NELSON INCORPORATED	
Balance Sheet	
As of December 31, 2012	
Assets	
Cash	<u>\$15,350</u>
Stockholders' equity	
Preferred stock, \$10 stated value, 7% cumulative, 300 shares authorized, 100 issued and outstanding	\$ 1,000
Common stock, \$10 par value, 250 shares authorized, 100 issued and outstanding	1,000
Common stock, class B, \$20 par value, 400 shares authorized, 150 issued and outstanding	3,000
Common stock, no par, 150 shares authorized, 100 issued and outstanding	2,200
Paid-in capital in excess of stated value—preferred	1,200
Paid-in capital in excess of par value—common	1,200
Paid-in capital in excess of par value—class B common	<u>750</u>
Total paid-in capital	10,350
Retained earnings	<u>5,000</u>
Total stockholders' equity	<u>\$15,350</u>

## STOCKHOLDERS' EQUITY TRANSACTIONS AFTER THE DAY OF ISSUE

**LO 5**

Show how treasury stock transactions affect a company's financial statements.

### Treasury Stock

When a company buys its own stock, the stock purchased is called *treasury stock*. Why would a company buy its own stock? Common reasons include (1) to have stock available to give employees pursuant to stock option plans, (2) to accumulate stock in preparation for a merger or business combination, (3) to reduce the number of shares outstanding in order to increase earnings per share, (4) to keep the price of the stock high when it appears to be falling, and (5) to avoid a hostile takeover (removing shares from the open market reduces the opportunity for outsiders to obtain enough voting shares to gain control of the company).

Conceptually, purchasing treasury stock is the reverse of issuing stock. When a business issues stock, the assets and equity of the business increase. When a business buys treasury stock, the assets and equity of the business decrease. To illustrate, return to the Nelson Incorporated example. Assume that in 2013 Nelson paid \$20 per share to buy back 50 shares of the \$10 par value common stock that it originally issued at \$22 per share. The purchase of treasury stock is an asset use transaction. Assets and stockholders' equity decrease by the cost of the purchase ( $\$20 \times 50 \text{ shares} = \$1,000$ ). The income statement is not affected. The cash outflow is reported in the financing activities section of the statement of cash flows. The effects on the financial statements follow.

Assets	=	Liab.	+	Equity			Rev.	-	Exp.	=	Net Inc.	Cash Flow
Cash	=			Other Equity Accts.	-	Treasury Stk.						
(1,000)	=	NA	+	NA	-	1,000	NA	-	NA	=	NA	(1,000) FA

The Treasury Stock account is a contra equity account. It is deducted from the other equity accounts in determining total stockholders' equity. In this example, the Treasury Stock account contains the full amount paid (\$1,000). The original issue price and the par value of the stock have no effect on the Treasury Stock account. Recognizing the full amount paid in the treasury stock account is called the **cost method of accounting for treasury stock** transactions. Although other methods could be used, the cost method is the most common.

Assume Nelson reissues 30 shares of treasury stock at a price of \$25 per share. As with any other stock issue, the sale of treasury stock is an asset source transaction. In this case, assets and stockholders' equity increase by \$750 ( $\$25 \times 30 \text{ shares}$ ). The income statement is not affected. The cash inflow is reported in the financing activities section of the statement of cash flows. The effects on the financial statements follow.

Assets	=	Liab.	+	Equity			Rev.	-	Exp.	=	Net Inc.	Cash Flow	
Cash	=			Other Equity Accounts	-	Treasury Stock	+	PIC from Treasury Stk.					
750	=	NA	+	NA	-	(600)	+	150	NA	-	NA	= NA	750 FA

The decrease in the Treasury Stock account increases stockholders' equity. The \$150 difference between the cost of the treasury stock ( $\$20 \text{ per share} \times 30 \text{ shares} = \$600$ ) and the sales price (\$750) is *not* reported as a gain. The sale of treasury stock

is a capital acquisition, not a revenue transaction. The \$150 is additional paid-in capital. *Corporations do not recognize gains or losses on the sale of treasury stock.*

After selling 30 shares of treasury stock, 20 shares remain in Nelson’s possession. These shares cost \$20 each, so the balance in the Treasury Stock account is now \$400 ( $\$20 \times 20$  shares). Treasury stock is reported on the balance sheet directly below retained earnings. Although this placement suggests that treasury stock reduces retained earnings, the reduction actually applies to the entire stockholders’ equity section. Exhibit 8.5 on page 302 shows the presentation of treasury stock in the balance sheet.

### CHECK YOURSELF 8.2

On January 1, 2012, Janell Company’s Common Stock account balance was \$20,000. On April 1, 2012, Janell paid \$12,000 cash to purchase some of its own stock. Janell resold this stock on October 1, 2012, for \$14,500. What is the effect on the company’s cash and stockholders’ equity from both the April 1 purchase and the October 1 resale of the stock?

**Answer** The April 1 purchase would reduce both cash and stockholders’ equity by \$12,000. The treasury stock transaction represents a return of invested capital to those owners who sold stock back to the company.

The sale of the treasury stock on October 1 would increase both cash and stockholders’ equity by \$14,500. The difference between the sales price of the treasury stock and its cost ( $\$14,500 - \$12,000$ ) represents additional paid-in capital from treasury stock transactions. The stockholders’ equity section of the balance sheet would include Common Stock, \$20,000, and Additional Paid-in Capital from Treasury Stock Transactions, \$2,500.

## Cash Dividend

Cash dividends are affected by three significant dates: *the declaration date, the date of record, and the payment date.* Assume that on October 15, 2013, the board of Nelson Incorporated declared a 7% cash dividend on the 100 outstanding shares of its \$10 stated value preferred stock. The dividend will be paid to stockholders of record as of November 15, 2013. The cash payment will be made on December 15, 2013.

**LO 6**

Explain the effects of declaring and paying cash dividends on a company’s financial statements.

### Declaration Date

Although corporations are not required to declare dividends, they are legally obligated to pay dividends once they have been declared. They must recognize a liability on the **declaration date** (in this case, October 15, 2013). The increase in liabilities is accompanied by a decrease in retained earnings. The income statement and statement of cash flows are not affected. The effects on the financial statements of *declaring* the \$70 ( $0.07 \times \$10 \times 100$  shares) dividend follow.

Assets	=	Liab.	+	Equity	Rev.	-	Exp.	=	Net Inc.	Cash Flow
Cash	=	Div. Pay.	+	Com. Stk.	+	Ret. Earn.				
NA	=	70	+	NA	+	(70)			NA	NA

### Date of Record

Cash dividends are paid to investors who owned the preferred stock on the **date of record** (in this case November 15, 2013). Any stock sold after the date of record but

## REALITY BYTES

As you have learned, dividends, unlike interest on bonds, do not have to be paid. In fact, a company’s board of directors must vote to pay dividends before they can be paid. Even so, once a company establishes a practice of paying a dividend of a given amount each period, usually quarterly, the company is reluctant to not pay the dividend. Furthermore, it is usually a significant news event when a company decides to increase the amount of its regular dividend.

When times are bad, however, dividends are often reduced, or eliminated entirely, as a quick way to conserve the company’s cash. This occurred often as a result of the economic downturn of 2008. An article in the February 28, 2009, edition of *The Wall Street Journal* listed ten large companies who had recently reduced or eliminated their common stock dividend. The companies named were: **Blackstone Group, CBS, Citigroup, Dow Chemical, General Electric, JP Morgan Chase, Motorola, New York Times, Pfizer, and Textron.** The article also noted that for the month of January 2009, dividends paid by companies in the S&P 500 Index were 24 percent lower than they had been in January 2008.



before the payment date (in this case December 15, 2013) is traded **ex-dividend**, meaning the buyer will not receive the upcoming dividend. The date of record is merely a cutoff date. It does not affect the financial statements.

### Payment Date

Nelson actually paid the cash dividend on the **payment date**. This event has the same effect as paying any other liability. Assets (cash) and liabilities (dividends payable) both decrease. The income statement is not affected. The cash outflow is reported in the financing activities section of the statement of cash flows. The effects of the cash payment on the financial statements follow.

Assets	=	Liab.	+	Equity	Rev.	-	Exp.	=	Net Inc.	Cash Flow
Cash	=	Div. Pay.	+	Com. Stk.	+	Ret. Earn.				
(70)	=	(70)	+	NA	+	NA			NA - NA = NA	(70) FA

### Stock Dividend

Dividends are not always paid in cash. Companies sometimes choose to issue **stock dividends**, wherein they distribute additional shares of stock to the stockholders. To illustrate, assume that Nelson Incorporated decided to issue a 10 percent stock dividend on its class B, \$20 par value common stock. Because dividends apply to outstanding shares only, Nelson will issue 15 (150 outstanding shares × 0.10) additional shares of class B stock.

Assume the new shares are distributed when the market value of the stock is \$30 per share. As a result of the stock dividend, Nelson will transfer \$450 (\$30 × 15 new shares) from retained earnings to paid-in capital.<sup>2</sup> The stock dividend is an equity exchange

#### LO 7

Explain the effects of stock dividends and stock splits on a company’s financial statements.

<sup>2</sup>The accounting here applies to small stock dividends. Accounting for large stock dividends is explained in a more advanced course.

transaction. The income statement and statement of cash flows are not affected. The effects of the stock dividend on the financial statements follow.

Assets	=	Liab.	+	Equity			Rev.	-	Exp.	=	Net Inc.	Cash Flow		
				Com. Stk.	+	PIC in Excess	+	Ret. Earn.						
NA	=	NA	+	300	+	150	+	(450)	NA	-	NA	=	NA	NA

Stock dividends have no effect on assets. They merely increase the number of shares of stock outstanding. Because a greater number of shares represents the same ownership interest in the same amount of assets, the market value per share of a company's stock normally declines when a stock dividend is distributed. A lower market price makes the stock more affordable and may increase demand for the stock, which benefits both the company and its stockholders.

## Stock Split

A corporation may also reduce the market price of its stock through a **stock split**. A stock split replaces existing shares with a greater number of new shares. Any par or stated value of the stock is proportionately reduced to reflect the new number of shares outstanding. For example, assume Nelson Incorporated declared a 2-for-1 stock split on the 165 outstanding shares (150 originally issued + 15 shares distributed in a stock dividend) of its \$20 par value, class B common stock. Nelson notes in the accounting records that the 165 old \$20 par shares are replaced with 330 new \$10 par shares. Investors who owned the 165 shares of old common stock would now own 330 shares of the new common stock.

Stock splits have no effect on the dollar amounts of assets, liabilities, and stockholders' equity. They only affect the number of shares of stock outstanding. In Nelson's case, the ownership interest that was previously represented by 165 shares of stock is now represented by 330 shares. Because twice as many shares now represent the same ownership interest, the market value per share should be one-half as much as it was prior to the split. However, as with a stock dividend, the lower market price will probably stimulate demand for the stock. As a result, doubling the number of shares will likely reduce the market price to slightly more than one-half of the pre-split value. For example, if the stock were selling for \$30 per share before the 2-for-1 split, it might sell for \$15.50 after the split.

## Appropriation of Retained Earnings

The board of directors may restrict the amount of retained earnings available to distribute as dividends. The restriction may be required by credit agreements, or it may be discretionary. A retained earnings restriction, often called an *appropriation*, is an equity exchange event. It transfers a portion of existing retained earnings to **Appropriated Retained Earnings**. Total retained earnings remains unchanged. To illustrate, assume that Nelson appropriates \$1,000 of retained earnings for future expansion. The income statement and the statement of cash flows are not affected. The effects on the financial statements of appropriating \$1,000 of retained earnings follow.

### LO 8

Show how the appropriation of retained earnings affects financial statements.

Assets	=	Liab.	+	Equity			Rev.	-	Exp.	=	Net Inc.	Cash Flow		
				Com. Stk.	+	Ret. Earn.	+	App. Ret. Earn.						
NA	=	NA	+	NA	+	(1,000)	+	1,000	NA	-	NA	=	NA	NA

## FINANCIAL STATEMENT PRESENTATION

The 2012 and 2013 events for Nelson Incorporated are summarized below. Events 1 through 8 are cash transactions. The results of the 2012 transactions (nos. 1–5) are reflected in Exhibit 8.4. The results of the 2013 transactions (nos. 6–9) are shown in Exhibit 8.5.

1. Issued 100 shares of \$10 par value common stock at a market price of \$22 per share.
2. Issued 150 shares of class B, \$20 par value common stock at a market price of \$25 per share.
3. Issued 100 shares of \$10 stated value, 7 percent cumulative preferred stock at a market price of \$22 per share.
4. Issued 100 shares of no-par common stock at a market price of \$22 per share.
5. Earned and retained \$5,000 cash from operations.
6. Purchased 50 shares of \$10 par value common stock as treasury stock at a market price of \$20 per share.
7. Sold 30 shares of treasury stock at a market price of \$25 per share.
8. Declared and paid a \$70 cash dividend on the preferred stock.
9. Issued a 10 percent stock dividend on the 150 shares of outstanding class B, \$20 par value common stock (15 additional shares). The additional shares were issued when the market price of the stock was \$30 per share. There are 165 (150 + 15) class B common shares outstanding after the stock dividend.
10. Issued a 2-for-1 stock split on the 165 shares of class B, \$20 par value common stock. After this transaction, there are 330 shares outstanding of the class B common stock with a \$10 par value.
11. Appropriated \$1,000 of retained earnings.

### EXHIBIT 8.5

#### NELSON INCORPORATED Balance Sheet As of December 31, 2013

Assets		
Cash		\$21,030
Stockholders' equity		
Preferred stock, \$10 stated value, 7% cumulative, 300 shares authorized, 100 issued and outstanding	\$1,000	
Common stock, \$10 par value, 250 shares authorized, 100 issued, and 80 outstanding	1,000	
Common stock, class B, \$10 par, 800 shares authorized, 330 issued and outstanding	3,300	
Common stock, no par, 150 shares authorized, 100 issued and outstanding	2,200	
Paid-in capital in excess of stated value—preferred	1,200	
Paid-in capital in excess of par value—common	1,200	
Paid-in capital in excess of par value—class B common	900	
Paid-in capital in excess of cost of treasury stock	150	
Total paid-in capital		\$10,950
Retained earnings		
Appropriated	1,000	
Unappropriated	9,480	
Total retained earnings		10,480
Less: Treasury stock, 20 shares @ \$20 per share		(400)
Total stockholders' equity		<u>\$21,030</u>

The illustration assumes that Nelson earned net income of \$6,000 in 2013. The ending retained earnings balance is determined as follows: Beginning Balance \$5,000 – \$70 Cash Dividend – \$450 Stock Dividend + \$6,000 Net Income = \$10,480.

## INVESTING IN CAPITAL STOCK

Stockholders may benefit in two ways when a company generates earnings. The company may distribute the earnings directly to the stockholders in the form of dividends. Alternatively, the company may retain some or all of the earnings to finance growth and increase its potential for future earnings. If the company retains earnings, the market value of its stock should increase to reflect its greater earnings prospects. How can analysts use financial reporting to help assess the potential for dividend payments or growth in market value?

LO 9

Explain some uses of accounting information in making stock investment decisions.

### Receiving Dividends

Is a company likely to pay dividends in the future? The financial statements can help answer this question. They show if dividends were paid in the past. Companies with a history of paying dividends usually continue to pay dividends. Also, to pay dividends in the future, a company must have sufficient cash and retained earnings. These amounts are reported on the balance sheet and the statement of cash flows.

### Increasing the Price of Stock

Is the market value (price) of a company's stock likely to increase? Increases in a company's stock price occur when investors believe the company's earnings will grow. Financial statements provide information that is useful in predicting the prospects for earnings growth. Here also, a company's earnings history is an indicator of its growth potential. However, because published financial statements report historical information, investors must recognize their limitations. Investors want to know about the future. Stock prices are therefore influenced more by forecasts than by history.

For example:

- On April 15, 2009, **Abbott Laboratories, Inc.**, announced that profits for the first quarter of its 2009 fiscal year were 53 percent higher than profits in the same quarter of 2008. In reaction to this news, the price of Abbott's stock *fell* by almost 5 percent. Why did the stock market respond in this way? Because company's revenues for the quarter were less than had been expected by analysts who follow the company.
- On May 18, 2009, **Lowe's Companies, Inc.**, announced first quarter earnings were \$0.32 per share, which was 22 percent lower than for the same period of the previous year. The stock market's reaction to the news was to *increase* the price of Lowe's stock by 8 percent. The market reacted this way because the analysts were expecting earnings per share for the first quarter to be only \$0.25 per share.

In each case, investors reacted to the potential for earnings growth rather than the historical earnings reports. Because investors find forecasted statements more relevant to decision making than historical financial statements, most companies provide forecasts in addition to historical financial statements.

The value of a company's stock is also influenced by nonfinancial information that financial statements cannot provide. For example, suppose **ExxonMobil** announced in the middle of its fiscal year that it had just discovered substantial oil reserves on property to which it held drilling rights. Consider the following questions:

- What would happen to the price of ExxonMobil's stock on the day of the announcement?
- What would happen to ExxonMobil's financial statements on that day?

The price of ExxonMobil's stock would almost certainly increase as soon as the discovery was made public. However, nothing would happen to its financial statements on that day. There would probably be very little effect on its financial statements for that year. Only after the company begins to develop the oil field and sell the oil will its financial statements reflect the discovery. Changes in financial statements tend to lag behind the announcements companies make regarding their earnings potential.

Stock prices are also affected by general economic conditions and consumer confidence as well as the performance measures reported in financial statements. For example, the stock prices of virtually all companies declined sharply immediately after the September 11, 2001, terrorist attacks on the World Trade Center and the Pentagon. Historically based financial statements are of little benefit in predicting general economic conditions or changes in consumer confidence.

### Exercising Control through Stock Ownership

The more influence an investor has over the operations of a company, the more the investor can benefit from owning stock in the company. For example, consider a power company that needs coal to produce electricity. The power company may purchase some common stock in a coal mining company to ensure a stable supply of coal. What percentage of the mining company's stock must the power company acquire to exercise significant influence over the mining company? The answer depends on how many investors own stock in the mining company and how the number of shares is distributed among the stockholders.

The greater its number of stockholders, the more *widely held* a company is. If stock ownership is concentrated in the hands of a few persons, a company is *closely held*. Widely held companies can generally be controlled with smaller percentages of ownership than closely held companies. Consider a company in which no existing investor owns more than 1 percent of the voting stock. A new investor who acquires a 5 percent interest would immediately become, by far, the largest shareholder and would likely be able to significantly influence board decisions. In contrast, consider a closely held company in which one current shareholder owns 51 percent of the company's stock. Even if another investor acquired the remaining 49 percent of the company, that investor could not control the company.

Financial statements contain some, but not all, of the information needed to help an investor determine ownership levels necessary to permit control. For example, the financial statements disclose the total number of shares of stock outstanding, but they normally contain little information about the number of shareholders and even less information about any relationships between shareholders. Relationships between shareholders are critically important because related shareholders, whether bound by family or business interests, might exercise control by voting as a block. For publicly traded companies, information about the number of shareholders and the identity of some large shareholders is disclosed in reports filed with the Securities and Exchange Commission.

### A Look Back

Starting a business requires obtaining financing; it takes money to make money. Although some money may be borrowed, lenders are unlikely to make loans to businesses that lack some degree of owner financing. Equity financing is therefore critical to virtually all profit-oriented businesses. This chapter has examined some of the issues related to accounting for equity transactions.

The idea that a business must obtain financing from its owners was one of the first events presented in this textbook. This chapter discussed the advantages and disadvantages of organizing a business as a sole proprietorship versus a partnership versus a corporation. These advantages and disadvantages include the following.

1. *Double taxation*—Income of corporations is subject to double taxation, but that of proprietorships and partnerships is not.
2. *Regulation*—Corporations are subject to more regulation than are proprietorships and partnerships.
3. *Limited liability*—An investor's personal assets are not at risk as a result of owning corporate securities. The investor's liability is limited to the amount of the investment. In general proprietorships and partnerships do not offer limited liability. However, laws in some states permit the formation of limited liability companies which operate like proprietorships and partnerships yet place some limits on the personal liability of their owners.
4. *Continuity*—Proprietorships and partnerships dissolve when one of the owners leaves the business. Corporations are separate legal entities that continue to exist regardless of changes in ownership.
5. *Transferability*—Ownership interests in corporations are easier to transfer than those of proprietorships or partnerships.
6. *Management structure*—Corporations are more likely to have independent professional managers than are proprietorships or partnerships.
7. *Ability to raise capital*—Because they can be owned by millions of investors, corporations have the opportunity to raise more capital than proprietorships or partnerships.

Corporations issue different classes of common stock and preferred stock as evidence of ownership interests. In general, *common stock* provides the widest range of privileges including the right to vote and participate in earnings. *Preferred stockholders* usually give up the right to vote in exchange for preferences such as the right to receive dividends or assets upon liquidation before common stockholders. Stock may have a *par value* or *stated value*, which relates to legal requirements governing the amount of capital that must be maintained in the corporation. Corporations may also issue *no-par stock*, avoiding some of the legal requirements that pertain to par or stated value stock.

Stock that a company issues and then repurchases is called *treasury stock*. Purchasing treasury stock reduces total assets and stockholders' equity. Reselling treasury stock represents a capital acquisition. The difference between the reissue price and the cost of the treasury stock is recorded directly in the equity accounts. Treasury stock transactions do not result in gains or losses on the income statement.

Companies may issue *stock splits* or *stock dividends*. These transactions increase the number of shares of stock without changing the net assets of a company. The per share market value usually drops when a company issues stock splits or dividends.

## A Look Forward



Financial statement analysis is so important that Chapter 9 is devoted solely to a detailed discussion of this subject. The chapter covers vertical analysis (analyzing relationships within a specific statement) and horizontal analysis (analyzing relationships across accounting periods). Finally, the chapter discusses limitations associated with financial statement analysis.



A step-by-step audio-narrated series of slides is provided on the text website at [www.mhhe.com/edmondssurvey3e](http://www.mhhe.com/edmondssurvey3e).



### SELF-STUDY REVIEW PROBLEM

Edwards Inc. experienced the following events:

1. Issued common stock for cash.
2. Declared a cash dividend.
3. Issued noncumulative preferred stock for cash.
4. Appropriated retained earnings.
5. Distributed a stock dividend.
6. Paid cash to purchase treasury stock.
7. Distributed a 2-for-1 stock split.
8. Issued cumulative preferred stock for cash.
9. Paid a cash dividend that had previously been declared.
10. Sold treasury stock for cash at a higher amount than the cost of the treasury stock.

#### Required

Show the effect of each event on the elements of the financial statements using a horizontal statements model like the one shown here. Use + for increase, – for decrease, and NA for not affected. In the Cash Flow column, indicate whether the item is an operating activity (OA), investing activity (IA), or a financing activity (FA). The first transaction is entered as an example.

Event	Assets	=	Liab.	+	Equity	Rev.	–	Exp.	=	Net Inc.	Cash Flow
1	+		NA		+	NA		NA		NA	+ FA

#### Solution to Self-Study Review Problem

Event	Assets	=	Liab.	+	Equity	Rev.	–	Exp.	=	Net Inc.	Cash Flow
1	+		NA		+	NA		NA		NA	+ FA
2	NA		+		–	NA		NA		NA	NA
3	+		NA		+	NA		NA		NA	+ FA
4	NA		NA		– +	NA		NA		NA	NA
5	NA		NA		– +	NA		NA		NA	NA
6	–		NA		–	NA		NA		NA	– FA
7	NA		NA		NA	NA		NA		NA	NA
8	+		NA		+	NA		NA		NA	+ FA
9	–		–		NA	NA		NA		NA	– FA
10	+		NA		+	NA		NA		NA	+ FA

#### KEY TERMS

Appropriated Retained Earnings 301  
 Articles of incorporation 288  
 Authorized stock 293  
 Board of directors 290  
 Book value per share 293

Closely held corporation 288  
 Common stock 294  
 Continuity 290  
 Corporation 288  
 Cost method of accounting for treasury stock 298

Cumulative dividends 295  
 Date of record 299  
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 Dividends in arrears 295  
 Double taxation 289  
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Ex-dividend 300	Par value 293	Stated value 293
Issued stock 293	Partnerships 288	Stock certificates 288
Legal capital 293	Partnership agreement 288	Stock dividends 300
Limited liability 290	Payment date 300	Stockholders 290
Limited liability companies (LLCs) 289	Preferred stock 294	Stock split 301
Market value 293	Securities Act of 1933 and Securities Exchange Act of 1934 289	Transferability 290
Outstanding stock 293	Sole proprietorships 288	Treasury stock 293
Paid-in Capital in Excess of Par Value 296		Withdrawals 291

## QUESTIONS

- What are the three major forms of business organizations? Describe each.
- How are sole proprietorships formed?
- Discuss the purpose of a partnership agreement. Is such an agreement necessary for partnership formation?
- What is meant by the phrase *separate legal entity*? To which type of business organization does it apply?
- What is the purpose of the articles of incorporation? What information do they provide?
- What is the function of the stock certificate?
- What prompted Congress to pass the Securities Act of 1933 and the Securities Exchange Act of 1934? What is the purpose of these laws?
- What are the advantages and disadvantages of the corporate form of business organization?
- What is a limited liability company? Discuss its advantages and disadvantages.
- How does the term *double taxation* apply to corporations? Give an example of double taxation.
- What is the difference between contributed capital and retained earnings for a corporation?
- What are the similarities and differences in the equity structure of a sole proprietorship, a partnership, and a corporation?
- Why is it easier for a corporation to raise large amounts of capital than it is for a partnership?
- What is the meaning of each of the following terms with respect to the corporate form of organization?
  - Legal capital
  - Par value of stock
  - Stated value of stock
  - Market value of stock
  - Book value of stock
  - Authorized shares of stock
  - Issued stock
  - Outstanding stock
  - Treasury stock
  - Common stock
  - Preferred stock
  - Dividends
- What is the difference between cumulative preferred stock and noncumulative preferred stock?
- What is no-par stock? How is it recorded in the accounting records?
- Assume that Best Co. has issued and outstanding 1,000 shares of \$100 par value, 10 percent, cumulative preferred stock. What is the dividend per share? If the preferred dividend is two years in arrears, what total amount of dividends must be paid before the common shareholders can receive any dividends?
- If Best Co. issued 10,000 shares of \$20 par value common stock for \$30 per share, what amount is added to the Common Stock account? What amount of cash is received?
- What is the difference between par value stock and stated value stock?
- Why might a company repurchase its own stock?
- What effect does the purchase of treasury stock have on the equity of a company?
- Assume that Day Company repurchased 1,000 of its own shares for \$30 per share and sold the shares two weeks later for \$35 per share. What is the amount of gain on the sale? How is it reported on the balance sheet? What type of account is treasury stock?
- What is the importance of the declaration date, record date, and payment date in conjunction with corporate dividends?

24. What is the difference between a stock dividend and a stock split?
25. Why would a company choose to distribute a stock dividend instead of a cash dividend?
26. What is the primary reason that a company would declare a stock split?
27. If Best Co. had 10,000 shares of \$20 par value common stock outstanding and declared a 5-for-1 stock split, how many shares would then be outstanding and what would be their par value after the split?
28. When a company appropriates retained earnings, does the company set aside cash for a specific use? Explain.
29. What is the largest source of financing for most U.S. businesses?
30. What is meant by *equity financing*? What is meant by *debt financing*?
31. What is a widely held corporation? What is a closely held corporation?
32. What are some reasons that a corporation might not pay dividends?



## MULTIPLE-CHOICE QUESTIONS

Multiple-choice questions are provided on the text website at [www.mhhe.com/edmondssurvey3e](http://www.mhhe.com/edmondssurvey3e)



### LO 1, 2

## EXERCISES

All applicable Exercises are available with McGraw-Hill's *Connect Accounting*.

### Exercise 8-1 *Effect of accounting events on the financial statements of a sole proprietorship*

A sole proprietorship was started on January 1, 2012, when it received \$60,000 cash from Mark Pruitt, the owner. During 2012, the company earned \$40,000 in cash revenues and paid \$19,300 in cash expenses. Pruitt withdrew \$5,000 cash from the business during 2012.

#### Required

Prepare the income statement, capital statement (statement of changes in equity), balance sheet, and statement of cash flows for Pruitt's 2012 fiscal year.

### LO 1, 2

### Exercise 8-2 *Effect of accounting events on the financial statements of a partnership*

Justin Harris and Paul Berryhill started the HB partnership on January 1, 2012. The business acquired \$56,000 cash from Harris and \$84,000 from Berryhill. During 2012, the partnership earned \$65,000 in cash revenues and paid \$32,000 for cash expenses. Harris withdrew \$2,000 cash from the business, and Berryhill withdrew \$3,000 cash. The net income was allocated to the capital accounts of the two partners in proportion to the amounts of their original investments in the business.

#### Required

Prepare the income statement, capital statement, balance sheet, and statement of cash flows for the HB partnership for the 2012 fiscal year.

### LO 1, 2

### Exercise 8-3 *Effect of accounting events on the financial statements of a corporation*

Morris Corporation was started with the issue of 5,000 shares of \$10 par common stock for cash on January 1, 2012. The stock was issued at a market price of \$18 per share. During 2012, the company earned \$63,000 in cash revenues and paid \$41,000 for cash expenses. Also, a \$4,000 cash dividend was paid to the stockholders.

#### Required

Prepare the income statement, statement of changes in stockholders' equity, balance sheet, and statement of cash flows for Morris Corporation's 2012 fiscal year.

**Exercise 8-4** *Effect of issuing common stock on the balance sheet***LO 4**

Newly formed Home Medical Corporation has 100,000 shares of \$5 par common stock authorized. On March 1, 2012, Home Medical issued 10,000 shares of the stock for \$12 per share. On May 2 the company issued an additional 20,000 shares for \$20 per share. Home Medical was not affected by other events during 2012.

**Required**

- a. Record the transactions in a horizontal statements model like the following one. In the Cash Flow column, indicate whether the item is an operating activity (OA), investing activity (IA), or financing activity (FA). Use NA to indicate that an element was not affected by the event.

Assets = Liab. + Equity				Rev. - Exp. = Net Inc.		Cash Flow
Cash	=	+ Com. Stk.	+ Paid-in Excess			

- b. Determine the amount Home Medical would report for common stock on the December 31, 2012, balance sheet.
- c. Determine the amount Home Medical would report for paid-in capital in excess of par.
- d. What is the total amount of capital contributed by the owners?
- e. What amount of total assets would Home Medical report on the December 31, 2012, balance sheet?

**Exercise 8-5** *Recording and reporting common and preferred stock transactions***LO 4**

Rainoy, Inc., was organized on June 5, 2012. It was authorized to issue 400,000 shares of \$10 par common stock and 50,000 shares of 4 percent cumulative class A preferred stock. The class A stock had a stated value of \$25 per share. The following stock transactions pertain to Rainoy, Inc.

1. Issued 20,000 shares of common stock for \$15 per share.
2. Issued 10,000 shares of the class A preferred stock for \$30 per share.
3. Issued 50,000 shares of common stock for \$18 per share.

**Required**

Prepare the stockholders' equity section of the balance sheet immediately after these transactions have been recognized.

**Exercise 8-6** *Effect of no-par common and par preferred stock on the horizontal statements model***LO 4**

Eaton Corporation issued 5,000 shares of no-par common stock for \$20 per share. Eaton also issued 2,000 shares of \$50 par, 6 percent noncumulative preferred stock at \$60 per share.

**Required**

Record these events in a horizontal statements model like the following one. In the cash flow column, indicate whether the item is an operating activity (OA), investing activity (IA), or financing activity (FA). Use NA to indicate that an element was not affected by the event.

Assets = Equity				Rev. - Exp. = Net Inc.		Cash Flow
Cash	=	Pfd. Stk.	+ Com. Stk.	+ PIC in Excess		

**Exercise 8-7** *Issuing stock for assets other than cash***LO 4**

Kaylee Corporation was formed when it issued shares of common stock to two of its shareholders. Kaylee issued 5,000 shares of \$10 par common stock to K. Breslin in exchange for \$60,000 cash (the

issue price was \$12 per share). Kaylee also issued 2,500 shares of stock to T. Lindsay in exchange for a one-year-old delivery van on the same day. Lindsay had originally paid \$35,000 for the van.

**Required**

- a. What was the market value of the delivery van on the date of the stock issue?
- b. Show the effect of the two stock issues on Kaylee’s books in a horizontal statements model like the following one. In the Cash Flow column, indicate whether the item is an operating activity (OA), investing activity (IA), or financing activity (FA). Use NA to indicate that an element was not affected by the event.

Assets		=	Equity		Rev.	-	Exp.	=	Net Inc.	Cash Flow
Cash	+ Van	=	Com. Stk.	+ PIC in Excess						

**LO 5 Exercise 8-8 Treasury stock transactions**

Graves Corporation repurchased 2,000 shares of its own stock for \$40 per share. The stock has a par of \$10 per share. A month later Graves resold 1,200 shares of the treasury stock for \$48 per share.

**Required**

What is the balance of the treasury stock account after these transactions are recognized?

**LO 5 Exercise 8-9 Recording and reporting treasury stock transactions**

The following information pertains to Smoot Corp. at January 1, 2012.

Common stock, \$10 par, 10,000 shares authorized, 2,000 shares issued and outstanding	\$20,000
Paid-in capital in excess of par, common stock	15,000
Retained earnings	65,000

Smoot Corp. completed the following transactions during 2012:

- 1. Issued 1,000 shares of \$10 par common stock for \$28 per share.
- 2. Repurchased 200 shares of its own common stock for \$25 per share.
- 3. Resold 50 shares of treasury stock for \$26 per share.

**Required**

- a. How many shares of common stock were outstanding at the end of the period?
- b. How many shares of common stock had been issued at the end of the period?
- c. Organize the transactions data in accounts under the accounting equation.
- d. Prepare the stockholders’ equity section of the balance sheet reflecting these transactions. Include the number of shares authorized, issued, and outstanding in the description of the common stock.

**LO 6 Exercise 8-10 Effect of cash dividends on financial statements**

On October 1, 2012, Smart Corporation declared a \$60,000 cash dividend to be paid on December 30 to shareholders of record on November 20.

**Required**

Record the events occurring on October 1, November 20, and December 30 in a horizontal statements model like the following one. In the Cash Flow column, indicate whether the item is an operating activity (OA), investing activity (IA), or financing activity (FA).

Date	Assets	=	Liab.	+ Com. Stock	+ Ret. Earn.	Rev.	-	Exp.	=	Net Inc.	Cash Flow
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**Exercise 8-11** *Accounting for cumulative preferred dividends***LO 6**

When Polledo Corporation was organized in January 2012, it immediately issued 5,000 shares of \$50 par, 5 percent, cumulative preferred stock and 10,000 shares of \$10 par common stock. The company's earnings history is as follows: 2012, net loss of \$15,000; 2013, net income of \$60,000; 2014, net income of \$95,000. The corporation did not pay a dividend in 2012.

**Required**

- How much is the dividend arrearage as of January 1, 2013?
- Assume that the board of directors declares a \$40,000 cash dividend at the end of 2013 (remember that the 2012 and 2013 preferred dividends are due). How will the dividend be divided between the preferred and common stockholders?

**Exercise 8-12** *Cash dividends for preferred and common shareholders*

B&S Corporation had the following stock issued and outstanding at January 1, 2012:

- 100,000 shares of \$5 par common stock.
- 5,000 shares of \$100 par, 5 percent, noncumulative preferred stock.

On May 10, B&S Corporation declared the annual cash dividend on its 5,000 shares of preferred stock and a \$1 per share dividend for the common shareholders. The dividends will be paid on June 15 to the shareholders of record on May 30.

**Required**

Determine the total amount of dividends to be paid to the preferred shareholders and common shareholders.

**Exercise 8-13** *Cash dividends: common and preferred stock***LO 6**

Varsity Corp. had the following stock issued and outstanding at January 1, 2012.

- 200,000 shares of no-par common stock.
- 10,000 shares of \$100 par, 8 percent, cumulative preferred stock. (Dividends are in arrears for one year, 2011.)

On February 1, 2012, Varsity declared a \$200,000 cash dividend to be paid March 31 to shareholders of record on March 10.

**Required**

What amount of dividends will be paid to the preferred shareholders versus the common shareholders?

**Exercise 8-14** *Accounting for stock dividends***LO 7**

Rollins Corporation issued a 5 percent stock dividend on 10,000 shares of its \$10 par common stock. At the time of the dividend, the market value of the stock was \$14 per share.

**Required**

- Compute the amount of the stock dividend.
- Show the effects of the stock dividend on the financial statements using a horizontal statements model like the following one.

Assets	=	Liab.	+	Com. Stk.	+	PIC in Excess	+	Ret. Earn.	Rev.	-	Exp.	=	Net Inc.	Cash Flow
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**Exercise 8-15** *Determining the effects of stock splits on the accounting records***LO 7**

The market value of Coe Corporation's common stock had become excessively high. The stock was currently selling for \$180 per share. To reduce the market price of the common stock, Coe declared a 2-for-1 stock split for the 300,000 outstanding shares of its \$10 par common stock.



**Required**

- How will Coe Corporation's books be affected by the stock split?
- Determine the number of common shares outstanding and the par value after the split.
- Explain how the market value of the stock will be affected by the stock split.

**LO 9****Exercise 8-16 Corporate announcements**

Super Drugs (one of the three largest drug makers) just reported that its 2012 third-quarter profits had increased substantially over its 2011 third-quarter profits. In addition to this announcement, the same day, Super Drugs also announced that the Food and Drug Administration had just denied approval of a new drug used to treat high blood pressure that Super Drugs developed. The FDA was concerned about potential side effects of the drug.

**Required**

Using the above information, answer the following questions.

- What do you think will happen to the stock price of Super Drugs on the day these two announcements are made? Explain your answer.
- How will the balance sheet be affected on that day by the above announcements?
- How will the income statement be affected on that day by the above announcements?
- How will the statement of cash flows be affected on that day by the above announcements?

**PROBLEMS**

**All applicable Problems are available with McGraw-Hill's Connect Accounting.**

**Problem 8-17 Effect of business structure on financial statements**

Calloway Company was started on January 1, 2012, when the owners invested \$40,000 cash in the business. During 2012, the company earned cash revenues of \$18,000 and incurred cash expenses of \$12,500. The company also paid cash distributions of \$3,000.

**Required**

Prepare the 2012 income statement, capital statement (statement of changes in equity), balance sheet, and statement of cash flows using each of the following assumptions. (Consider each assumption separately.)

- Calloway is a sole proprietorship owned by Macy Calloway.
- Calloway is a partnership with two partners, Macy Calloway and Artie Calloway. Macy Calloway invested \$25,000 and Artie Calloway invested \$15,000 of the \$40,000 cash that was used to start the business. A. Calloway was expected to assume the vast majority of the responsibility for operating the business. The partnership agreement called for A. Calloway to receive 60 percent of the profits and M. Calloway to get the remaining 40 percent. With regard to the \$3,000 distribution, A. Calloway withdrew \$1,200 from the business and M. Calloway withdrew \$1,800.
- Calloway is a corporation. It issued 5,000 shares of \$5 par common stock for \$40,000 cash to start the business.

**Problem 8-18 Recording and reporting stock transactions and cash dividends across two accounting cycles**

Davis Corporation was authorized to issue 100,000 shares of \$10 par common stock and 50,000 shares of \$50 par, 6 percent, cumulative preferred stock. Davis Corporation completed the following transactions during its first two years of operation.

**2012**

- Jan. 2 Issued 5,000 shares of \$10 par common stock for \$28 per share.
- 15 Issued 1,000 shares of \$50 par preferred stock for \$70 per share.

**LO 1, 2****CHECK FIGURES**

- Net Income: \$5,500
- Macy Calloway Capital: \$25,400

**LO 4-6****CHECK FIGURES**

- Preferred Stock, 2012: \$50,000
- Common Shares Outstanding, 2013: 19,500

- Feb. 14 Issued 15,000 shares of \$10 par common stock for \$30 per share.  
 Dec. 31 During the year, earned \$170,000 of cash service revenue and paid \$110,000 of cash operating expenses.  
 31 Declared the cash dividend on outstanding shares of preferred stock for 2012. The dividend will be paid on January 31 to stockholders of record on January 15, 2013.

**2013**

- Jan. 31 Paid the cash dividend declared on December 31, 2012.  
 Mar. 1 Issued 2,000 shares of \$50 par preferred stock for \$58 per share.  
 June 1 Purchased 500 shares of common stock as treasury stock at \$43 per share.  
 Dec. 31 During the year, earned \$210,000 of cash service revenue and paid \$175,000 of cash operating expenses.  
 31 Declared the dividend on the preferred stock and a \$0.60 per share dividend on the common stock.

**Required**

- Organize the transaction data in accounts under an accounting equation.
- Prepare the stockholders' equity section of the balance sheet at December 31, 2012.
- Prepare the balance sheet at December 31, 2013.

**Problem 8-19 Recording and reporting treasury stock transactions**

Midwest Corp. completed the following transactions in 2012, the first year of operation.

- Issued 20,000 shares of \$10 par common stock at par.
- Issued 2,000 shares of \$30 stated value preferred stock at \$32 per share.
- Purchased 500 shares of common stock as treasury stock for \$15 per share.
- Declared a 5 percent dividend on preferred stock.
- Sold 300 shares of treasury stock for \$18 per share.
- Paid the cash dividend on preferred stock that was declared in Event 4.
- Earned cash service revenue of \$75,000 and incurred cash operating expenses of \$42,000.
- Appropriated \$6,000 of retained earnings.

**Required**

- Organize the transaction in accounts under an accounting equation.
- Prepare the stockholders' equity section of the balance sheet as of December 31, 2012.

**Problem 8-20 Recording and reporting treasury stock transactions**

Boley Corporation reports the following information in its January 1, 2012, balance sheet:

Stockholders' equity	
Common stock, \$10 par value,	
50,000 shares authorized, 30,000 shares issued and outstanding	\$300,000
Paid-in capital in excess of par value	150,000
Retained earnings	<u>100,000</u>
Total stockholders' equity	<u>\$550,000</u>

During 2012, Boley was affected by the following accounting events.

- Purchased 1,000 shares of treasury stock at \$18 per share.
- Reissued 600 shares of treasury stock at \$20 per share.
- Earned \$64,000 of cash service revenues.
- Paid \$38,000 of cash operating expenses.

**Required**

Prepare the stockholders' equity section of the year-end balance sheet.

**LO 5, 6, 8****eXcel****CHECK FIGURE**

b. Total Paid-In Capital: \$264,900

**LO 5****CHECK FIGURES**

Total Paid-In Capital: \$451,200  
 Total Stockholders' Equity:  
 \$570,000

**LO 4, 6, 7**

**CHECK FIGURES**

- b. Total Paid-In Capital: \$895,000
- b. Retained Earnings: \$17,500

**Problem 8-21 Recording and reporting stock dividends**

Chan Corp. completed the following transactions in 2012, the first year of operation.

1. Issued 20,000 shares of \$20 par common stock for \$30 per share.
2. Issued 5,000 shares of \$50 par, 5 percent, preferred stock at \$51 per share.
3. Paid the annual cash dividend to preferred shareholders.
4. Issued a 5 percent stock dividend on the common stock. The market value at the dividend declaration date was \$40 per share.
5. Later that year, issued a 2-for-1 split on the 21,000 shares of outstanding common stock.
6. Earned \$210,000 of cash service revenues and paid \$140,000 of cash operating expenses.

**Required**

- a. Record each of these events in a horizontal statements model like the following one. In the Cash Flow column, indicate whether the item is an operating activity (OA), investing activity (IA), or financing activity (FA). Use NA to indicate that an element is not affected by the event.

Assets = Liab. +					Equity			Rev. - Exp. = Net Inc.	Cash Flow
Pfd. Stk. +		Com. Stk. +	PIC in Excess PS +	PIC in Excess CS +	Ret. Earn.				

- b. Prepare the stockholders' equity section of the balance sheet at the end of 2012.

**LO 4, 7**



**CHECK FIGURES**

- a. Par value per share: \$10
- b. Dividend per share: \$.60

**Problem 8-22 Analyzing the stockholders' equity section of the balance sheet**

The stockholders' equity section of the balance sheet for Brawner Company at December 31, 2012, is as follows:

Paid-in capital		
Preferred stock, ? par value, 6% cumulative, 50,000 shares authorized, 30,000 shares issued and outstanding	\$300,000	
Common stock, \$10 stated value, 150,000 shares authorized, 50,000 shares issued and ? outstanding	500,000	
Paid-in capital in excess of par—Preferred	30,000	
Paid-in capital in excess of stated value—Common	<u>200,000</u>	
Total paid-in capital		\$1,030,000
Retained earnings		250,000
Treasury stock, 1,000 shares		<u>(100,000)</u>
Total stockholders' equity		<u>\$1,180,000</u>

*Note:* The market value per share of the common stock is \$25, and the market value per share of the preferred stock is \$12.

**Required**

- a. What is the par value per share of the preferred stock?
- b. What is the dividend per share on the preferred stock?
- c. What is the number of common stock shares outstanding?
- d. What was the average issue price per share (price for which the stock was issued) of the common stock?
- e. Explain the difference between the average issue price and the market price of the common stock.
- f. If Brawner declared a 2-for-1 stock split on the common stock, how many shares would be outstanding after the split? What amount would be transferred from the retained earnings account because of the stock split? Theoretically, what would be the market price of the common stock immediately after the stock split?

**Problem 8-23** *Different forms of business organization***LO 1**

Shawn Bates was working to establish a business enterprise with four of his wealthy friends. Each of the five individuals would receive a 20 percent ownership interest in the company. A primary goal of establishing the enterprise was to minimize the amount of income taxes paid. Assume that the five investors are taxed at the rate of 15% on dividend income and 30% on all other income and that the corporate tax rate is 30 percent. Also assume that the new company is expected to earn \$400,000 of cash income before taxes during its first year of operation. All earnings are expected to be immediately distributed to the owners.

**Required**

Calculate the amount of after-tax cash flow available to each investor if the business is established as a partnership versus a corporation. Write a memo explaining the advantages and disadvantages of these two forms of business organization. Explain why a limited liability company may be a better choice than either a partnership or a corporation.

**Problem 8-24** *Effects of equity transactions on financial statements***LO 4-8**

The following events were experienced by Abbot Inc.:

1. Issued cumulative preferred stock for cash.
2. Issued common stock for cash.
3. Distributed a 2-for-1 stock split on the common stock.
4. Issued noncumulative preferred stock for cash.
5. Appropriated retained earnings.
6. Sold treasury stock for an amount of cash that was more than the cost of the treasury stock.
7. Distributed a stock dividend.
8. Paid cash to purchase treasury stock.
9. Declared a cash dividend.
10. Paid the cash dividend declared in Event 9.

**Required**

Show the effect of each event on the elements of the financial statements using a horizontal statements model like the following one. Use + for increase, – for decrease, and NA for not affected. In the Cash Flow column, indicate whether the item is an operating activity (OA), investing activity (IA), or financing activity (FA). The first transaction is entered as an example.

Event No.	Assets	=	Liab.	+	Equity	Rev.	–	Exp.	=	Net Inc.	Cash Flow
1	+		NA		+	NA		NA		NA	+ FA

**ANALYZE, THINK, COMMUNICATE****ATC 8-1 Business Applications Case** *Understanding real-world annual reports*

Use the [Target Corporation](#)'s annual report in Appendix B to answer the following questions.

Target Corporation

**Required**

- a. What is the par value per share of Target's stock?
- b. How many shares of Target's common stock were *outstanding* as of January 31, 2010?
- c. Target's annual report provides some details about the company's executive officers. How many are identified? What is their minimum, maximum, and average age? How many are females?
- d. Target's balance sheet does not show a balance for treasury stock. Does this mean the company has not repurchased any of its own stock? Explain.



### ATC 8-2 Group Assignment *Missing information*

Listed here are the stockholders' equity sections of three public companies for years ending in 2008 and 2007:

	2008	2007
<b>Wendy's</b> (in thousands) (merger with Triare in 2008)		
Stockholders' equity		
Common stock, ?? stated value per share, authorized:		
1,500,000; 470,424 in 2008 and 93,576 in		
2007 shares issued, respectively	\$ 47,042	\$ 9,357
Capital in excess of stated value	2,752,987	291,122
Retained earnings	(357,541)	167,267
Acc. other comp. income (loss)	(43,253)	(2,098)
Treasury stock, at cost: 1,220 in 2008 and 841 in 2007	(15,944)	(16,774)
<b>Coca-Cola</b> (in millions)		
Stockholders' equity		
Common stock, ?? par value per share, authorized:		
5,600; issued: 3,519 shares in 2008 and 3,519 shares in 2007	880	880
Capital surplus	7,966	7,378
Reinvested earnings	38,513	36,235
Acc. other comp. inc. (loss)	(2,674)	(626)
Treasury stock, at cost: (1,207 shares in 2008; 1,201 shares in 2007)	(24,213)	(23,375)
<b>Harley-Davidson</b> (dollar amounts are presented in thousands)		
Stockholders' equity		
Common stock, ?? par value per share, authorized: 800,000,000, issued:		
335,653,577 in 2008 and 335,211,201 shares in 2007	3,357	3,352
Additional paid-in capital	846,796	812,224
Retained earnings	6,458,778	6,117,567
Acc. other comp. inc. (loss)	(522,526)	(137,258)
Treasury stock, at cost: 102,889,370 for 2008 and 96,725,399 for 2007	(4,670,802)	(4,420,394)

#### Required

- Divide the class in three sections and divide each section into groups of three to five students. Assign each section one of the companies.

#### Group Tasks

Based on the company assigned to your group, answer the following questions.

- What is the per share par or stated value of the common stock in 2008?
- What was the average issue price of the common stock for each year?
- How many shares of stock are outstanding at the end of each year?
- What is the average cost per share of the treasury stock for 2008?
- Do the data suggest that your company was profitable in 2008?
- Can you determine the amount of net income from the information given? What is missing?
- What is the total stockholders' equity of your company for each year?

#### Class Discussion

- Have each group select a representative to present the information about its company. Compare the share issue price and the par or stated value of the companies.
- Compare the average issue price to the current market price for each of the companies. Speculate about what might cause the difference.

### ATC 8-3 Research Assignment *Analyzing PepsiCo's equity structure*

Using either **Big Lots, Inc.** most current Form 10-K or the company's annual report, answer the questions below. To obtain the Form 10-K use either the EDGAR system following the instructions in Appendix A or the company's website. The company's annual report is available on its website.

#### Required

- What is the *book value* of Big Lots' stockholders' equity that is shown on the company's balance sheet?



- b. What is the par value of Big Lots' common stock?
- c. Does Big Lots have any treasury stock? If so, how many shares of treasury stock does the company hold?
- d. Why does the stock of a company such as a Big Lots have a market value that is higher than its book value?

#### ATC 8-4 Writing Assignment *Comparison of organizational forms*

Jim Baku and Scott Hanson are thinking about opening a new restaurant. Baku has extensive marketing experience but does not know that much about food preparation. However, Hanson is an excellent chef. Both will work in the business, but Baku will provide most of the funds necessary to start the business. At this time, they cannot decide whether to operate the business as a partnership or a corporation.



##### Required

Prepare a written memo to Baku and Hanson describing the advantages and disadvantages of each organizational form. Also, from the limited information provided, recommend the organizational form you think they should use.

#### ATC 8-5 Ethical Dilemma *Bad news versus very bad news*

Louise Stinson, the chief financial officer of Bostonian Corporation, was on her way to the president's office. She was carrying the latest round of bad news. There would be no executive bonuses this year. Corporate profits were down. Indeed, if the latest projections held true, the company would report a small loss on the year-end income statement. Executive bonuses were tied to corporate profits. The executive compensation plan provided for 10 percent of net earnings to be set aside for bonuses. No profits meant no bonuses. While things looked bleak, Stinson had a plan that might help soften the blow.



After informing the company president of the earnings forecast, Stinson made the following suggestion: Because the company was going to report a loss anyway, why not report a big loss? She reasoned that the directors and stockholders would not be much more angry if the company reported a large loss than if it reported a small one. There were several questionable assets that could be written down in the current year. This would increase the current year's loss but would reduce expenses in subsequent accounting periods. For example, the company was carrying damaged inventory that was estimated to have a value of \$2,500,000. If this estimate were revised to \$500,000, the company would have to recognize a \$2,000,000 loss in the current year. However, next year when the goods were sold, the expense for cost of goods sold would be \$2,000,000 less and profits would be higher by that amount. Although the directors would be angry this year, they would certainly be happy next year. The strategy would also have the benefit of adding \$200,000 to next year's executive bonus pool ( $\$2,000,000 \times 0.10$ ). Furthermore, it could not hurt this year's bonus pool because there would be no pool this year because the company is going to report a loss.

Some of the other items that Stinson is considering include (1) converting from straight-line to accelerated depreciation, (2) increasing the percentage of receivables estimated to be uncollectible in the current year and lowering the percentage in the following year, and (3) raising the percentage of estimated warranty claims in the current period and lowering it in the following period. Finally, Stinson notes that two of the company's department stores have been experiencing losses. The company could sell these stores this year and thereby improve earnings next year. Stinson admits that the sale would result in significant losses this year, but she smiles as she thinks of next year's bonus check.

##### Required

- a. Explain how each of the three numbered strategies for increasing the amount of the current year's loss would affect the stockholders' equity section of the balance sheet in the current year. How would the other elements of the balance sheet be affected?
- b. If Stinson's strategy were effectively implemented, how would it affect the stockholders' equity in subsequent accounting periods?
- c. Comment on the ethical implications of running the company for the sake of management (maximization of bonuses) versus the maximization of return to stockholders.
- d. Formulate a bonus plan that will motivate managers to maximize the value of the firm instead of motivating them to manipulate the reporting process.
- e. How would Stinson's strategy of overstating the amount of the reported loss in the current year affect the company's current P/E ratio?