

SOLE PROPRIETORSHIPS, PARTNERSHIPS, AND CORPORATIONS



THE NAVIGATOR ✓

- Understand *Concepts for Review*

- Read *Feature Story*

- Scan *Study Objectives*

- Read *Preview*

- Read text and answer *Before You Go On*
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- Work *Demonstration Problem*

- Review *Summary of Study Objectives*

- Complete *Assignments*

CONCEPTS FOR REVIEW

Before studying this chapter, you should know or, if necessary, review:

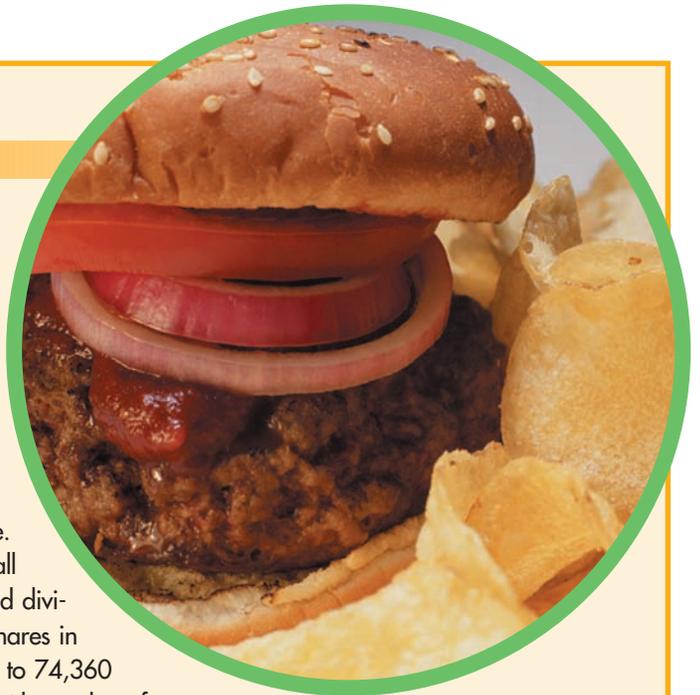
- a. The content of the stockholders' equity section of a balance sheet. (Ch. 5, pp. 157–158)
- b. How to prepare closing entries for a corporation. (Ch. 5, pp. 144–148)
- c. The difference between paid-in capital and retained earnings. (Ch. 1, p. 12)

F E A T U R E S T O R Y

“Two All Beef Patties, Special Sauce, Lettuce, Cheese, Pickles, Onions on a Sesame Seed Bun”

Many people know this saying too well and can even say it with a rhythm. It all started with a true salesman, Raymond Albert Kroc. Ray Kroc’s entrepreneurial zeal, combined with an almost evangelical ability to motivate nearly everyone he touched, enabled him to build the largest and most successful restaurant franchise company in the world. Ray didn’t promise franchisees success. Instead, he offered the opportunity to achieve it. Ray’s fair and balanced franchise partnership is said to be his greatest legacy. To underscore his own commitment to “taking the hamburger business more seriously than anyone else,” he established Hamburger University. By so doing, he confirmed his willingness to invest in the training and education of McDonald’s people and thereby accentuated his franchising commitment.

As a corporation, **McDonald’s** went to Wall Street in 1965, selling stocks in round lots of 100 shares at \$2,250, or \$22.50 per share. If one calculates all the stock splits and dividends, the 100 shares in 1965 had grown to 74,360 shares in 1998, with a value of over \$2.8 million. In 1985, McDonald’s was added to one of the 30 companies whose share prices make up the formula to derive the Dow Jones Industrial Average. Ray’s operating credo of “Quality, Service, Cleanliness and Value” became the mantra for all McDonald’s owners and established a permanent benchmark for the entire foodservice and food processing industries and, by extension, all service industry components. His exacting mandates for uniformity and product consistency made it possible for a customer to get a Big Mac and french fries in Houston, Texas, or Moscow, Russia. In fact, the Golden Arches are said to be the second



most widely recognized trademark in the world. Ray’s company changed the dining lifestyle of an entire society in less than one generation. Consequently, 96 percent of all Americans have eaten at a McDonald’s restaurant on at least one occasion, and an average McDonald’s restaurant brings in \$1.6 million in sales per year in the United States. To improve sales in the international units, McDonald’s has ongoing initiatives to include more local flavor in its menu options.

SOURCES: www.mcdonalds.com/corporate/info/history and www.hrm.uh.edu/?PageID=191

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STUDY OBJECTIVES

After studying this chapter, you should be able to

1. Identify the major characteristics of a sole proprietorship.
2. Identify the major characteristics of a partnership.
3. Explain the accounting entries for the formation of a partnership.
4. Identify the bases for dividing net income or net loss.
5. Identify the major characteristics of a corporation.
6. Record the issuance of common stock.
7. Explain the accounting for treasury stock.

Continued

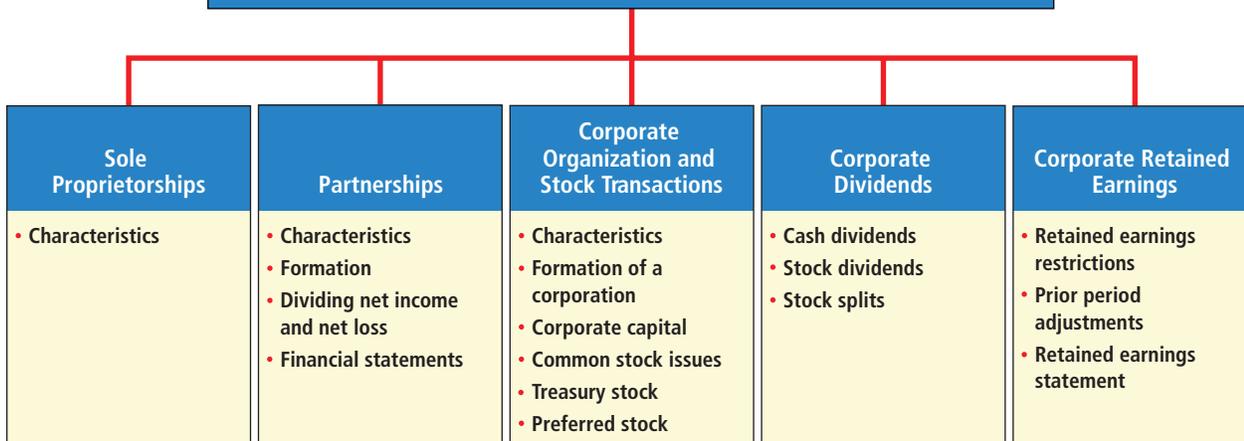
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PREVIEW OF CHAPTER 14

At some time in your hospitality career, you might want to open your own restaurant, build your own bed-and-breakfast, or purchase a franchise hotel. How should you structure or organize your business? Small businesses mostly start as sole proprietorships. Some business people get together with friends or business partners and pull resources together to form a partnership. In contrast, corporations like **Hilton**, **Disney**, and **Marriott** have substantial resources. In fact, the corporation is the dominant form of business organization in the United States in terms of dollar volume of sales and earnings and number of employees. All of the 500 largest companies in the United States are corporations. In this chapter we will explain the essential features of a proprietorship, a partnership, and a corporation and will look at the accounting for both forms of business organizations.

The content and organization of Chapter 14 are as follows:

SOLE PROPRIETORSHIPS, PARTNERSHIPS, AND CORPORATIONS



STUDY OBJECTIVES (CONTINUED)

- Differentiate preferred stock from common stock.
- Prepare the entries for cash dividends and stock dividends.
- Identify the items that are reported in a retained earnings statement.

SOLE PROPRIETORSHIPS

STUDY OBJECTIVE 1

Identify the major characteristics of a sole proprietorship.

The simplest form of business organization is **sole proprietorship**. For entrepreneurs in the hospitality business who want to own their own business, this is the easiest way to begin. A sole proprietorship is formed by a single individual and owned by this same person. This individual will register as “doing business as” with the proper authority and can begin. Thus one of characteristics of a sole proprietorship is the *ease of formation*. In addition, since it is owned by one person, the decision-making process is less complex, affording the business with *flexibility*. Moreover, when profits are reaped, the single owner will *retain all the money*.

However, a sole proprietorship also has some risky characteristics. Since it is owned by one person, should there be a loss in the business, this one person will have to ab-

sorb all the loss. Legally, there is also *unlimited liability*. Thus the creditors can seize the owner's personal belongings to pay the bills. Another negative characteristic is that it is often *difficult to raise funds* through one person's collateral. Therefore, many hospitality businesses are formed as partnerships or, more often, corporations.

PARTNERSHIPS

The Uniform Partnership Act provides the basic rules for the formation and operation of partnerships in more than 90 percent of the states. This act defines a **partnership** as “an association of two or more persons to carry on as co-owners of a business for profit.” The partnership form of business organization is not restricted to any particular type of business, but it is most often used in relatively small companies and in professional fields, as mentioned earlier.

Illustration 14-1 shows principal characteristics of the partnership form of business organization.



STUDY OBJECTIVE 2

Identify the major characteristics of a partnership.

Illustration 14-1

Partnership characteristics

ASSOCIATION OF INDIVIDUALS

A partnership is a voluntary association of two or more individuals based on a legally binding contract, which may be written, oral, or implied. Under the Uniform Partnership Act, a partnership is considered a legal entity for certain purposes. For instance, property (land, buildings, equipment) can be owned in the name of the partnership, and the firm can sue or be sued. **A partnership also represents an accounting entity for financial reporting purposes.** Thus the purely personal assets, liabilities, and personal transactions of the partners are excluded from the accounting records of the partnership, just as they are in a proprietorship. In addition, the net income of a partnership is not taxed as a separate entity. However, a partnership is required to file an information tax return showing partnership net income and each partner's share of the net income. Each partner's share is taxable, regardless of the amount of net income withdrawn from the business during the year.

MUTUAL AGENCY

Each partner acts on behalf of the partnership when engaging in partnership business. The act of any partner is binding on all other partners, even when partners act beyond the scope of their authority, as long as the act appears to be appropriate for the partnership. For example, a partner of a catering company who purchases a delivery truck creates a binding contract in the name of the partnership, even if the

partnership agreement denies this authority. In contrast, if a partner in a catering company purchased a snowmobile for the partnership, such an act would not be binding on the partnership because it is clearly outside the scope of partnership business.

LIMITED LIFE

A partnership does not have unlimited life. Its continuance as a going concern rests in the partnership contract. As long as existing partners are willing to be bound by the contract, the maximum life of a partnership is equal to the life of any one of its partners. A partnership may be ended voluntarily at any time through the acceptance of a new partner into the firm or the withdrawal of a partner. A partnership may be ended involuntarily by the death or incapacity of a partner. In short, any change in the number of partners, regardless of the cause, effects the **dissolution** of the partnership. Thus the life of a partnership is unpredictable.

UNLIMITED LIABILITY

Each partner is personally and individually liable for all partnership liabilities. Creditors' claims attach first to partnership assets and then to the personal resources of any partner, irrespective of that partner's capital equity in the company. To illustrate, assume that (1) the Rowe-Sanchez partnership is terminated when the claims of company creditors exceed partnership assets by \$30,000 and (2) L. Rowe's personal assets total \$40,000 but B. Sanchez has no personal assets. Creditors can collect their total claims from Rowe regardless of Rowe's capital balance in the firm, even though Sanchez and Rowe may be equal partners. Rowe, in turn, has a legal claim on Sanchez, but this would be worthless under the conditions described. Some states allow **limited partnerships**, in which the liability of a partner is limited to the partner's capital equity. However, there must always be at least one partner with unlimited liability, often referred to as the **general partner**.

CO-OWNERSHIP OF PROPERTY

Partnership assets are co-owned by the partners. Once assets have been invested in the partnership, they are owned jointly by all the partners. Moreover, if the partnership is terminated, the assets do not legally revert to the original contributor. Each partner has a claim on total assets equal to the balance in his or her respective capital account, but this claim does not attach to specific assets that an individual partner may have contributed to the firm.

Similarly, if a partner invests a \$100,000 building in the partnership, and the building is sold later at a gain of \$20,000, that partner does not personally receive the entire gain. Partnership net income (or net loss) is also co-owned; if the partnership agreement does not specify to the contrary, all net income or net loss is shared equally by the partners. As you will see later, however, the partnership agreement may provide for unequal sharing of net income or net loss.

ADVANTAGES AND DISADVANTAGES OF A PARTNERSHIP

What are the major advantages and disadvantages of a partnership? One major advantage is that the **skills and resources of two or more individuals** can be combined. For example, a large public accounting firm such as **PricewaterhouseCoopers** must have combined expertise in auditing, taxation, and management consulting, not to mention specialists within each of these areas. In addition, a partnership does not have to contend with the "red tape" that a corporation must face; that is, a partnership is easily formed and is relatively free from governmental regulations and restrictions. Decisions can be made quickly on substantive matters affecting the firm, whereas in a corporation, formal meetings with the board of directors are often needed.

On the other hand, the major disadvantages of a partnership are mutual agency, limited life, and unlimited liability. Unlimited liability is particularly troublesome to many individuals, because they may lose not only their initial investment but

also their personal assets, if they are needed to pay partnership creditors. As a result, it is often difficult to obtain large amounts of investment capital in a partnership. That is one reason why the largest business enterprises in the United States are corporations, not partnerships.

The advantages and disadvantages of the partnership form of business organization are summarized in Illustration 14-2.

Advantages	Disadvantages
Combining skills and resources of two or more individuals	Mutual agency
Ease of formation	Limited life
Freedom from government regulations and restrictions	Unlimited liability
Ease of decision making	

Illustration 14-2

Advantages and disadvantages of a partnership

THE PARTNERSHIP AGREEMENT

A partnership is created by a contract expressing the voluntary agreement of two or more individuals. The written partnership agreement, often referred to as the partnership agreement or **articles of co-partnership**, contains such basic information as the name and principal location of the firm, the purpose of the business, and date of inception. In addition, different relationships that will exist among the partners, such as the following, should be specified:

- Names and capital contributions of partners
- Rights and duties of partners
- Basis for sharing net income or net loss
- Provision for withdrawals of income
- Procedures for submitting disputes to arbitration
- Procedures for the withdrawal or addition of a partner
- Rights and duties of surviving partners in the event of a partner's death

The importance of a written contract cannot be overemphasized. The agreement should be drawn with care and should attempt to anticipate all possible situations, contingencies, and disagreements. The help of a lawyer is highly desirable in preparing the agreement. A poorly drawn contract may create friction among the partners and eventually cause the termination of the partnership.

FORMATION OF A PARTNERSHIP

Each partner's initial investment in a partnership should be recorded at the fair market value of the assets at the date of their transfer to the partnership. The values assigned must be agreed to by all of the partners.

To illustrate, assume that A. Rolfe and T. Shea combine their proprietorships to start a partnership named U.S. Pizza. Rolfe and Shea invest in the partnership as shown in Illustration 14-3.

	Book Value		Market Value	
	A. Rolfe	T. Shea	A. Rolfe	T. Shea
Cash	\$ 8,000	\$ 9,000	\$ 8,000	\$ 9,000
Equipment	5,000		4,000	
Accumulated depreciation	(2,000)			
Accounts receivable		4,000		4,000
Allowance for doubtful accounts		(700)		(1,000)
	\$11,000	\$12,300	\$12,000	\$12,000

STUDY OBJECTIVE 3

Explain the accounting entries for the formation of a partnership.

Illustration 14-3

Book and market value of assets invested

The entries to record the investments are

<u>Investment of A. Rolfe</u>		
Cash	8,000	
Equipment	4,000	
A. Rolfe, Capital		12,000
(To record investment of Rolfe)		
<u>Investment of T. Shea</u>		
Cash	9,000	
Accounts Receivable	4,000	
Allowance for Doubtful Accounts		1,000
T. Shea, Capital		12,000
(To record investment of Shea)		

Note that neither the original cost of the equipment (\$5,000) nor its book value (\$5,000 – \$2,000) is recorded by the partnership. The equipment has not been used by the partnership, so there can be no accumulated depreciation. In contrast, the gross claims on customers (\$4,000) are carried forward to the partnership, and the allowance for doubtful accounts is adjusted to \$1,000 to arrive at a cash (net) realizable value of \$3,000. A partnership may start with an Allowance for Doubtful Accounts account because this balance pertains to existing accounts receivable that are expected to be uncollectible in the future. In addition, this procedure maintains the control and the subsidiary relationship between accounts receivable and the customers' ledger.

After the partnership has been formed, the accounting for its transactions is similar to accounting for transactions of any other type of business organization. For example, all transactions with outside parties, such as the purchase or sale of merchandise inventory and the payment or receipt of cash, should be recorded in the same manner for a partnership as for a proprietorship.

DIVISION OF NET INCOME OR NET LOSS

Partnership net income or net loss is shared equally unless the partnership contract specifically indicates the manner in which net income and net loss are to be divided. The same basis of division usually applies to both net income and net loss. As a result, it is customary to refer to the basis as the **income ratio**, the **income and loss ratio**, or the **profit and loss ratio**. Because of its wide acceptance, we will use the term income ratio to identify the basis for dividing both net income and net loss. A partner's share of net income or net loss is recognized in the accounts through closing entries.

Closing Entries

You may recall from Chapter 5 that four closing entries are needed during the closing process. The first two entries close revenues and expenses to Income Summary; the latter two entries transfer the balance in Income Summary to the partners' capital accounts and close their drawing accounts to their capital accounts.

To refresh your memory concerning the closing entries for a partnership, assume that L. Arbor and D. Barnett share net income and net loss equally. After closing all revenue and expense accounts, there is a credit balance in Income Summary of \$32,000, which is the net income for the period. The entry to close this balance to the respective capital accounts is as follows:

Income Summary	32,000	
L. Arbor, Capital		16,000
D. Barnett, Capital		16,000
(To close net income to partners' capitals)		

STUDY OBJECTIVE 4

Identify the bases for dividing net income or net loss.

If Arbor and Barnett have balances in their drawing accounts of \$8,000 and \$6,000, respectively, the entry to close these accounts looks like this:

L. Arbor, Capital	8,000	
D. Barnett, Capital	6,000	
L. Arbor, Drawing		8,000
D. Barnett, Drawing		6,000
(To close partners' drawings)		

Assuming the beginning capital balance is \$47,000 for Arbor and \$36,000 for Barnett, the following capital and drawing accounts (Illustration 14-4) will appear in the general ledger.

L. Arbor, Capital				D. Barnett, Capital			
Drawing	8,000	Beg. Bal.	47,000	Drawing	6,000	Beg. Bal.	36,000
		Net income	16,000			Net income	16,000
		End Bal.	55,000			End Bal.	46,000
L. Arbor, Drawing				D. Barnett, Drawing			
End Bal.	<u>8,000</u>	To Capital	<u>8,000</u>	End Bal.	<u>6,000</u>	To Capital	<u>6,000</u>

Illustration 14-4

Ledger balances after closing

The capital accounts indicate each partner's "permanent" investment, whereas the partners' drawing accounts are temporary owners' equity accounts. Normally, the capital accounts will have credit balances, whereas the drawing accounts will have debit balances. The drawing account is commonly debited in situations where cash or other assets are withdrawn by the partner for personal use. For example, the partnership contract may permit each partner to withdraw cash monthly for personal living expenses.

Income Ratios

As indicated earlier, the partnership agreement should specify the basis for sharing net income or net loss. The following are typical of the ratios that may be used:

- A fixed ratio, expressed as a proportion (6:4), a percentage (70 percent and 30 percent), or a fraction ($2/3$ and $1/3$)
- A ratio based either on capital balances at the beginning of the year or on average capital balances during the year
- Salaries to partners and the remainder on a fixed ratio
- Interest on partners' capitals and the remainder on a fixed ratio
- Salaries to partners, interest on partners' capitals, and the remainder on a fixed ratio

The objective is to reach agreement on a basis that will equitably reflect the differences among partners in terms of their capital investment and service to the partnership.

A fixed ratio is easy to apply, and it may be an equitable basis in some circumstances. Assume, for example, that Hughes and Lane are partners. Each contributes the same amount of capital; but Hughes expects to work full-time in the partnership, and Lane expects to work only half-time. Accordingly, the partners agree to a fixed ratio of $2/3$ to Hughes and $1/3$ to Lane.

A ratio based on capital balances may be appropriate when the funds invested in the partnership are considered the critical factor. This might be true when the

partners expect to give equal service to the partnership. Capital balances may also be equitable when a manager is hired to run the business and the partners do not plan to take an active role in daily operations.

The three remaining ratios give specific recognition to differences that may exist among partners by providing salary allowances for time worked and interest allowances for capital invested. Then, any remaining net income or net loss is allocated on a fixed ratio. Some caution needs to be exercised in working with these types of income ratios. These ratios pertain exclusively to the computations that are required in dividing net income or net loss. **Salaries to partners and interest on partners' capitals are not expenses of the partnership.** Therefore, these items do not enter into the matching of expenses with revenues and the determination of net income or net loss. For a partnership, as well as for other entities, salaries expense pertains to the cost of services performed by employees, and interest expense relates to the cost of borrowing money from creditors. Partners in their ownership capacity are not considered either employees or creditors. When the income ratio includes a salary allowance for partners, some partnership agreements permit the partner to make monthly withdrawals of cash based on their "salary." In such cases, the withdrawals are debited to the partner's drawing account.

Salaries, Interest, and Remainder on a Fixed Ratio

Under this income ratio the provisions for salaries and interest must be applied before the remainder is allocated on the specified fixed ratio. This is true even if the provisions exceed net income or if the partnership has suffered a net loss for the year. Detailed information concerning the division of net income or net loss should be shown at the bottom of the income statement.

To illustrate this income ratio, we will assume that Sara King and Ray Lee are co-partners in Kingslee Pizza. The partnership agreement provides for (1) salary allowances of \$8,400 to King and \$6,000 to Lee, (2) interest allowances of 10 percent on capital balances at the beginning of the year, and (3) the remainder equally. Capital balances on January 1 were King, \$28,000, and Lee, \$24,000. In 2008, partnership net income was \$22,000. The division of net income is as shown in Illustration 14-5.

Illustration 14-5

Income statement with
division of net income

KINGSLEE PIZZA			
Income Statement			
For the Year Ended December 31, 2008			
Sales			\$200,000
Net income			<u>\$ 22,000</u>
	<u>Division of Net Income</u>		
	Sara King	Ray Lee	Total
Salary allowance	\$ 8,400	\$6,000	\$14,400
Interest allowance			
Sara King ($\$28,000 \times 10\%$)	2,800		
Ray Lee ($\$24,000 \times 10\%$)		2,400	
Total interest			<u>5,200</u>
Total salaries and interest	11,200	8,400	19,600
Remaining income, \$2,400			
Sara King ($\$2,400 \times 50\%$)	1,200		
Ray Lee ($\$2,400 \times 50\%$)		1,200	
Total remainder			<u>2,400</u>
Total division	<u>\$12,400</u>	<u>\$9,600</u>	<u>\$22,000</u>

The entry to record the division of net income looks like this:

Dec. 31	Income Summary	22,000	
	Sara King, Capital		12,400
	Ray Lee, Capital		9,600
	(To close net income to partners' capitals)		

To illustrate a situation in which the salary and interest allowances exceed net income, we will assume that net income in Kingslee Pizza was only \$18,000. In this case, the allowances will create a deficiency of \$1,600 (\$19,600 – \$18,000). Since the computations of the salary and interest allowances are the same as those shown in Illustration 14-5, we will begin the division of net income with total salaries and interest as shown in Illustration 14-6.

	Sara King	Ray Lee	Total
Total salaries and interest	\$11,200	\$8,400	\$19,600
Remaining deficiency (\$1,600)			
Sara King (\$1,600 × 50%)	(800)		
Ray Lee (\$1,600 × 50%)		(800)	
Total remainder			(1,600)
Total division	<u>\$10,400</u>	<u>\$7,600</u>	<u>\$18,000</u>

Illustration 14-6

Division of net income—
income deficiency

PARTNERSHIP FINANCIAL STATEMENTS

The financial statements of a partnership are similar to those of a proprietorship. The differences are generally related to the fact that a number of owners are involved in a partnership. In a balance sheet, for instance, each partner's capital balance is reported. The income statement for a partnership is identical to the income statement for a proprietorship, except for the division of net income, as shown earlier.

The owner's equity statement for a partnership is called **partners' capital statement**. Its function is to explain the changes in each partner's capital account and in total partnership capital during the year. As in a proprietorship, changes in capital may result from three causes: (1) additional capital investment, (2) drawings, and (3) net income or net loss.

The partners' capital statement for Kingslee Pizza shown in Illustration 14-7 is based on the division of \$22,000 of net income. The statement includes assumed data for the additional investment and for drawings.

KINGSLEE PIZZA			
Partners' Capital Statement			
For the Year Ended December 31, 2008			
	Sara King	Ray Lee	Total
Capital, January 1	\$28,000	\$24,000	\$52,000
Add: Additional investment	2,000		2,000
Net income	<u>12,400</u>	<u>9,600</u>	<u>22,000</u>
	42,400	33,600	76,000
Less: Drawings	<u>7,000</u>	<u>5,000</u>	<u>12,000</u>
Capital, December 31	<u>\$35,400</u>	<u>\$28,600</u>	<u>\$64,000</u>

Illustration 14-7

Partners' capital statement

The capital statement is prepared from the income statement and the partners' capital and drawing accounts.

THE CORPORATE FORM OF ORGANIZATION AND STOCK TRANSACTIONS

In 1819, Chief Justice John Marshall defined a **corporation** as “an artificial being, invisible, intangible, and existing only in contemplation of law.” This definition is the foundation for the prevailing legal interpretation that a corporation is an entity separate and distinct from its owners.

A corporation is created by law, and its continued existence depends on the statutes of the state in which it is incorporated. As a legal entity, a corporation has most of the rights and privileges of a person. The major exceptions relate to privileges that only a living person can exercise, such as the right to vote or to hold public office. A corporation is subject to the same duties and responsibilities as a person. For example, it must abide by the laws, and it must pay taxes.

Corporations may be classified in a variety of ways. Two common bases are by purpose and by ownership. A corporation may be organized for the purpose of making a **profit**, or it may be **nonprofit**. Corporations for profit include such well-known companies as **McDonald’s**, **Darden**, **Landry’s**, **Hilton**, **Starwood**, and **Marriott**. Nonprofit corporations are organized for charitable, medical, or educational purposes. Examples are the **Salvation Army**, the **American Cancer Society**, the **Hilton Foundation**, and the **Forte Foundation**.

Classification by *ownership* distinguishes between publicly held and privately held corporations. A **publicly held corporation** may have thousands of stockholders. Its stock is regularly traded on a national securities exchange, such as the New York Stock Exchange. Most of the largest U.S. corporations are publicly held. Examples of publicly held hospitality corporations are **Starwood**, **Hilton**, **Marriott**, **Disney**, **Darden**, and **Landry’s**. In contrast, a **privately held corporation**, often referred to as a *closely held corporation*, usually has only a few stockholders and does not offer its stock for sale to the general public. Privately held companies are generally much smaller than publicly held companies, although some notable exceptions exist. **Hyatt Hotels** is one of the most well-known hotel companies in the United States that is privately held.

CHARACTERISTICS OF A CORPORATION

A number of characteristics distinguish a corporation from proprietorships and partnerships. The most important of these characteristics are explained here.

Separate Legal Existence

As an entity separate and distinct from its owners, the corporation acts under its own name rather than in the name of its stockholders. **Disney** may buy, own, and sell property. It may borrow money and may enter into legally binding contracts in its own name. It also may sue or be sued, and it pays its own taxes.

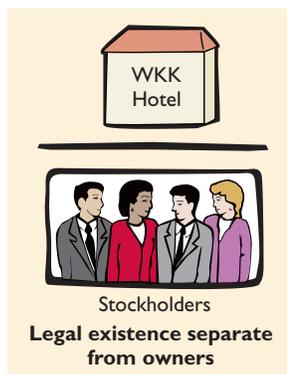
In contrast to a partnership, in which acts of the owners (partners) bind the partnership, the acts of its owners (stockholders) do not bind the corporation unless such owners are duly appointed agents of the corporation. For example, if you owned shares of Disney stock, you would not have the right to purchase a theme park for the company unless you were appointed as an agent of the corporation.

Limited Liability of Stockholders

Since a corporation is a separate legal entity, creditors have recourse only to corporate assets to satisfy their claims. The liability of stockholders is normally limited to their investment in the corporation. Creditors have no legal claim on the personal assets of the owners unless fraud has occurred. Even in the event of bankruptcy, stockholders’ losses are generally limited to their capital investment in the corporation.

STUDY OBJECTIVE 5

Identify the major characteristics of a corporation.



Transferable Ownership Rights

Ownership of a corporation is held in shares of capital stock. These are transferable units. Stockholders may dispose of part or all of their interest in a corporation simply by selling their stock. The transfer of an ownership interest in a partnership requires the consent of each owner. In contrast, the transfer of stock is entirely at the discretion of the stockholder. It does not require the approval of either the corporation or other stockholders.

The transfer of ownership rights between stockholders normally has no effect on the operating activities of the corporation. Nor does it affect the corporation's assets, liabilities, and total ownership equity. The transfer of these ownership rights is a transaction between individual owners. The enterprise does not participate in such transfers after it issues the capital stock.

Ability to Acquire Capital

It is relatively easy for a corporation to obtain capital through the issuance of stock. Buying stock in a corporation is often attractive to an investor because a stockholder has limited liability and shares of stock are readily transferable. Also, numerous individuals can become stockholders by investing small amounts of money. In sum, the ability of a successful corporation to obtain capital is virtually unlimited.

Continuous Life

The life of a corporation is stated in its charter. The life may be perpetual, or it may be limited to a specific number of years. If it is limited, the life can be extended through renewal of the charter. Since a corporation is a separate legal entity, its continuance as a going concern is not affected by the withdrawal, death, or incapacity of a stockholder, employee, or officer. As a result, a successful enterprise can have a continuous and perpetual life.

Corporation Management

As in **Marriott**, stockholders legally own the corporation. But they manage the corporation indirectly through a board of directors they elect. The board, in turn, formulates the operating policies for the company. The board also selects officers, such as a president and one or more vice presidents, to execute policy and to perform daily management functions.

A typical organization chart showing the delegation of responsibility is shown in Illustration 14-8 on page 422.

The **president** is the chief executive officer. This individual has direct responsibility for managing the business. As the organization chart shows, the president delegates responsibility to other officers. The chief accounting officer is the **controller**. The controller's responsibilities include (1) maintaining the accounting records; (2) maintaining an adequate system of internal control; and (3) preparing financial statements, tax returns, and internal reports. The **treasurer** has custody of the corporation's funds and is responsible for maintaining the company's cash position.

On one hand, the organizational structure of a corporation enables a company to hire professional managers to run the business. On the other hand, the separation of ownership and management prevents owners from having an active role in managing the company, which some owners like to have.

Government Regulations

A corporation is subject to numerous state and federal regulations. State laws usually prescribe the requirements for issuing stock, the distributions of earnings permitted to stockholders, and the effects of retiring stock. Federal securities laws govern the sale of capital stock to the general public. Also, most publicly held

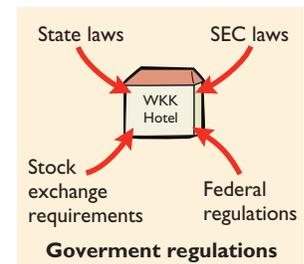
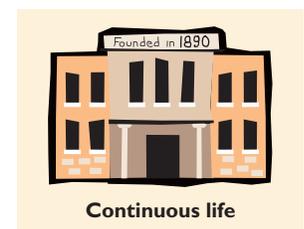
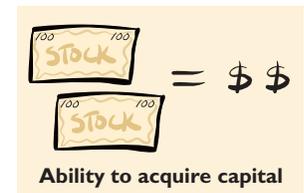
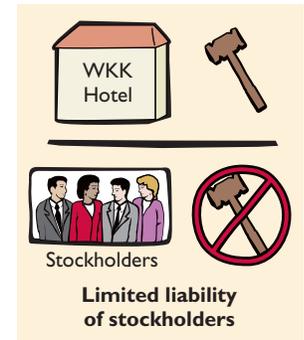
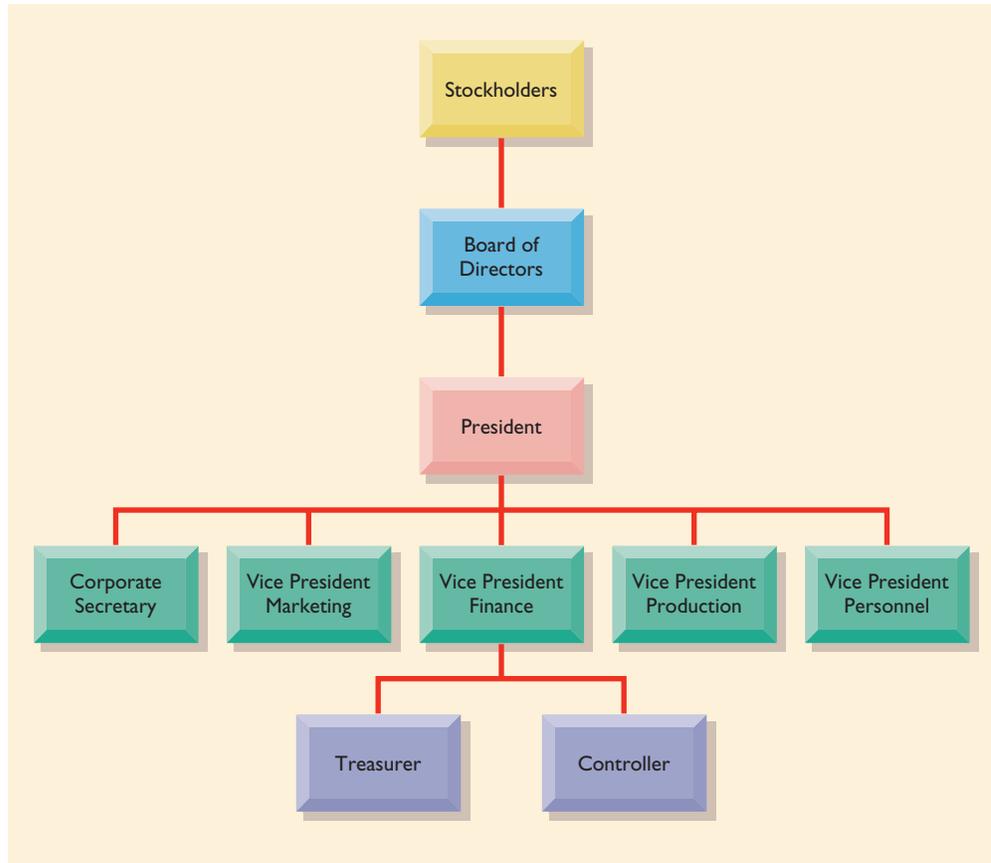


Illustration 14-8

Corporation organization chart

ETHICS NOTE
 Managers who are not owners are often compensated based on the performance of the firm. They thus may be tempted to exaggerate firm performance by inflating income figures.



ACCOUNTING IN ACTION  *Business Insight*



When a group of investors in a company is unhappy with a company’s performance, it sometimes tries to elect new members to the board of directors at the company’s annual stockholder meeting. This is referred to as a proxy fight. Usually these efforts fail because it has been very expensive to get in contact with all of the company’s shareholders to try to convince them to vote for your group of nominees.

But the Internet has changed that, says James Heard, chief executive of **Proxy Monitor**, a New York firm that consults institutional shareholders on how to vote on corporate governance issues. “Increasingly the Internet is being used as a tool of communication among shareholders to pressure managements,” he said. One recent case involved an effort by a shareholder at **Luby’s** to get four new people elected to that company’s board of directors. That shareholder attracted considerable support from other Luby’s shareholders by posting messages on a **Yahoo!** message board.

SOURCE: Aaron Elstein, “Online Grousing Over Luby’s Escalates to Proxy Solicitation,” *Wall Street Journal*, October 25, 2000.

corporations are required to make extensive disclosure of their financial affairs to the Securities and Exchange Commission (SEC) through quarterly and annual reports. In addition, when a corporate stock is traded on organized securities exchanges, the corporation must comply with the reporting requirements of these exchanges. Government regulations are designed to protect the owners of the corporation. Such protection is needed because most stockholders do not participate in the day-to-day management of the company.

ACCOUNTING IN ACTION *Ethics Perspective*

In the wake of **Enron's** collapse, the members of Enron's board of directors have been questioned and scrutinized to determine what they knew and when they knew it. A *Wall Street Journal* story reported that Enron's board contends it was "kept in the dark" by management and by Arthur Andersen—Enron's longtime auditors—and didn't learn about the company's troublesome accounting until October 2001. But the *Wall Street Journal* reported that according to outside attorneys, "directors on at least two occasions waived Enron's ethical code of conduct to approve partnership between Enron and its chief financial officer. Those partnership kept significant debt off of Enron's books and masked actual company finances."

Was Enron's board of directors fulfilling its role in a corporate organization when it waived Enron's ethical code on two occasions?

SOURCE: Carol Hymowitz, "Serving on a Board Now Means Less Talk, More Accountability," *Wall Street Journal Online*, January 29, 2002.

Additional Taxes

Neither proprietorships nor partnerships pay income taxes. The owner's share of earnings from these organizations is reported on his or her personal income tax return. Taxes are then paid by the individual on this amount. Corporations, on the other hand, must pay federal and state income taxes as a separate legal entity. These taxes are substantial: They can amount to more than 40 percent of taxable income.

In addition, stockholders are required to pay taxes on cash dividends (pro rata distributions of net income). Thus, many argue that corporate income is **taxed twice (double taxation)**, once at the corporate level and again at the individual level.

From the foregoing, we can identify the following advantages and disadvantages of a corporation compared to proprietorship or partnership (Illustration 14-9).



<u>Advantages</u>	<u>Disadvantages</u>
Separate legal existence	Corporation management—separation of ownership and management
Limited liability of stockholders	Government regulations
Transferable ownership rights	Additional taxes
Ability to acquire capital	
Continuous life	
Corporation management—professional managers	

Illustration 14-9

Advantages and disadvantages of a corporation

S-Corporation

As you can see, while the characteristics of a regular corporation provide more liability protection for the investors, it is not practical for small, individual entrepreneurs to really take advantage of forming a corporation. In order to encourage business development, the government does allow a category of corporation known as the sub-chapter S corporation under the Internal Revenue Services Code, more widely known as S-corp, for smaller investors. The one characteristic of an S-corp that is similar to that of a regular corporation is limited liability. However, there is no double-taxation. The earnings or losses are passed directly to the owners and are taxed at the owners' individual tax rates.

If an S-corp has these good characteristics, why do all corporations not become S-corp? As I mentioned, the aim of the government is to encourage small businesses to still form as businesses but not to bear some of the disadvantages of a sole proprietorship. To become an S-corp, a corporation must have fewer than thirty-five shareholders, be a domestic corporation, and have only one class of stocks. These are all set up to provide protection and encouragement for domestic small businesses.

ALTERNATIVE TERMINOLOGY

The charter is often referred to as the *articles of incorporation*.

INTERNATIONAL NOTE

U.S. corporations are identified by *Inc.*, which stands for Incorporated. In Italy, the letters used are *SpA* (*Societa per Azioni*); in Sweden, *AB* (*Aktiebolag*); in France, *SA* (*Sociedad Anonima*); and in the Netherlands, *NV* (*Naamloze Vennootschap*). In the United Kingdom, public limited corporations are identified by *PLC*, and private corporations are denoted by *Ltd.* (*Limited*). The parallel designations in Germany are *AG* for public corporations and *GmbH* for private corporations.

FORMING A CORPORATION

The initial step in forming a corporation is to file an application with the secretary of state in the state in which incorporation is desired. The application contains such information as (1) the name and purpose of the proposed corporation; (2) amounts, kinds, and number of shares of capital stock to be authorized; (3) the names of the incorporators; and (4) the shares of stock to which each has subscribed.

After the application is approved, a **charter** is granted. The charter may be an approved copy of the application form, or it may be a separate document containing the same basic data. The issuance of the charter creates the corporation. Upon receipt of the charter, the corporation develops its bylaws. The **bylaws** establish the internal rules and procedures for conducting the affairs of the corporation. They also indicate the powers of the stockholders, directors, and officers of the enterprise.¹

Regardless of the number of states in which a corporation has operating divisions, it is incorporated in only one state. It is to the company's advantage to incorporate in a state whose laws are favorable to the corporate form of business organization.

Corporations engaged in interstate commerce must also obtain a license from each state in which they do business. The license subjects the corporation's operating activities to the corporation laws of the state.

Costs incurred in the formation of a corporation are called **organization costs**. These costs include legal and state fees and promotional expenditures involved in the organization of the business. **Organization costs are expensed as incurred.** To determine the amount and the timing of future benefits is so difficult that a conservative approach of expensing these costs immediately is followed.

ACCOUNTING IN ACTION *Business Insight*

It is not necessary for a corporation to have an office in the state in which it incorporates. In fact, more than 50 percent of the Fortune 500 corporations are incorporated in Delaware. A primary reason is the Delaware courts' long-standing "business judgment rule." The rule provides that as long as directors exercise "due care" in the interests of stockholders, their actions will not be second-guessed by the courts. The rule has enabled directors to reject hostile takeover offers and to spurn takeovers simply because they did not want to sell the company. However, new interpretations are emerging. In a recent case, the state court ruled for a company that made a hostile takeover bid. On appeal, the Delaware Supreme Court ruled for the directors but gave the following guideline to the state courts: "Was the board's response reasonable in the light of the threat posed?"

CORPORATE CAPITAL

Owners' equity in a corporation is identified as **stockholders' equity, shareholders' equity, or corporate capital**. The stockholders' equity section of a corporation's balance sheet consists of (1) paid-in (contributed) capital and (2) retained earnings (earned capital). The distinction between paid-in capital and retained earnings is important from both a legal and a financial point of view. Legally, distributions of earnings (dividends) can be declared out of retained earnings in all states, but in many states dividends cannot be declared out of paid-in capital.

¹Following approval by two-thirds of the stockholders, the bylaws become binding on all stockholders, directors, and officers. Legally, a corporation is regulated first by the laws of the state, second by its charter, and third by its bylaws. Care must be exercised to ensure that the provisions of the bylaws are not in conflict with either state laws or the charter.

Financially, management, stockholders, and others look to earnings for the continued existence and growth of the corporation.

Ownership Rights of Stockholders

When chartered, the corporation may begin selling ownership rights in the form of shares of stock. When a corporation has only one class of stock, it is identified as **common stock**. Each share of common stock gives the stockholder the ownership rights pictured in Illustration 14-10. The ownership rights of a share of stock are stated in the articles of incorporation or in the bylaws.

Stockholders have the right to:

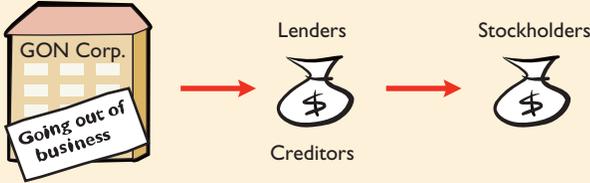
- Vote in the election of board of directors at the annual meeting and on actions that require stockholder approval.
 
- Share the corporate earnings through receipt of dividends.
 
- Keep same percentage ownership when new shares of stock are issued (**preemptive right**²).
 
- Share in assets upon liquidation, in proportion to their holdings; called a **residual claim** because owners are paid with assets remaining after all claims have been paid.
 

Illustration 14-10
Ownership rights of stockholders

ACCOUNTING IN ACTION *International Insight*



In Japan, stockholders are considered to be far less important to a corporation than employees, customers, and suppliers. There, stockholders are rarely asked to vote on an issue, and the notion of bending corporate policy to favor stockholders borders on the heretical. This attitude toward stockholders appears to be slowly changing, however, as influential Japanese are advocating listening to investors, raising the extremely low dividends paid by Japanese corporations, and improving disclosure of financial information.

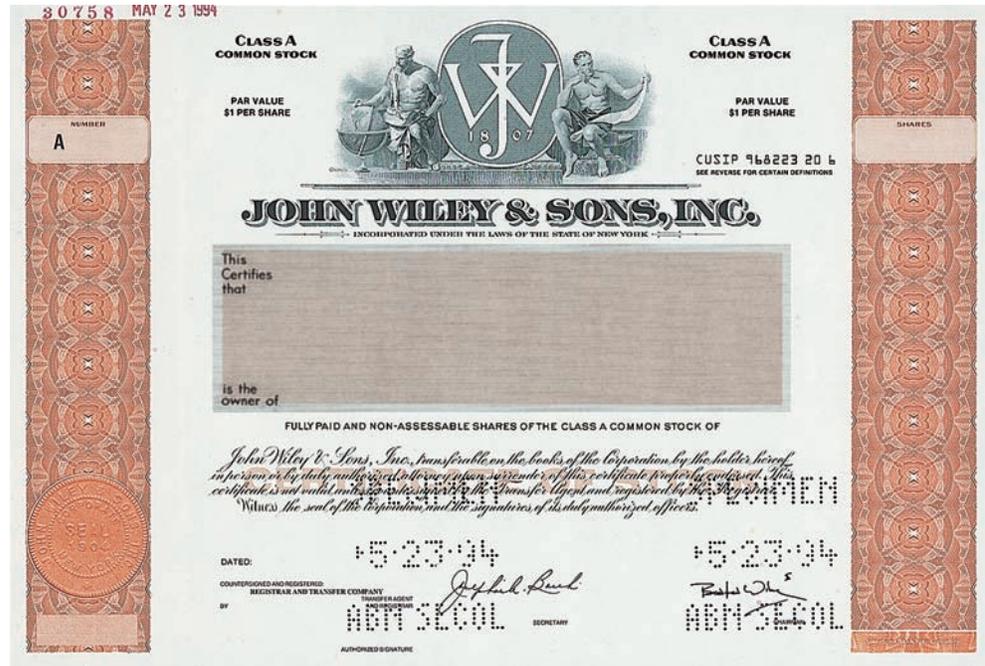


²Several companies have eliminated the preemptive right because they believe that it makes an unnecessary and cumbersome demand on management. For example, by stockholder approval, **IBM** has dropped its preemptive right for stockholders.

Proof of stock ownership is evidenced by a form known as a **stock certificate**. As shown in Illustration 14-11, the face of the certificate shows the name of the corporation, the stockholder's name, the class and special features of the stock, the number of shares owned, and the signatures of duly authorized corporate officials. Certificates are prenumbered to facilitate accountability. They may be issued for any quantity of shares.

Illustration 14-11

A stock certificate



BEFORE YOU GO ON...

REVIEW IT

1. What are the advantages and disadvantages of a corporation compared to a proprietorship and a partnership?
2. Identify the principal steps in forming a corporation.
3. What rights are inherent in owning a share of stock in a corporation?



INTERNATIONAL NOTE

U.S. and U.K. corporations raise most of their capital through millions of outside shareholders and bondholders. In contrast, companies in Germany, France, and Japan acquire financing from large banks or other institutions. In the latter environment, shareholders are less important, and external reporting and auditing receive less emphasis.

Stock Issue Considerations

In considering the issuance of stock, a corporation must resolve a number of basic questions: How many shares should be authorized for sale? How should the stock be issued? At what price should the shares be issued? What value should be assigned to the stock? These questions are answered in the following sections.

AUTHORIZED STOCK. The amount of stock that a corporation is *authorized* to sell is indicated in its charter. The total amount of **authorized stock** at the time of incorporation normally anticipates both initial and subsequent capital needs. As a result, the number of shares authorized generally exceeds the number initially sold. If all authorized stock is sold, a corporation must obtain consent of the state to amend its charter before it can issue additional shares.

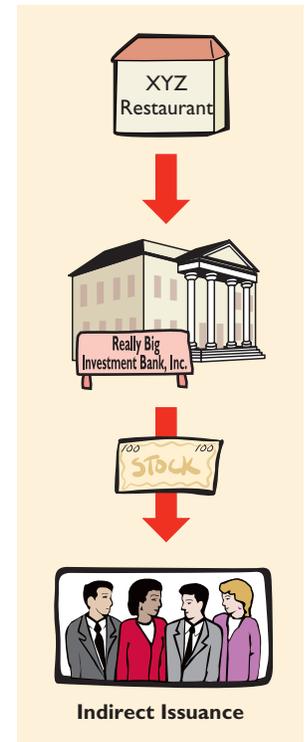
The authorization of capital stock does not result in a formal accounting entry. This event has no immediate effect on either corporate assets or stockholders' equity. But disclosure of the number of authorized shares is often reported in the stockholders' equity section. It is then simple to determine the number of unissued shares that can be issued without amending the charter: Subtract the total shares issued from the total authorized. For example, if Micro Hotel was authorized to sell 100,000 shares of common stock and issued 80,000 shares, 20,000 shares would remain unissued.

ISSUANCE OF STOCK. A corporation can issue common stock directly to investors. Or it can issue the stock indirectly through an investment banking firm (brokerage house) that specializes in bringing securities to the attention of prospective investors. Direct issue is typical in closely held companies. Indirect issue is customary for a publicly held corporation.

In an indirect issue, the investment banking firm may agree to **underwrite** the entire stock issue. In this arrangement, the investment banker buys the stock from the corporation at a stipulated price and resells the shares to investors. The corporation thus avoids any risk of being unable to sell the shares. Also, it obtains immediate use of the cash received from the underwriter. The investment banking firm, in turn, assumes the risk of reselling the shares in return for an underwriting fee.³ For example, **Bahama Resorts** used an underwriter to help it issue common stock to the public. The underwriter charged a 6.6 percent underwriting fee on Bahama's approximately \$20 million public offering.

How does a corporation set the price for a new issue of stock? Among the factors to be considered are (1) the company's anticipated future earnings, (2) its expected dividend rate per share, (3) its current financial position, (4) the current state of the economy, and (5) the current state of the securities market. The calculation can be complex and is properly the subject of a finance course.

MARKET VALUE OF STOCK. The stock of publicly held companies is traded on organized exchanges. The dollar prices per share are established by the interaction between buyers and sellers. In general, the prices set by the marketplace tend to



ACCOUNTING IN ACTION *Business Insight*



The volume of trading on national and international exchanges is heavy. Shares in excess of a billion are often traded daily on the New York Stock Exchange (NYSE) alone. For each listed stock, the *Wall Street Journal Online* reports the total volume of stock traded for a given day, the high and the low prices for the day (now in decimals), the closing market price, and the net change for the day. A recent listing for **PepsiCo** is shown.

<u>Stock</u>	<u>Volume</u>	<u>High</u>	<u>Low</u>	<u>Close</u>	<u>Net Change</u>
PepsiCo	2,942,400	48.88	47.31	47.50	-0.10

These numbers indicate that PepsiCo's trading volume was 2,942,400 shares. The high, low, and closing prices for that date were \$48.88, \$47.31, and \$47.50, respectively. The net change for the day was a decrease of \$0.10 per share.

For stock traded on organized stock exchanges, how are the dollar prices per share established? What factors might influence the price of shares in the marketplace?



³Alternatively, the investment banking firm may agree only to enter into a **best efforts** contract with the corporation. In such a case, the banker agrees to sell as many shares as possible at a specified price. The corporation bears the risk of unsold stock. Under a best efforts arrangement, the banking firm is paid a fee or a commission for its services.

follow the trend of a company's earnings and dividends. But factors beyond a company's control, such as international turmoil, changes in interest rates, and the outcome of a presidential election, may cause day-to-day fluctuations in market prices.

The trading of capital stock on securities exchanges involves the transfer of **already issued shares** from an existing stockholder to another investor. These transactions have no impact on a corporation's stockholders' equity.

TECHNOLOGY IN ACTION



Giant, publicly held corporations could not exist without the organized stock markets, and the stock markets could not exist without massive computerization. Not too many years ago, the NYSE "ticker" would run behind, or trading would even be halted, when sales exceeded 30 million shares or so. Now, with sales sometimes in excess of 800 million shares, the NYSE and its companion exchanges throughout the country operate efficiently with computer technology. Technology has also made possible extended trading hours. An investor in New York can trade electronically at 3:30 A.M., which is the time in New York when the London Stock Exchange opens at 8:30 A.M. Some predict that twenty-four-hour trading is not far off.

PAR AND NO-PAR VALUE STOCKS. **Par value stock** is capital stock that has been assigned a value per share in the corporate charter. The par value may be any amount selected by the corporation. Generally, the par value is quite low because states often levy a tax on the corporation based on par value. For example, **Starwood** has a par of \$0.01. **Hilton's** common stock carries a par value of \$2.50 per share, whereas its preferred stock has a par value of \$1.00 per share.

Par value does not indicate the worth or the market value of the stock. **Disney**, like **Starwood**, also carries stocks with a par value \$0.01; but its recent market price was \$18.18 per share. **Par value** has legal significance. It represents the **legal capital** per share that must be retained in the business for the protection of corporate creditors. That amount is not available for withdrawal by stockholders. Thus most states require the corporation to sell its shares at par or above.

No-par value stock is capital stock that has not been assigned a value in the corporate charter. It is often issued because some confusion still exists concerning par value and fair market value. If shares are not assigned a par value, the questionable use of par value as a basis for fair market value never arises. The major disadvantage of no-par value stock is that some states levy a high tax on such shares.

No-par value stock is quite common today. For example, **Marriott's** preferred stock has no par value. In many states the board of directors is permitted to assign a **stated value** to the no-par shares. This value becomes the legal capital per share. The stated value of no-par stock may be changed at any time by action of the directors. Stated value, like par value, does not indicate the market value of the stock. When there is no assigned stated value, the entire proceeds received on issuance of the stock is considered to be legal capital.

The relationship of par and no-par value to legal capital is shown in Illustration 14-12.

Illustration 14-12

Relationship of par and no-par value stock to legal capital

<u>Stock</u>	<u>Legal Capital per Share</u>
Par value	→ Par value
No-par value with stated value	→ Stated value
No-par value without stated value	→ Entire proceeds

ALTERNATIVE TERMINOLOGY
 Paid-in Capital in Excess of Par is also called *Premium on Stock*.

If Hydro-Slide issues an additional 1,000 shares of the \$1 par value common stock for cash at \$5 per share, the entry is

A	=	L	+	SE
+5,000				+1,000 +4,000

Cash	5,000	
Common Stock		1,000
Paid-in Capital in Excess of Par Value		4,000
(To record issuance of 1,000 shares of common stock in excess of par)		

The total paid-in capital from these two transactions is \$6,000, and the legal capital is \$2,000. If Hydro-Slide has retained earnings of \$27,000, the stockholders' equity section is as shown in Illustration 14-13.

Illustration 14-13

Stockholders' equity—
 paid-in capital in excess of
 par value

HYDRO-SLIDE THEME PARK	
Balance Sheet (partial)	
Stockholders' equity	
Paid-in-capital	
Common stock	\$ 2,000
Paid-in capital in excess of par value	4,000
Total paid-in capital	6,000
Retained earnings	27,000
Total stockholders' equity	\$33,000

When stock is issued for less than par value, the account Paid-in Capital in Excess of Par Value is debited, if a credit balance exists in this account. If a credit balance does not exist, then the amount less than par is debited to Retained Earnings. This situation occurs only rarely: The sale of common stock below par value is not permitted in most states because stockholders may be held personally liable for the difference between the price paid upon original sale and par value.

Issuing No-Par Common Stock for Cash

When no-par common stock has a stated value, the entries are similar to those illustrated for par value stock. The stated value represents legal capital. Therefore, it is credited to Common Stock. Also, when the selling price of no-par stock exceeds stated value, the excess is credited to Paid-in Capital in Excess of Stated Value. For example, assume that instead of \$1 par value stock, Hydro-Slide Theme Park has \$5 stated value no-par stock and the company issues 5,000 shares at \$8 per share for cash. The entry looks like this:

A	=	L	+	SE
+40,000				+25,000 +15,000

Cash	40,000	
Common Stock		25,000
Paid-in Capital in Excess of Stated Value		15,000
(To record issue of 5,000 shares of \$5 stated value no-par stock)		

Paid-in Capital in Excess of Stated Value is reported as part of paid-in capital in the stockholders' equity section.

What happens when no-par stock does not have a stated value? In that case, the entire proceeds from the issue become legal capital and are credited to Common Stock. Thus, if Hydro-Slide does not assign a stated value to its no-par stock, the issuance of the 5,000 shares at \$8 per share for cash is recorded as follows:

Cash Common Stock (To record issue of 5,000 shares of no-par stock)	40,000	40,000	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="text-align: right;">A</td> <td style="text-align: center;">=</td> <td style="text-align: left;">L</td> <td style="text-align: center;">+</td> <td style="text-align: left;">SE</td> </tr> <tr> <td style="text-align: right;">+40,000</td> <td></td> <td></td> <td></td> <td style="text-align: right;">+40,000</td> </tr> </table>	A	=	L	+	SE	+40,000				+40,000
A	=	L	+	SE									
+40,000				+40,000									

The amount of legal capital for Hydro-Slide stock with a \$5 stated value is \$25,000. Without a stated value, it is \$40,000.

Issuing Common Stock for Services or Noncash Assets

Stock also may be issued for services (compensation to attorneys or consultants) or for noncash assets (land, buildings, and equipment). In such cases, what cost should be recognized in the exchange transaction? To comply with the **cost principle**, in a noncash transaction, **cost is the cash equivalent price**. Thus **cost is either the fair market value of the consideration given up or the fair market value of the consideration received, whichever is more clearly determinable**.

To illustrate, assume that attorneys have helped Jordan Sports Spa incorporate. They have billed the company \$5,000 for their services. They agree to accept 4,000 shares of \$1 par value common stock in payment of their bill. At the time of the exchange, there is no established market price for the stock. In this case, the market value of the consideration received, \$5,000, is more clearly evident. Accordingly, the entry is

Organization Expense Common Stock Paid-in Capital in Excess of Par Value (To record issuance of 4,000 shares of \$1 par value stock to attorneys)	5,000	4,000 1,000	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="text-align: right;">A</td> <td style="text-align: center;">=</td> <td style="text-align: left;">L</td> <td style="text-align: center;">+</td> <td style="text-align: left;">SE</td> </tr> <tr> <td></td> <td></td> <td></td> <td></td> <td style="text-align: right;">-5,000</td> </tr> <tr> <td></td> <td></td> <td></td> <td></td> <td style="text-align: right;">+4,000</td> </tr> <tr> <td></td> <td></td> <td></td> <td></td> <td style="text-align: right;">+1,000</td> </tr> </table>	A	=	L	+	SE					-5,000					+4,000					+1,000
A	=	L	+	SE																			
				-5,000																			
				+4,000																			
				+1,000																			

As explained on page 424, organization costs are expensed as incurred.

In contrast, assume that Athletic Rock Climbing Camp is an existing publicly held corporation. Its \$5 par value stock is actively traded at \$8 per share. The company issues 10,000 shares of stock to acquire land recently advertised for sale at \$90,000. The most clearly evident value in this noncash transaction is the market price of the consideration given, \$80,000. The transaction is recorded as follows:

Land Common Stock Paid-in Capital in Excess of Par Value (To record issuance of 10,000 shares of \$5 par value stock for land)	80,000	50,000 30,000	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="text-align: right;">A</td> <td style="text-align: center;">=</td> <td style="text-align: left;">L</td> <td style="text-align: center;">+</td> <td style="text-align: left;">SE</td> </tr> <tr> <td style="text-align: right;">+80,000</td> <td></td> <td></td> <td></td> <td style="text-align: right;">+50,000</td> </tr> <tr> <td></td> <td></td> <td></td> <td></td> <td style="text-align: right;">+30,000</td> </tr> </table>	A	=	L	+	SE	+80,000				+50,000					+30,000
A	=	L	+	SE														
+80,000				+50,000														
				+30,000														

As illustrated in these examples, **the par value of the stock is never a factor in determining the cost of the assets received**. This is also true of the stated value of no-par stock.

BEFORE YOU GO ON...

▶ REVIEW IT

1. Explain the accounting for par and no-par common stock issued for cash.
2. Explain the accounting for the issuance of stock for services or noncash assets.

▶ DO IT

Cayman Resorts begins operations on March 1 by issuing 100,000 shares of \$10 par value common stock for cash at \$12 per share. On March 15, it issues 5,000 shares of common stock to attorneys in settlement of their bill of \$50,000 for organization costs. Journalize the issuance of the shares, assuming the stock is not publicly traded.

ACTION PLAN

- In issuing shares for cash, credit Common Stock for par value per share.
- Credit any additional proceeds in excess of par value to a separate paid-in capital account.
- When stock is issued for services, use the cash equivalent price.
- For the cash equivalent price, use either the fair market value of what is given up or the fair market value of what is received, whichever is more clearly determinable.

SOLUTION

Mar. 1	Cash	1,200,000	
	Common Stock		1,000,000
	Paid-in Capital in Excess of Par Value		200,000
	(To record issuance of 100,000 shares at \$12 per share)		
Mar. 15	Organization Expense	50,000	
	Common Stock		50,000
	(To record issuance of 5,000 shares for attorneys' fees)		



ACCOUNTING FOR TREASURY STOCK

STUDY OBJECTIVE 7

Explain the accounting for treasury stock.

HELPFUL HINT

Treasury stock is so named because the company often holds the shares in its treasury for safekeeping.

HELPFUL HINT

Treasury shares do not have dividend rights or voting rights.

Treasury stock is a corporation's own stock that has been issued, fully paid for, and reacquired by the corporation but not retired. A corporation may acquire treasury stock for various reasons:

1. To reissue the shares to officers and employees under bonus and stock compensation plans.
2. To increase trading of the company's stock in the securities market in the hopes of enhancing its market value.
3. To have additional shares available for use in the acquisition of other companies.
4. To reduce the number of shares outstanding and thereby increase earnings per share.
5. To rid the company of disgruntled investors, perhaps to avoid a takeover.

Many corporations have treasury stock. One survey of 600 companies in the United States found that 66 percent have treasury stock.⁴ Specifically, **The Coca-Cola Company** reported as of December 31, 2005, \$19,644 million; and **Marriott** reported \$2,667 million in treasury stock.

⁴*Accounting Trends & Techniques 2000* (New York: American Institute of Certified Public Accountants).

ACCOUNTING IN ACTION *Business Insight*



Why would a company use its own cash or, worse yet, borrow money to buy back its own shares? Wouldn't a company want the public to buy its shares so that it could raise funds for future projects? Stock repurchase is a really interesting phenomenon. In 2000, more than a dozen lodging companies initiated repurchase programs. These include **Cendant Corporation**, **Choice Hotels International**, **Marriott International**, **Park Place Entertainment**, and **Sun International**, among others. Some companies believe their stocks are undervalued, and therefore, a stock repurchase program can maximize their returns. Such is the case with **John Q. Hammons Hotels**; it realized a 63 percent gain on its repurchase move.

Restaurants also use this tactic. **Landry's** repurchased its own shares in 1999, 2000, and 2001, totaling more than \$89 million. In 2002, **Starbucks Corporation** also announced the repurchase of 3.5 million of its common stock at a value of more than \$50 million. Its board also has approved up to a 10-million-share repurchase. In 2005, **Royal Caribbean Cruises, Ltd.**, announced a \$250 million stock repurchase plan. **Morgans Hotel Group** is one of the latest hotel groups that made known its \$50 stock repurchase plan to the public in December 2006.

SOURCES: M. Whitford, "Stock Buybacks Spur Demand," *Hotel and Motel Management* 215(16) (2000): 44.

"Starbucks Perks Up Stock Buyback Plan," *Nation's Restaurant News* 36(26) (2002): 12.

"Morgans Hotel Group Announces \$50 Million Stock Repurchase Program," <http://biz.yahoo.com/bw/061207/20061207005841.html?.v=1>

"Royal Carribbean in Stock Repurchase," www.bizjournals.com/pacific/stories/2005/09/26/daily1.html.

Purchase of Treasury Stock

Treasury stock is generally accounted for by the cost method. This method uses the cost of the shares purchased to value the treasury stock. **Under the cost method, Treasury Stock is debited for the price paid to reacquire the shares.**

The same amount is credited to Treasury Stock when the shares are disposed of. To illustrate, assume that on January 1, 2008, the stockholders' equity section of Mead Foods, Inc., has 100,000 shares of \$5 par value common stock outstanding (all issued at par value) and Retained Earnings of \$200,000. The stockholders' equity section before purchase of treasury stock is shown in Illustration 14-14.

MEAD FOODS, INC.	
Balance Sheet (partial)	
Stockholders' equity	
Paid-in capital	
Common stock, \$5 par value, 100,000 shares issued and outstanding	\$500,000
Retained earnings	<u>200,000</u>
Total stockholders' equity	<u>\$700,000</u>

Illustration 14-14

Stockholders' equity with no treasury stock

On February 1, 2008, Mead acquires 4,000 shares of its stock at \$8 per share:

Feb. 1	Treasury Stock	32,000		
	Cash		32,000	
	(To record purchase of 4,000 shares of treasury stock at \$8 per share)			

A	=	L	+	SE
-32,000				-32,000

Note that Treasury Stock is debited for the cost of the shares purchased. Is the original paid-in capital account, Common Stock, affected? No, because the number of issued shares does not change. In the stockholders' equity section of the balance sheet, treasury stock is deducted from total paid-in capital and retained earnings. Treasury Stock is a contra stockholders' equity account.

The stockholders' equity section of Mead Foods after purchase of treasury stock is shown in Illustration 14-15.

Illustration 14-15

Stockholders' equity with treasury stock

MEAD FOODS, INC.	
Balance Sheet (partial)	
Stockholders' equity	
Paid-in capital	
Common stock, \$5 par value, 100,000 shares issued and 96,000 shares outstanding	\$500,000
Retained earnings	<u>200,000</u>
Total paid-in capital and retained earnings	700,000
Less: Treasury stock (4,000 shares)	<u>32,000</u>
Total stockholders' equity	<u><u>\$668,000</u></u>

Thus the acquisition of treasury stock reduces stockholders' equity.

In the balance sheet, both the number of shares issued (100,000) and the number in the treasury (4,000) are disclosed. The difference between these two amounts is the number of shares of stock outstanding (96,000). The term **outstanding stock** means the number of shares of issued stock that are being held by stockholders.

Some maintain that treasury stock should be reported as an asset because it can be sold for cash. Under this reasoning, unissued stock also should be shown as an asset, clearly an erroneous conclusion. Rather than being an asset, treasury stock reduces stockholder claims on corporate assets. This effect is correctly shown by reporting treasury stock as a deduction from total paid-in capital and retained earnings.

Disposal of Treasury Stock

Treasury stock is usually sold or retired. The accounting for its sale is different when treasury stock is sold above cost than when it is sold below cost.

SALE OF TREASURY STOCK ABOVE COST. If the selling price of the treasury shares is equal to cost, the sale of the shares is recorded by a debit to Cash and a credit to Treasury Stock. When the selling price of the shares is greater than cost, the difference is credited to Paid-in Capital from Treasury Stock.

To illustrate, assume that 1,000 shares of treasury stock of Mead Foods, Inc., previously acquired at \$8 per share, are sold at \$10 per share on July 1. The entry is as follows:

HELPFUL HINT

Treasury stock transactions are classified as capital stock transactions. As in the case when stock is issued, the income statement is not involved.

A	=	L	+	SE
+10,000				+8,000 +2,000

July 1	Cash	10,000	
	Treasury Stock		8,000
	Paid-in Capital from Treasury Stock		2,000
	(To record sale of 1,000 shares of treasury stock above cost)		

The \$2,000 credit in the entry would not be considered a gain on sale of treasury stock for two reasons: (1) Gains on sales occur when **assets** are sold, and treasury stock is not an asset. (2) A corporation does not realize a gain or suffer a loss from stock transactions with its own stockholders. Thus paid-in capital arising from the sale of treasury stock should not be included in the measurement of net income. Paid-in Capital from Treasury Stock is listed separately on the balance sheet as a part of paid-in capital.

SALE OF TREASURY STOCK BELOW COST. When treasury stock is sold below its cost, the excess of cost over selling price is usually debited to Paid-in Capital from Treasury Stock. Thus, if Mead Foods, Inc., sells an additional 800 shares of treasury stock on October 1 at \$7 per share, the entry is as follows:

Oct. 1	Cash	5,600	
	Paid-in Capital from Treasury Stock	800	
	Treasury Stock		6,400
	(To record sale of 800 shares of treasury stock below cost)		

A	=	L	+	SE
+5,600				-800
				+6,400

Observe the following from the two sales entries: (1) Treasury Stock is credited at cost in each entry. (2) Paid-in Capital from Treasury Stock is used for the difference between cost and the resale price of the shares. (3) The original paid-in capital account, Common Stock, is not affected. **The sale of treasury stock increases both total assets and total stockholders' equity.**

After posting the foregoing entries, the treasury stock accounts will show the following balances on October 1 (Illustration 14-16).

Treasury Stock				Paid-in Capital from Treasury Stock			
Feb. 1	32,000	July 1	8,000	Oct. 1	800	July 1	2,000
		Oct. 1	6,400			Oct. 1 Bal.	1,200
Oct. 1 Bal.	17,600						

Illustration 14-16
Treasury stock accounts

When the credit balance in Paid-in Capital from Treasury Stock is eliminated, any additional excess of cost over selling price is debited to Retained Earnings. To illustrate, assume that Mead Foods, Inc., sells its remaining 2,200 shares at \$7 per share on December 1. The excess of cost over selling price is \$2,200 [2,200 × (\$8 – \$7)]. In this case, \$1,200 of the excess is debited to Paid-in Capital from Treasury Stock. The remainder is debited to Retained Earnings. The entry follows:

Dec. 1	Cash	15,400	
	Paid-in Capital from Treasury Stock	1,200	
	Retained Earnings	1,000	
	Treasury Stock		17,600
	(To record sale of 2,200 shares of treasury stock at \$7 per share)		

A	=	L	+	SE
+15,400				-1,200
				-1,000
				+17,600

BEFORE YOU GO ON...

▶ REVIEW IT

1. What is treasury stock, and why do companies acquire it?
2. How is treasury stock recorded?
3. Where is treasury stock reported in the financial statements? Does a company record gains and losses on treasury stock transactions? Explain.

▶ DO IT

Santa Anita Resorts, Inc., purchases 3,000 shares of its \$60 par value common stock for \$180,000 cash on July 1. The shares are to be held in the treasury until resold. On November 1, the corporation sells 1,000 shares of treasury stock for cash at \$70 per share. Journalize the treasury stock transactions.

ACTION PLAN

- Record the purchase of treasury stock at cost.
- When treasury stock is sold above its cost, credit the excess of the selling price over cost to Paid-in Capital from Treasury Stock.
- When treasury stock is sold below its cost, debit the excess of cost over selling price to Paid-in Capital from Treasury Stock.

SOLUTION

July 1	Treasury Stock	180,000	
	Cash		180,000
	(To record the purchase of 3,000 shares at \$60 per share)		
Nov. 1	Cash	70,000	
	Treasury Stock		60,000
	Paid-in Capital from Treasury Stock		10,000
	(To record the sale of 1,000 shares at \$70 per share)		



STUDY OBJECTIVE 8

Differentiate preferred stock from common stock.

PREFERRED STOCK

To appeal to more potential investors, a corporation may issue an additional class of stock, called preferred stock. **Preferred stock** has contractual provisions that give it a preference or priority over common stock in certain areas. Typically, preferred stockholders have a priority as to (1) distributions of earnings (dividends) and (2) assets in the event of liquidation. However, they generally do not have voting rights.

Like common stock, preferred stock may be issued for cash or for noncash assets. The entries for these transactions are similar to the entries for common stock. When a corporation has more than one class of stock, each paid-in capital account title should identify the stock to which it relates. For example, a company might have the following accounts: Preferred Stock, Common Stock, Paid-in Capital in Excess of Par Value—Preferred Stock, and Paid-in Capital in Excess of Par Value—Common Stock. Assume that Stine Hotel Corporation issues 10,000 shares of \$10 par value preferred stock for \$12 cash per share. The entry to record the issuance follows:

A	=	L	+	SE
+120,000				+100,000
				+20,000

Cash	120,000	
Preferred Stock		100,000
Paid-in Capital in Excess of Par Value—Preferred Stock		20,000
(To record the issuance of 10,000 shares of \$10 par value preferred stock)		

Preferred stock may have either a par value or a no-par value. In the stockholders' equity section of the balance sheet, preferred stock is shown first because of its dividend and liquidation preferences over common stock.

Various features associated with the issuance of preferred stock, including dividend preferences, liquidation preferences, convertibility, and callability, are discussed on the following pages.

Dividend Preferences

As noted earlier, **preferred stockholders have the right to share in the distribution of corporate income before common stockholders.** For example, if the dividend rate on preferred stock is \$5 per share, common shareholders will not receive any dividends in the current year until preferred stockholders have received \$5 per share. The first claim to dividends does not, however, guarantee the payment of dividends. Dividends depend on many factors, such as adequate retained earnings and availability of cash.

The per share dividend amount is stated as a percentage of the preferred stock's par value or as a specified amount. For example, Crane Resorts specifies a $3\frac{3}{4}$ percent dividend on its \$100 par value preferred ($\$100 \times 3\frac{3}{4}\% = \3.75 per share).

Cumulative Dividend

Preferred stock often contains a **cumulative dividend** feature. This means that preferred stockholders must be paid both current-year dividends and any unpaid prior-year dividends before common stockholders receive dividends. When preferred stock is cumulative, preferred dividends not declared in a given period are called **dividends in arrears**.

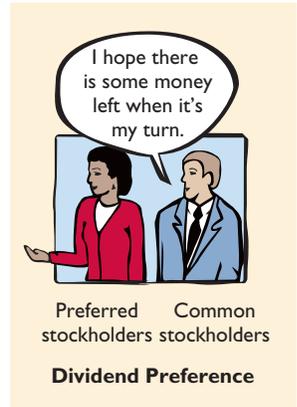
To illustrate, assume that Sun Resorts and Spas has 5,000 shares of 7 percent, \$100 par value, cumulative preferred stock outstanding. The annual dividend is \$35,000 ($5,000 \times \7 per share), but dividends are two years in arrears. In this case, preferred stockholders are entitled to receive the dividends shown in Illustration 14-17 in the current year.

Dividends in arrears ($\$35,000 \times 2$)	\$ 70,000
Current-year dividends	<u>35,000</u>
Total preferred dividends	<u>\$105,000</u>

No distribution can be made to common stockholders until this entire preferred dividend is paid. In other words, dividends cannot be paid to common stockholders while any preferred stock is in arrears.

Dividends in arrears are not considered a liability. No payment obligation exists until a dividend is declared by the board of directors. However, the amount of dividends in arrears should be disclosed in the notes to the financial statements. Doing so enables investors to assess the potential impact of this commitment on the corporation's financial position.

Companies that are unable to meet their dividend obligations are not looked upon favorably by the investment community. As a financial officer noted in discussing one company's failure to pay its cumulative preferred dividend for a period of time, "Not meeting your obligations on something like that is a major black mark on your record." The accounting entries for preferred stock dividends are explained in the following section.

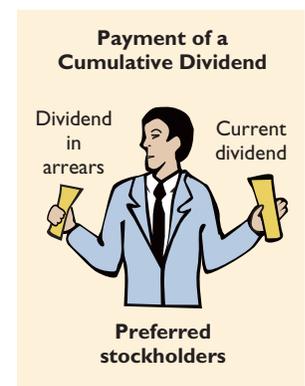


HELPFUL HINT

The cumulative dividend feature is often critical in investors' acceptance of a preferred stock issue. Investors are much less interested in a noncumulative preferred stock because a dividend passed in any year is lost forever.

Illustration 14-17

Computation of total dividends to preferred stock



DIVIDENDS

STUDY OBJECTIVE 9

Prepare the entries for cash dividends and stock dividends.

A **dividend** is a distribution by a corporation to its stockholders on a pro rata (proportional) basis. Potential buyers and sellers of stock are very interested in a company's dividend policies and practices. Dividends can take four forms: (1) cash, (2) property, (3) scrip (a promissory note to pay cash), or (4) stock. Cash dividends predominate in practice, and stock dividends are declared with some frequency. These two forms of dividends will be the focus of discussion in this chapter.

Dividends may be expressed in two ways: (1) as a percentage of the par or stated value of the stock or (2) as a dollar amount per share. In the financial press, dividends are generally reported **quarterly** as a **dollar amount per share**.

CASH DIVIDENDS

A **cash dividend** is a pro rata distribution of cash to stockholders. For a corporation to pay a cash dividend, it must have three things:

1. **Retained earnings.** The legality of a cash dividend depends on the laws of the state in which the company is incorporated. Payment of cash dividends from retained earnings is legal in all states. In general, cash dividend distributions based only on common stock (legal capital) are illegal. Statutes vary considerably with respect to cash dividends based on paid-in capital in excess of par or stated value. Many states permit such dividends. A dividend declared out of paid-in capital is termed a **liquidating dividend**. The amount originally paid in by stockholders is being reduced, or "liquidated," by such a dividend.
2. **Adequate cash.** The legality of a dividend and the ability to pay a dividend are two different things. For example, Best Hotels, with retained earnings of \$3 million, could legally declare a dividend of \$3 million. But Best's cash balance is only \$250,000. In order to pay a \$3 million dividend, Best would need to raise additional cash through the sale of other assets or through additional financing.

Before declaring a cash dividend, a company's board of directors must carefully consider both current and future demands on the company's cash resources. In some cases, current liabilities may make a cash dividend inappropriate. In other cases, a major plant expansion program may warrant only a relatively small dividend. **Sysco** declared an \$8.17 per share dividend per quarter in 2006. For the same period, **Hilton** declared a \$0.04 per share dividend, whereas **Marriott** paid \$0.05 to \$0.06 per share.

3. **A declaration of dividends.** A company does not pay dividends unless its board of directors decides to do so, at which point the board "declares" the dividend. The board of directors has full authority to determine the amount of income to be distributed in the form of a dividend and the amount to be retained in the business. Dividends do not accrue like interest on a note payable, and they are not a liability until declared.

The amount and the timing of a dividend are important issues. The payment of a large cash dividend could lead to liquidity problems for the enterprise. On the other hand, a small dividend or a missed dividend may cause unhappiness among stockholders. Many of them expect to receive a reasonable cash payment from the company on a periodic basis. Many companies declare and pay cash dividends quarterly.

Entries for Cash Dividends

Three dates are important in connection with dividends: (1) the declaration date, (2) the record date, and (3) the payment date. Normally, there are two to four

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To pay, or not to pay, that seems to be the question. As stock prices fall and the market becomes more volatile, investors become more interested in dividends. And what they found was not too pleasing. One article noted, “According to Standard and Poor’s, only 72 percent of companies in its S&P 500 index paid a dividend last year [2001], down from 94 percent in 1980.” However, as a result of new tax regulations reducing the tax on dividends to only 15 percent, many corporate boards increased their dividend in 2003.

What factors must a board of directors consider before declaring a cash dividend?

SOURCE: “Dividends’ End: Should Technology Companies Pay Dividends?” *The Economist*, January 12, 2002, p. 68.

weeks between each date. Accounting entries are required on two of the dates—the declaration date and the payment date.

On the **declaration date**, the board of directors formally declares (authorizes) the cash dividend and announces it to stockholders. Declaration of a cash dividend **commits the corporation to a legal obligation**. The obligation is binding and cannot be rescinded. An entry is required to recognize the decrease in retained earnings and the increase in the liability Dividends Payable. To illustrate, assume that on December 1, 2008, the directors of Heavenly Resorts declare a 50 cents per share cash dividend on 100,000 shares of \$10 par value common stock. The dividend is \$50,000 (100,000 × 50 cents). The entry to record the declaration is

Declaration Date			
Dec. 1	Retained Earnings	50,000	
	Dividends Payable		50,000
	(To record declaration of cash dividend)		

HELPFUL HINT

What is the effect of the declaration of a cash dividend on (1) total stockholders’ equity, (2) total liabilities, (3) total assets? Answer: (1) decrease, (2) increase, (3) no effect.

A	=	L	+	SE	
		+50,000		-50,000	

Dividends Payable is a current liability: It will normally be paid within the next several weeks.

Instead of debiting Retained Earnings, the account Dividends may be debited. This account provides additional information in the ledger. Also, a company may have separate dividend accounts for each class of stock. When a dividend account is used, its balance is transferred to Retained Earnings at the end of the year by a closing entry. Whichever account is used for the dividend declaration, the effect is the same: Retained earnings is decreased and a current liability is increased. For homework problems, you should use the Retained Earnings account for recording dividend declarations.

At the **record date**, ownership of the outstanding shares is determined for dividend purposes. The records maintained by the corporation supply this information. In the interval between the declaration date and the record date, the corporation updates its stock ownership records. For Heavenly Resorts, the record date is December 22. No entry is required on this date because the corporation’s liability recognized on the declaration date is unchanged.

Record Date			
Dec. 22	No entry necessary		

HELPFUL HINT

Between the declaration date and the record date, the number of shares outstanding should remain the same. The purpose of the record date is to identify the persons or entities that will receive the dividend, not to determine the amount of the dividend liability.

A	=	L	+	SE	
		-50,000		-50,000	

On the **payment date**, dividend checks are mailed to the stockholders, and the payment of the dividend is recorded. Assuming that the payment date is January 20 for Heavenly Resorts, the entry on that date would be:

		Payment Date		
Jan. 20	Dividends Payable Cash (To record payment of cash dividend)	50,000		50,000

Note that payment of the dividend reduces both current assets and current liabilities. It has no effect on stockholders' equity. The **cumulative effect** of the **declaration and payment** of a cash dividend is to **decrease both stockholders' equity and total assets**. Illustration 14-18 summarizes the three important dates associated with dividends.

Illustration 14-18
Key dividend dates



Allocating Cash Dividends between Preferred and Common Stock

As explained earlier in this chapter, preferred stock has priority over common stock in regard to dividends. Preferred stockholders must be paid any unpaid prior-year dividends before common stockholders receive dividends.

To illustrate, assume that at December 31, 2008, IBR Hotels Inc. has 1,000 shares of 8 percent, \$100 par value cumulative preferred stock. It also has 50,000 shares of \$10 par value common stock outstanding. The dividend per share for preferred stock is \$8 (\$100 par value × 8%). The required annual dividend for preferred stock is therefore \$8,000 (1,000 × \$8). At December 31, 2008, the directors declare a \$6,000 cash dividend. In this case, the entire dividend amount goes to preferred stockholders because of their dividend preference. The entry to record the declaration of the dividend looks like this:

A = L + SE +6,000 -6,000

Dec. 31	Retained Earnings Dividends Payable (To record \$6 per share cash dividend to preferred stockholders)	6,000		6,000
---------	---	-------	--	-------

Because of the cumulative feature, dividends of \$2 per share are in arrears on preferred stock for 2008. These dividends must be paid to preferred stockholders

before any future dividends can be paid to common stockholders. Dividends in arrears should be disclosed in the financial statements.

On December 31, 2008, IBR declares a \$50,000 cash dividend. Illustration 14-19 shows the allocation of the dividend to the two classes of stock.

Total dividend		\$50,000
Allocated to preferred stock		
Dividends in arrears, 2004 (1,000 × \$2)	\$2,000	
2005 dividend (1,000 × \$8)	8,000	10,000
Remainder allocated to common stock		<u>\$40,000</u>

Illustration 14-19

Allocating dividends to preferred and common stock

The entry to record the declaration of the dividend looks like this:

Dec. 31	Retained Earnings	50,000	
	Dividends Payable		50,000
	(To record declaration of cash dividends of \$10,000 to preferred stock and \$40,000 to common stock)		

A	=	L	+	SE
		+50,000		-50,000

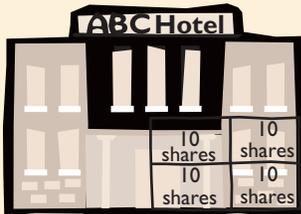
What if IBR’s preferred stock were not cumulative? In that case, preferred stockholders would have received only \$8,000 in dividends in 2008. Common stockholders would have received \$42,000.

STOCK DIVIDENDS

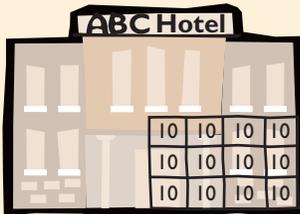
A **stock dividend** is a pro rata distribution to stockholders of the corporation’s own stock. Whereas a cash dividend is paid in cash, a stock dividend is paid in stock. **A stock dividend results in a decrease in retained earnings and an increase in paid-in capital.** Unlike a cash dividend, a stock dividend does not decrease total stockholders’ equity or total assets.

To illustrate, assume that you have a 2 percent ownership interest in Cetus Restaurant, Inc.; you own twenty of its 1,000 shares of common stock. If Cetus declares a 10 percent stock dividend, it would issue 100 shares (1,000 × 10%) of stock. You would receive two shares (2% × 100). Would your ownership interest change? No, it would remain at 2 percent (22 ÷ 1,100). **You now own more shares of stock, but your ownership interest has not changed.** Illustration 14-20 shows the effect of a stock dividend for stockholders.

Before stock dividend



After stock dividend





“I owned 40 shares before and I own 120 shares now, but I still own only 1/4 of the company!”

Number of shares owned increases, but percentage of company owned remains the same.

Illustration 14-20

Effect of stock dividend for stockholders

From the company’s point of view, no cash has been disbursed, and no liabilities have been assumed by the corporation. What are the purposes and benefits of a stock dividend? Corporations issue stock dividends generally for one or more of the following reasons:

1. To satisfy stockholders’ dividend expectations without spending cash.
2. To increase the marketability of the corporation’s stock. When the number of shares outstanding increases, the market price per share decreases. Decreasing the market price of the stock makes it easier for smaller investors to purchase the shares.
3. To emphasize that a portion of stockholders’ equity has been permanently reinvested in the business (and is unavailable for cash dividends).

The size of the stock dividend and the value to be assigned to each dividend share are determined by the board of directors when the dividend is declared. The per share amount must be at least equal to the par or stated value in order to meet legal requirements.

The accounting profession distinguishes between a **small stock dividend** (less than 20 to 25 percent of the corporation’s issued stock) and a **large stock dividend** (greater than 20 to 25 percent). For small stock dividends, it recommends that the directors assign the **fair market value per share**. This treatment is based on the assumption that a small stock dividend will have little effect on the market price of the outstanding shares. Many stockholders consider small stock dividends to be distributions of earnings equal to the fair market value of the shares distributed. The amount to be assigned for a large stock dividend is not specified by the accounting profession. **Par or stated value per share** is normally assigned. Small stock dividends predominate in practice. Thus we will illustrate only the entries for small stock dividends.

ENTRIES FOR STOCK DIVIDENDS

To illustrate the accounting for small stock dividends, assume that Medland Restaurants Corporation has a balance of \$300,000 in retained earnings. It declares a 10 percent stock dividend on its 50,000 shares of \$10 par value common stock. The current fair market value of its stock is \$15 per share. The number of shares to be issued is 5,000 ($10\% \times 50,000$). Therefore, the total amount to be debited to Retained Earnings is \$75,000 ($5,000 \times \15). The entry to record the declaration of the stock dividend is as follows:

A	=	L	+	SE			
				-75,000		Retained Earnings	75,000
				+50,000		Common Stock Dividends Distributable	50,000
				+25,000		Paid-in Capital in Excess of Par Value	25,000
						(To record declaration of 10% stock dividend)	

Note that Retained Earnings is debited for the fair market value of the stock issued ($\$15 \times 5,000$). Common Stock Dividends Distributable is credited for the par value of the dividend shares ($\$10 \times 5,000$), and the excess over par ($\$5 \times 5,000$) is credited to Paid-in Capital in Excess of Par Value.

Common Stock Dividends Distributable is a **stockholders’ equity account**. It is not a liability because assets will not be used to pay the dividend. If a balance sheet is prepared before the dividend shares are issued, the distributable account is reported under Paid-in capital, as an addition to common stock issued. This is shown in Illustration 14-21.

Paid-in capital		
Common stock	\$500,000	
Common stock dividends distributable	<u>50,000</u>	\$550,000

Illustration 14-21

Statement presentation of common stock dividends distributable

When the dividend shares are issued, Common Stock Dividends Distributable is debited, and Common Stock is credited as follows:

Common Stock Dividends Distributable	50,000	
Common Stock		50,000
(To record issuance of 5,000 shares in a stock dividend)		

A	=	L	+	SE
				-50,000
				+50,000

EFFECTS OF STOCK DIVIDENDS

How do stock dividends affect stockholders' equity? They change the composition of stockholders' equity because a portion of retained earnings is transferred to paid-in capital. However, **total stockholders' equity remains the same**. Stock dividends also have no effect on the par or stated value per share. But the number of shares outstanding increases. These effects are shown for Medland Corporation in Illustration 14-22.

	<u>Before Dividend</u>	<u>After Dividend</u>
Stockholders' equity		
Paid-in capital		
Common stock, \$10 par	\$ 500,000	\$ 550,000
Paid-in capital in excess of par value	<u>-0-</u>	<u>25,000</u>
Total paid-in capital	500,000	575,000
Retained earnings	<u>300,000</u>	<u>225,000</u>
Total stockholders' equity	<u>\$ 800,000</u>	<u>\$ 800,000</u>
Outstanding shares	<u>50,000</u>	<u>55,000</u>

Illustration 14-22

Stock dividend effects

In this example, total paid-in capital is increased by \$75,000, and retained earnings is decreased by the same amount. Note also that total stockholders' equity remains unchanged at \$800,000.

STOCK SPLITS

A **stock split**, like a stock dividend, involves the issuance of additional shares to stockholders according to their percentage ownership. **A stock split results in a reduction in the par or stated value per share.** The purpose of a stock split is to increase the marketability of the stock by lowering its market value per share. A lower market value also makes it easier for the corporation to issue additional stock.

The effect of a split on market value is generally inversely proportional to the size of the split. For example, after a two-for-one stock split, the market value of a stock will fall. The lower market value stimulates market activity.

In a stock split, the number of shares is increased in the same proportion that par or stated value per share is decreased. For example, in a two-for-one split, one

HELPFUL HINT

A stock split changes the par value per share but does not affect any balances in stockholders' equity.

share of \$10 par value stock is exchanged for two shares of \$5 par value stock. **A stock split does not have any effect on total paid-in capital, retained earnings, or total stockholders' equity.** But the number of shares outstanding increases. These effects are shown in Illustration 14-23 for Medland Restaurants, assuming that it splits its 50,000 shares of common stock on a two-for-one basis.

Illustration 14-23

Stock split effects

	<u>Before Stock Split</u>	<u>After Stock Split</u>
Stockholders' equity		
Paid-in capital		
Common stock	\$500,000	\$500,000
Paid-in capital in excess of par value	-0-	-0-
Total paid-in capital	500,000	500,000
Retained earnings	300,000	300,000
Total stockholders' equity	\$ 800,000	\$ 800,000
Outstanding shares	50,000	100,000

SYSCO Corporation is well known for splitting its stocks. In the past twenty-five years, it has had eight splits. The earlier splits were three-for-two and the latter were two-for-one. If you owned two shares of SYSCO in 1979, you will have 288 shares today! A stock split does not affect the balances in any stockholders' equity accounts. Therefore, **it is not necessary to journalize a stock split.** However, a memorandum entry explaining the effect of the split is typically made.

The significant differences between stock splits and stock dividends are shown in Illustration 14-24.

Illustration 14-24

Differences between the effects of stock splits and stock dividends

<u>Item</u>	<u>Stock Split</u>	<u>Stock Dividend</u>
Total paid-in capital	No change	Increase
Total retained earnings	No change	Decrease
Total par value (common stock)	No change	Increase
Par value per share	Decrease	No change

ACCOUNTING IN ACTION *Business Insight*



A handful of U.S. companies have no intention of keeping their stock trading in a range accessible to mere mortals. These companies never split their stock, no matter how high their stock price gets. The king is investment company **Berkshire Hathaway's** Class A stock, which sells for a pricey \$110,100—per share! The company's Class B stock is a relative bargain at roughly \$3,663 per share. Another “premium” stocks is **Mechanics Bank** of Richmond, California, at \$19,500.

BEFORE YOU GO ON...

▶ REVIEW IT

1. What entries are made for cash dividends on (a) the declaration date, (b) the record date, and (c) the payment date?

- Distinguish between a small and a large stock dividend, and indicate the basis for valuing each kind of dividend.
- Contrast the effects of a small stock dividend and a two-for-one stock split on (a) stockholders' equity and (b) outstanding shares.

► **DO IT**

Sing Resort Company has had five years of record earnings. Owing to this success, the market price of its 500,000 shares of \$2 par value common stock has tripled from \$15 per share to \$45. During this period, paid-in capital remained the same at \$2 million. Retained earnings increased from \$1.5 million to \$10 million. President Jan Ellis is considering either (1) a 10 percent stock dividend or (2) a two-for-one stock split. She asks you to show the before-and-after effects of each option on (a) retained earnings and (b) total stockholders' equity and the total shares outstanding.

ACTION PLAN

- Calculate the stock dividend's effect on retained earnings by multiplying the number of new shares times the market price of the stock (or par value for a large stock dividend).
- Recall that a stock dividend increases the number of shares without affecting total equity.
- Recall that a stock split only increases the number of shares outstanding and decreases the par value per share.

SOLUTION

- (a) (1) The stock dividend amount is \$2,250,000 $[(500,000 \times 10\%) \times \$45]$. The new balance in retained earnings is \$7,750,000 $(\$10,000,000 - \$2,250,000)$.
- (2) The retained earnings balance after the stock split would be the same as it was before the split: \$10 million.
- (b) The effects on total stockholders' equity and total shares outstanding are

	<u>Original Balances</u>	<u>After Dividend</u>	<u>After Split</u>
Paid-in capital	\$ 2,000,000	\$ 4,250,000	\$ 2,000,000
Retained earnings	<u>10,000,000</u>	<u>7,750,000</u>	<u>10,000,000</u>
Total stockholders' equity	<u>\$12,000,000</u>	<u>\$12,000,000</u>	<u>\$12,000,000</u>
Shares outstanding	<u>500,000</u>	<u>550,000</u>	<u>1,000,000</u>



RETAINED EARNINGS

Retained earnings is net income that is retained in the business. The balance in retained earnings is part of the stockholders' claim on the total assets of the corporation. It does not, though, represent a claim on any specific asset; nor can the amount of retained earnings be associated with the balance of any asset account. For example, a \$100,000 balance in retained earnings does not mean that there should be \$100,000 in cash. The reason is that the cash resulting from the excess of revenues over expenses may have been used to purchase buildings, equipment, and other assets. To illustrate that retained earnings and cash may be quite different, Illustration 14-25 shows recent amounts of retained earnings and cash in selected companies.

STUDY OBJECTIVE 10

Identify the items that are reported in a retained earnings statement.

Illustration 14-25

Retained earnings and cash balances

Company	(in millions)	
	Retained Earnings	Cash
Walt Disney Co.	\$17,990	\$1,819
Landry's	198	43
McDonald's	23,516	4,260
Hilton	1,125	1,336

HELPFUL HINT

Remember that Retained Earnings is a stockholders' equity account, whose normal balance is a credit.

Remember that when a company has net profit, the net income that is retained in the business is recorded in retained earnings by means of a closing entry. This entry debits Income Summary and credits Retained Earnings.

However, when expenses exceed revenues, a **net loss** results. A net loss is debited to Retained Earnings in a closing entry. This is done even if it results in a debit balance in Retained Earnings. **Net losses are not debited to paid-in capital accounts.** To do so would destroy the distinction between paid-in and earned capital. A debit balance in Retained Earnings is identified as a **deficit**. It is reported as a deduction in the stockholders' equity section, as shown in Illustration 14-26.

Illustration 14-26

Stockholders' equity with deficit

Balance Sheet (partial)	
Stockholders' equity	
Paid-in capital	
Common stock	\$800,000
Retained earnings (deficit)	(50,000)
Total stockholders' equity	<u>\$750,000</u>

RETAINED EARNINGS RESTRICTIONS

The balance in retained earnings is generally available for dividend declarations. Some companies state this fact.

In some cases, there may be **retained earnings restrictions**. These make a portion of the retained earnings balance currently unavailable for dividends. Restrictions result from one or more of the following causes: legal, contractual, or voluntary.

- 1. Legal restrictions.** Many states require a corporation to restrict retained earnings for the cost of treasury stock purchased. The restriction keeps intact the corporation's legal capital that is being temporarily held as treasury stock. When the treasury stock is sold, the restriction is lifted.
- 2. Contractual restrictions.** Long-term debt contracts may restrict retained earnings as a condition for the loan. The restriction limits the use of corporate assets for payment of dividends. Thus, it increases the likelihood that the corporation will be able to meet required loan payments.
- 3. Voluntary restrictions.** The board of directors may voluntarily create retained earnings restrictions for specific purposes. For example, the board may authorize a restriction for future plant expansion. By reducing the amount of retained earnings available for dividends, more cash may be available for the planned expansion.

Retained earnings restrictions are generally disclosed in the notes to the financial statements.

PRIOR PERIOD ADJUSTMENTS

Suppose that a corporation's books have been closed and the financial statements have been issued. The corporation then discovers that a material error has been made in reporting net income of a prior year. How should this situation be recorded in the accounts and reported in the financial statements?

The correction of an error in previously issued financial statements is known as a **prior period adjustment**. The correction is made directly to Retained Earnings because the effect of the error is now in this account: The net income for the prior period has been recorded in retained earnings through the journalizing and posting of closing entries.

To illustrate, assume that General Microtels discovers in 2008 that it understated depreciation expense in 2005 by \$300,000 due to computational errors. These errors overstated both net income for 2005 and the current balance in retained earnings. The entry for the prior period adjustment, assuming all tax effects are ignored, is as follows:

Retained Earnings Accumulated Depreciation (To adjust for understatement of depreciation in a prior period)	300,000	300,000	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="text-align: center;">A</td> <td style="text-align: center;">=</td> <td style="text-align: center;">L</td> <td style="text-align: center;">+</td> <td style="text-align: center;">SE</td> </tr> <tr> <td style="text-align: center;">-300,000</td> <td></td> <td></td> <td></td> <td style="text-align: center;">-300,000</td> </tr> </table>	A	=	L	+	SE	-300,000				-300,000
A	=	L	+	SE									
-300,000				-300,000									

A debit to an income statement account in 2008 would be incorrect because the error pertains to a prior year.

Prior period adjustments are reported in the retained earnings statement.⁵ They are added (or deducted, as the case may be) from the beginning retained earnings balance. This results in an adjusted beginning balance. Assuming General Microtels has a beginning balance of \$800,000 in retained earnings, the prior period adjustment is reported in Illustration 14-27.

GENERAL MICROTELS	
Retained Earnings Statement (partial)	
Balance, January 1, as reported	\$800,000
Correction for overstatement of net income in prior period (depreciation error)	<u>(300,000)</u>
Balance, January 1, as adjusted	\$500,000

Illustration 14-27

Statement presentation of prior period adjustments

Again, reporting the correction in the current year's income statement would be incorrect because it applies to a prior year's income statement.

RETAINED EARNINGS STATEMENT

The **retained earnings statement** shows the changes in retained earnings during the year. The statement is prepared from the Retained Earnings account. Transactions and events that affect retained earnings are tabulated in account form as shown in Illustration 14-28 on page 448.

⁵A complete retained earnings statement is shown in Illustration 14-29 (p. 448).

Illustration 14-28

Debits and credits to retained earnings

Retained Earnings	
<ol style="list-style-type: none"> 1. Net loss 2. Prior period adjustments for overstatement of net income 3. Cash dividends and stock dividends 4. Some disposals of treasury stock 	<ol style="list-style-type: none"> 1. Net income 2. Prior period adjustments for understatement of net income

As indicated, net income increases retained earnings, and a net loss decreases retained earnings. Prior period adjustments may either increase or decrease retained earnings. Both cash dividends and stock dividends decrease retained earnings. The circumstances under which treasury stock transactions decrease retained earnings were explained earlier, on pages 433-435.

Illustration 14-29 shows a complete retained earnings statement for Graber Hotels, Inc., based on assumed data.

Illustration 14-29

Retained earnings statement

GRABER HOTELS, INC. Retained Earnings Statement For the Year Ended December 31, 2008		
Balance, January 1, as reported		\$1,050,000
Correction for understatement of net income in prior period (inventory error)		<u>50,000</u>
Balance, January 1, as adjusted		1,100,000
Add: Net income		<u>360,000</u>
		1,460,000
Less: Cash dividends	\$100,000	
Stock dividends	<u>200,000</u>	<u>300,000</u>
Balance, December 31		<u><u>\$1,160,000</u></u>

BEFORE YOU GO ON...

▶ **REVIEW IT**

1. How are retained earnings restrictions generally reported?
2. What is a prior period adjustment, and how is it reported?
3. What are the principal sources of debits and credits to Retained Earnings?

▶ **DO IT**

Vega Casino Corporation has retained earnings of \$5,130,000 on January 1, 2008. During the year, Vega earns \$2 million of net income. It declares and pays a \$250,000 cash dividend. In 2008, Vega records an adjustment of \$180,000 owing to the understatement of 2007 depreciation expense from a mathematical error. Prepare a retained earnings statement for 2008.

ACTION PLAN

- Recall that a retained earnings statement begins with retained earnings, as reported at the end of the previous year.
- Add or subtract any prior period adjustments to arrive at the adjusted beginning figure.
- Add net income and subtract dividends declared to arrive at the ending balance in retained earnings.

SOLUTION

VEGA CASINO CORPORATION	
Retained Earnings Statement	
For the Year Ended December 31, 2008	
Balance, January 1, as reported	\$5,130,000
Correction for overstatement of net income in prior period (depreciation error)	(180,000)
Balance, January 1, as adjusted	4,950,000
Add: Net income	2,000,000
	6,950,000
Less: Cash dividends	250,000
Balance, December 31	<u>\$6,700,000</u>



DEMONSTRATION PROBLEM

The Rolman Hotel Corporation is authorized to issue 1 million shares of \$5 par value common stock. In its first year, 2008, the company has the following stock transactions:

- Jan. 10 Issued 400,000 shares of stock at \$8 per share.
- July 1 Issued 100,000 shares of stock for land. The land had an asking price of \$900,000. The stock is currently selling on a national exchange at \$8.25 per share.
- Sept. 1 Purchased 10,000 shares of common stock for the treasury at \$9 per share.
- Dec. 1 Sold 4,000 shares of the treasury stock at \$10 per share.

Instructions

- (a) Journalize the transactions.
- (b) Prepare the stockholders' equity section assuming the company had retained earnings of \$200,000 at December 31, 2008.

SOLUTION TO DEMONSTRATION PROBLEM

(a) Jan. 10	Cash	3,200,000	
	Common Stock		2,000,000
	Paid-in Capital in Excess of Par Value (To record issuance of 400,000 shares of \$5 par value stock)		1,200,000
July 1	Land	825,000	
	Common Stock		500,000
	Paid-in Capital in Excess of Par Value (To record issuance of 100,000 shares of \$5 par value stock for land)		325,000
Sept. 1	Treasury Stock	90,000	
	Cash		90,000
	(To record purchase of 10,000 shares of treasury stock at cost)		

ACTION PLAN

- When common stock has a par value, credit Common Stock for par value.
- Use fair market value in a noncash transaction.
- Debit and credit the Treasury Stock account at cost.
- Record differences between the cost and the selling price of treasury stock in stockholders' equity accounts, not as gains or losses.

Dec. 1	Cash	40,000	
	Treasury Stock		36,000
	Paid-in Capital from Treasury Stock		4,000
	(To record sale of 4,000 shares of treasury stock above cost)		

(b) **ROLMAN HOTEL CORPORATION**
Balance Sheet (partial)
December 31, 2008

Stockholders' equity		
Paid-in capital		
Capital stock		
Common stock, \$5 par value, 1,000,000 shares authorized, 500,000 shares issued, 494,000 shares outstanding		\$2,500,000
Additional paid-in capital		
In excess of par value	\$1,525,000	
From treasury stock	4,000	
Total additional paid-in capital		1,529,000
Total paid-in capital		4,029,000
Retained earnings		200,000
Total paid-in capital and retained earnings		4,229,000
Less: Treasury stock (6,000 shares)		(54,000)
Total stockholders' equity		<u>\$4,175,000</u>



SUMMARY OF STUDY OBJECTIVES

1. Identify the major characteristics of a sole proprietorship. The major characteristics of a sole proprietorship are easy formation, no dilution of profits, limited life, and unlimited liability.

2. Identify the major characteristics of a partnership. The major characteristics of a partnership are association of individuals, mutual agency, limited life, unlimited liability, and co-ownership of property.

3. Explain the accounting entries for the formation of a partnership. Each partner's initial investment in a partnership should be recorded at the fair market value of the assets at the date of their transfer to the partnership. The values assigned must be agreed to by all of the partners. Cash, Equipment, or other asset accounts are debited. The same amount is credited under the partner's name in the capital account.

4. Identify the bases for dividing net income or net loss. Partnership net income or loss is shared equally unless the partnership contract specifically indicates the manner in which net income and net loss are to be divided. The same basis of division usually applies to both net income and net loss.

5. Identify the major characteristics of a corporation. The major characteristics of a corporation are separate legal existence, limited liability of stockholders, transferable ownership rights, ability to acquire capital, continuous life, corporation management, government regulations, and additional taxes.

6. Record the issuance of common stock. When the issuance of common stock for cash is recorded, the par value of the shares is credited to Common Stock; the portion of the proceeds that is above or below par value is recorded in a separate paid-in capital account. When no-par common stock has a stated value, the entries are similar to those for par value stock. When no-par does not have a stated value, the entire proceeds from the issue become legal capital and are credited to Common Stock.

7. Explain the accounting for treasury stock. The cost method is generally used in accounting for treasury stock. Under this approach, Treasury Stock is debited at the price paid to reacquire the shares. The same amount is credited to Treasury Stock when the shares are sold. The difference between the sales price and the cost is recorded in stockholders' equity accounts, not in income statement accounts.

8. Differentiate preferred stock from common stock. Preferred stock has contractual provisions that give it priority over common stock in certain areas. Typically, preferred stockholders have a preference as to (1) dividends and (2) assets in the event of liquidation. They usually do not have voting rights.

9. Prepare the entries for cash dividends and stock dividends. Entries for both cash and stock dividends are required at the

declaration date and at the payment date. At the declaration date, the entries are: Cash dividend—debit Retained Earnings and credit Dividends Payable; small stock dividend—debit Retained Earnings, credit Paid-in Capital in Excess of Par (or Stated) Value, and credit Common Stock Dividends Distributable. At the payment date, the entries for cash and stock dividends, respectively, are: debit Dividends Payable and credit Cash; and debit Common Stock Dividends Distributable and credit Common Stock.

10. Identify the items that are reported in a retained earnings statement. Each of the individual debits and credits to retained earnings should be reported in the retained earnings statement. Additions consist of net income and prior period adjustments to correct understatements of prior years' net income. Deductions consist of net loss, adjustments to correct overstatements of prior years' net income, cash and stock dividends, and some disposals of treasury stock.



GLOSSARY

Articles of co-partnership A document detailing the organization of the partnership and including information such as name and principal location of the firm, the purpose of the business, and the date of inception (p. 415).

Authorized stock The amount of stock that a corporation is authorized to sell as indicated in its charter (p. 426).

Bylaws The internal rules and procedures for conducting the affairs of a corporation (p. 424).

Cash dividend A pro rata distribution of cash to stockholders (p. 438).

Charter A document that creates a corporation (p. 424).

Corporate capital The owners' equity in a corporation. Also called *stockholders' equity* or *shareholders' equity* (p. 424).

Corporation A business organized as a legal entity separate and distinct from its owners under state corporation law (p. 420).

Cumulative dividend A feature of preferred stock entitling the stockholder to receive current and unpaid prior year dividends before common stockholders receive any dividends (p. 437).

Declaration date The date the board of directors formally declares the dividend and announces it to stockholders (p. 439).

Deficit A debit balance in retained earnings (p. 446).

Dividend A distribution by a corporation to its stockholders on a pro rata (equal) basis (p. 438).

General partner This partner's liability is not limited to his or her capital equity in the business. There must always be at least one partner with unlimited liability in a partnership (p. 414).

Income ratio The basis for dividing both net income and net loss in a partnership (p. 416).

Legal capital The amount per share of stock that must be retained in the business for the protection of corporate creditors (p. 428).

Limited partnership This partner's liability is limited to his or her capital equity in the business (p. 414).

Liquidating dividend A dividend declared out of paid-in capital (p. 438).

No-par value stock Capital stock that has not been assigned a value in the corporate charter (p. 428).

Organization costs Costs incurred in the formation of a corporation (p. 424).

Outstanding stock Capital stock that has been issued and is being held by stockholders (p. 434).

Partnership An association of two or more persons to carry on as co-owners of a business for profit (p. 413).

Partners' capital statement The owners' equity statement for a partnership (p. 419).

Par value stock Capital stock that has been assigned a value per share in the corporate charter (p. 428).

Payment date The date dividend checks are mailed to stockholders (p. 440).

Preferred stock Capital stock that has contractual preferences over common stock in certain areas (p. 436).

Prior period adjustment The correction of an error in previously issued financial statements (p. 447).

Privately held corporation A corporation that has only a few stockholders and whose stock is not available for sale to the general public (p. 420).

Publicly held corporation A corporation that may have thousands of stockholders and whose stock is regularly traded on a national securities market (p. 420).

Record date The date when ownership of outstanding shares is determined for dividend purposes (p. 439).

Retained earnings Net income that is retained in the business (p. 445).

Retained earnings restrictions Circumstances that make a portion of retained earnings currently unavailable for dividends (p. 446).

Retained earnings statement A financial statement that shows the changes in retained earnings during the year (p. 447).

Sole proprietorship A business owned by one individual (p. 412).

Stated value The amount per share assigned by the board of directors to no-par stock that becomes legal capital per share (p. 428).

Stock dividend A pro rata distribution of the corporation's own stock to stockholders (p. 441).

Stock split The issuance of additional shares of stock to stockholders accompanied by a reduction in the par or stated value per share (p. 443).

Stockholders' equity account A statement that shows the changes in each stockholders' equity account and in total stockholders' equity during the year (p. 442).

Treasury stock A corporation's own stock that has been issued, fully paid for, and reacquired by the corporation but not retired (p. 432).

EXERCISES

Prepare entries for the formation of a partnership.
(SO 3)

Prepare entries for the formation of a partnership.
(SO 3)

Journalize the division of income of a partnership.
(SO 4)

Journalize the division of income of a partnership.
(SO 4)

Journalize issuance of common stock.
(SO 6)

Prepare entries for issuance of common stock and purchase of treasury stock.
(SO 6, 7, 8)

Journalize cash dividends; indicate statement presentation.
(SO 9)

14-1 Lori and Timothy combined their savings to open the Tres Leche Bakery. Lori invested \$10,000 in cash, whereas Timothy put in \$7,500 in cash and some kitchen equipment with a book value at \$8,000, accumulated depreciation at \$2,000, and a market value at \$5,000. Provide the journal entries to record these investments.

14-2 Chris and Carl have been partners for more than five years in their catering business, where Chris put in 40 percent of the equity and Carl put in the other 60 percent. With the growth of the business, Chris and Carl decide to part ways and each open up a new catering company. If the total amount in the Income Summary is \$80,000, prepare the entries needed for Chris and Carl to close the Income Summary amount and also their capital accounts.

14-3 After Carl starts his own catering company, he realizes that there is a lot of demand for desserts from his clients. Therefore, he negotiates with another friend, Mike, who is a pastry chef at a five-star hotel, to become a partner with him in this new venture. On January 1, 2008, 5-Star Gourmet Desserts started with \$30,000 from Carl and \$40,000 from Mike. The net income of the first year was \$12,000. If the income is divided according to their capital, how should the income be divided?

14-4 Referring back to 14-3, please prepare the partner's capital statement for the year ended December 31, 2008, for 5-Star Gourmet Desserts if Mike withdraws \$1,000 from the partnership.

14-5 During the first year of operations, Benji's Health Club had the following transactions pertaining to its common stock:

- Jan. 8 Issued 50,000 shares for cash at \$10 per share.
- Aug. 1 Issued 25,000 shares for cash at \$12 per share.

Instructions

- (a) Journalize the transactions, assuming that the common stock has a par value of \$1 per share.
- (b) Journalize the transactions, assuming that the common stock is no-par with a stated value of \$0.50 per share.

14-6 Cocoa Beach Hotels and Resorts had the following transactions during the current period:

- Feb. 22 Issued 10,000 shares of \$1 par value common stock to attorneys in payment of a bill for \$30,000 for services rendered in helping the company to incorporate.
- Mar. 23 Issued 80,000 shares of \$1 par value common stock for cash of \$400,000.
- July 15 Issued 2,000 shares of \$100 par value preferred stock for cash at \$125 per share.
- Dec. 1 Purchased 3,000 shares of treasury stock for \$90,000.

Instructions

Please prepare the necessary journal entries for these transactions.

14-7 On June 1, Meyers Hotel Corporation had 80,000 shares of no-par common stock issued and outstanding. The stock has a stated value of \$10 per share. During the year, the following occurred:

- Jul. 1 Issued 10,000 additional shares of common stock.
- Aug. 1 Declared a cash dividend of \$1.50 per share to stockholders of record on August 30.
- Oct. 1 Paid the \$1.50 per share cash dividend.
- Nov. 3 Issued 2,500 additional shares of common stock.
- Dec. 3 Declared a cash dividend on outstanding shares of \$1.60 per share to stockholders of record on December 31.

Instructions

- (a) Prepare the entries, if any, on each of the three dividend dates.
- (b) How are dividends and dividends payable reported in the financial statements prepared at December 31?

14-8 On March 1, 2008, Peluso Hotels had retained earnings of \$690,000. During the year, Peluso had the following selected transactions:

Prepare a retained earnings statement.
(SO 10)

1. Declared cash dividends \$155,000.
2. Corrected understatement of 2007 net income because of inventory valuation error of \$35,000.
3. Earned net income \$411,500.
4. Declared stock dividends \$50,000.

Instructions

Prepare a retained earnings statement for the year.

14-9 A June 1999 issue of *Money* magazine included an article by David Futrelle entitled “Stock Splits: How the Dumb Get Rich.”

Instructions

Read the article and answer the following questions:

- (a) What is a stock split?
- (b) How do anxious traders and investors obtain timely information about stock splits?
- (c) What are the statistics relative to market-price reactions for stocks of companies that have split their stocks?
- (d) Is there a downside to buying the stock of companies that announce stock splits?

EXPLORING THE WEB

14-11 SEC filings of publicly traded companies are available to view online.

Address: <http://biz.yahoo.com/i/>

Steps

1. Pick a company, and type in the company’s name.
2. Choose **Quote**.

Instructions

Answer the following questions.

- (a) What company did you select?
- (b) What is its stock symbol?
- (c) What was the stock’s trading range today?
- (d) What was the stock’s trading range for the year?



Remember to go back to the Navigator box on the chapter-opening page and check off your completed work.