**Chapter 15 and 16: Stockholders' Equity**

I. General

A. Influence of state law – accounting for stockholders' equity depends upon the state of incorporation, and the laws of each state vary.

B. Capital stock system

1. Capital stock represents the ownership interest in the corporation.
2. Common stockholders have the lowest priority claim on a corporation's assets in the event of liquidation – a residual interest. While common stockholders bear the greatest risk of loss, they also receive the greatest benefits in the event the corporation is profitable.
3. Four basic rights:
   -- To share proportionately in management - voting
   -- To share proportionately in profits and losses through dividends
   -- To share in the distribution of corporate assets in the event of liquidation
   -- To purchase shares of the corporation's common stock on a pro rata basis when new issues of the same class of stock are offered for sale – preemptive right.

C. A variety of ownership interests exists

Common stock is not the only ownership interest. Shareholders may contract to give up some of the 4 basic rights discussed above in exchange for other preferential rights – Thus either Preferred stock or different classes of Common stock exist.

D. Limited liability of shareholders

E. Dividends

1. Dividend distributions must comply with state law
2. Distributions must be formally approved by the Board of Directors
3. Dividends must be paid according to the stock contract

II. Accounting Issues Involved in Issuing Stock.

A. If the stock has a par value – then we should keep accounts for:

1. each class of stock issued
2. any PIC-excess of par (premium)
3. The typical entry is:

| | | |
|---|---|---|
| Cash | xxx | |
| Common Stock | | xxx |
| PIC-excess of par | | xxx |

B. If the stock has no stated par value, then no PIC account exists. The entire credit goes to Common Stock.

C. If the stock has a stated value, treat the stated value just like you would treat the par value and change the name of the PIC account to PIC – excess of stated value.

D. If stock is issued on a subscription basis, then:
1. only a partial payment is made by the future shareholders initially
2. the stock issuance is recorded as:

| | | |
|---|---|---|
| Subscriptions Receivable | xxx | |
| Common Stock Subscribed | | xxx |
| PIC – Excess of Par | | xxx |

3. At the date of final payment, Common Stock Subscribed is removed from the books (at par) and the Common Stock is issued (at par).

E. Stock may also be issued in exchange for noncash assets.
General Rule: Record the property at the FMV of the stock issued or the FMV of the noncash consideration received, whichever is more clearly determinable.

F. Several classes of stock may also be issued in one transaction.
In this situation, the problem is how to value each class of security.
-- IF the market value of each security is known, then the lump sum purchase price is allocated based on the relative market values of each class of security.
-- If the FMV of each security is unknown/not determinable, then allocate cost equal to the FMV to any securities for which the value is known and assign the remaining cost to the unknown securities.

G. Other issues
1. Authorized vs. Issued vs. Outstanding
2. Stock issue costs:
-- Can capitalize these as an intangible asset and amortize them.
Or
-- Treat them as a reduction of PIC

III. Treasury Stock
A. Treasury stock is not an asset – and – it is not considered outstanding for purposes of voting, paying dividends, etc. Thus, issued >= outstanding.

B. Cost Method
-- This is the most widely used method
-- When you reacquire T/S, debit T/S for the cost of the reacquisition.
-- When you reissue T/S, the journal entry depends on the relationship between the cost of the T/S (acquisition cost) and the reissue price.
- if the acquisition cost < reissue price, then

| | | |
|---|---|---|
| Cash | xxx | |
| TS (at cost) | | xxx |
| PIC – from TS | | xxx |

- if the acquisition cost > reissue price, then

| | | |
|---|---|---|
| Cash | xxx | |
| PIC from TS | xxx | |
| TS (at cost) | | xxx |

- if PIC from TS doesn't exist , then reduce RE.
- To determine acquisition cost if you've made several purchases of TS, use LIFO, FIFO, or Average cost.

-- When you retire treasury stock:
- Treasury stock is credited by the amount originally debited
- Remove common stock (@ par)
- Remove PIC – Excess of Par (from original issue)

C. Par Value Method

-- When you reacquire treasury stock, you
- Debit treasury stock for the par value of the stock
- Reduce PIC – Excess of Par for the reacquired stocks pro rata share of any original PIC.
- if acquisition cost > original issue price, reduce PIC from TS if it exists and then reduce RE for the difference.
- if acquisition cost < original issue price, credit PIC from TS for the difference.

-- Under this method, we view the purchase of the TS as an "in substance" retirement of the stock.

-- This is the most theoretically correct method of accounting for TS because it maintains the integrity of the various components of capital.

-- To retire treasury stock, credit treasury stock and debit common stock for the par value of the shares being retired.

IV. Dividends

A. Types of Dividends

1. Cash Dividend – distribution of cash to shareholders as of the date of record.
   - Date of Declaration – liability is created
   - Date of Record – no entry required
   - Date of Payment – cash is paid, liability is reduced
2. Property Dividends – instead of paying cash, property is distributed as a dividend.
   - Accounting Question – At what value do we measure the transfer of property? Use the fair market value of the asset transferred.
   - This valuation requires that the company first write the asset being transferred up or down (and recognize the gain or loss) before the dividend is recorded.
3. Scrip Dividend – this is a dividend that will be paid at a future date instead of being paid currently – essentially, a note payable to shareholders.
   - At date of declaration:

| | | |
|---|---|---|
| Retained Earnings | xxx | |
| Note Payable to Shareholders | | xxx |

   - At date of payment

| | | |
|---|---|---|
| Note Payable to Shareholders | xxx | |
| Cash | | xxx |

4. Liquidating Dividends – Typically dividends are based on earned capital. If, however, the dividend is a return of shareholders' contributed capital, it is a liquidating dividend. This involves a decrease of the PIC-Excess of Par account in addition to the reduction

of retained earnings

5. Stock Dividends
   -- No assets are distributed. Instead, each shareholder receives a number of shares proportionate to the shares possessed before the declaration of the stock dividend.
   -- A stock dividend is simply a "capitalization" of retained earnings – amounts are reclassified from retained earnings to contributed capital.
   -- The accounting question is what value to attach to this transaction:
      - Small stock dividend – less than 20-25% of outstanding shares; use the fair market value of stock issued:

      At declaration:

| | | |
|---|---|---|
| Retained Earnings (@FMV) | xxx | |
| CS Distributable | | xxx |
| PIC-Excess of par | | xxx |

      At distribution:

| | | |
|---|---|---|
| CS Distributable | xxx | |
| Common Stock | | xxx |

      - Large stock dividend – greater than 20-25% of outstanding shares; use the par value of stock issued

      At declaration:

| | | |
|---|---|---|
| Retained earnings (@par) | xxx | |
| CS Distributable | | xxx |

      At distribution:

| | | |
|---|---|---|
| CS Distributable | xxx | |
| Common Stock | | xxx |

   -- Understand the differences between stock splits and stock dividends.

6. Dividend Preferences
   -- Cumulative: The Board of Directors is not obligated to pay dividends each year. If a year is skipped, the cumulative feature of preferred stock entitles the preferred shareholder to receive not only the current dividend but also any past dividends not paid (in arrears) before common shareholders receive anything.
   -- Participation Feature: Typically, preferred shareholders receive a stated dividend percentage and no more. If the preferred stock is participating, the preferred shareholders will still receive their stated percentage but they will also share proportionately in dividends to common shareholders after common shareholders have received a certain amount (as discussed in class: common shareholders will receive the same % of their par value as the preferred shareholders before the participation feature kicks in).
   -- Convertible and Callable – Understand the differences
   -- Be able to calculate how much of a dividend each class of shareholder will receive.