STOCKHOLDERS’ EQUITY

Think about it
Who owns a company?
The Stockholders
Who controls a company?
The Stockholders
Who runs the company?
Executive Management (called “C” level, as in C’EO, C’FO, C’OO- think of “C” as Chief)
So if the shareholders control the company, but management runs things, how do the shareholders maintain control?
The Corporate bylaws grant this power to the Board of Directors (BOD). The shareholders vote for the BOD to represent them. The BOD is management’s boss, they are responsible for insuring that the Shareholders’ objectives are carried out by management.
BOD are under increasing pressure in the “post-Enron” era.

Stockholders’ interest in a firm is a ...
Residual Interest
Derived from the basic accounting equation ...
Assets - Liabilities = Stockholders’ Equity

Stockholders’ Equity Components
Three Buckets:
1. Contributed Capital
   ■ Common Stock
   ■ Preferred Stock
2. Earned Capital
   ■ Retained Earnings
   ■ Accumulated Other Comprehensive Income
3. Treasury Stock
   ■ Company cannot own itself, so when it buys its own shares, they are treated as a contra-equity amount

Stock is assigned a “par” value. The value it sells for is usually different than its “par” value. The difference between the amount paid and “par” is called APIC.
- If no-par, think of par as whatever it sells for, therefore no APIC on no-par stock
- If sells for < par, then it is a “contingent liability of the purchaser, it is a debit APIC to the Company.
Retained Earnings

**True or False:**

Extraordinary items do not affect retained earnings, as they are taken directly to the income statement.

False - Net income impacts retained earnings

Very few companies pay dividends in amounts equal to their retained earnings legally available for dividends.

True

Corporate Form of Entity

- Articles of Incorporation
- Laws of state of incorporation govern the owners’ equity transactions
- For each class of stock, each share is exactly equal to every other share
- Ownership percentage is determined by number of share owned
Corporate Form of Entity

In the absence of restrictive provisions, each share carries right to participate equally in:
- profits,
- management,
- corporate assets upon liquidation, and
- any new issues of stock of the same class (preemptive right).

Limited Liability

Stockholders cannot lose more than their investment.
If stock is purchased below par ...
  a contingent liability exists for the stockholder (to the creditors).

Variety of Ownership Interest

Common stock --
- Residual interest that bears the ultimate risks and receives the benefits
Preferred stock --
- Obtains certain preferences to earnings, but may sacrifice a voice in management or
  the right to share in profits above a stated rate.
Other classes of common stock may differ in voting rights.

Preferred Stock

Dividends expressed as a percentage of par value.
Cumulative preferred?
Participating preferred?
Preference as to assets in liquidation
Convertible into common stock
Callable by corporation
Nonvoting
Difference Between “Common” and “Preferred” Stock- For the lay-person

Just as the name implies, Preferred Stock is simply stock which has certain preferences, such as:

- Preferred returns (dividends) before common stockholders;
- Conversion features:
  - Conversion to debt;
  - Conversion to common stock
- Non-voting

Preferred stock smells a lot more like debt

Example: Issued 100 shares for $30 per share

<table>
<thead>
<tr>
<th>Stock has a par value of $10 per share --</th>
<th>Stock has no-par value --</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash 3,000</td>
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</tr>
<tr>
<td>Common stock (100 x $10) 1,000</td>
<td>Common stock 3,000</td>
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<tr>
<td>API 200</td>
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</tbody>
</table>

Example: Issued 100 shares for $9 per share

<table>
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<th>Stock has a par value of $10 per share --</th>
<th>Stock has no-par value --</th>
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<td>Cash 900</td>
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<td>Common stock 900</td>
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No-Par Stock

- Avoids a contingent liability
- In some cases no-par stock is given a stated or minimum value
Reacquisition of Shares

Corporations may buy their own stock to -
- Stock trading for less than perceived value
- meet employee stock compensation contracts,
- increase earnings per share,
- meet the stock needs of a merger,
- thwart take-over attempts,
- make a market in the stock,
- reduce the size of the company,
- Capital gains is better to the stockholder than ordinary income of a dividend.

Treasury Stock

Corporation cannot own a part of itself- IT IS NOT AN ASSET!
It is a contra-equity account Two methods of accounting --
- Cost Method (Most Common)
- Par Value Method

COST METHOD-PURCHASES

Purchase Shares by Company (Treasury Stock)
- Simply debit the contra-equity account entitled “Treasury Stock” for the amount paid and credit cash in a like amount.
- The “outstanding shares” decreases by the amount repurchased and the “treasury shares” goes up by that amount
- We cover presentation of shares in a few slides.

Example: $10-Par common stock, issued originally at $25 per share on April 1 --

<table>
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<tr>
<th>Re-acquired 1,000 shares at $22 per share --</th>
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<td>Treasury stock</td>
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<td>Cash</td>
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<th>Re-acquired 1,000 shares at $28 per share --</th>
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<tr>
<td>Treasury stock</td>
<td>28,000</td>
</tr>
<tr>
<td>Cash</td>
<td>28,000</td>
</tr>
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COST METHOD: SALES

Sale above cost:
- Debit cash for amount received
- Credit "Treasury Stock" for your cost basis
- Credit "Paid in Capital from Treasury stock" for the cash received in excess of your cost - PRESENTED AS PART OF PAID IN CAPITAL IN STOCKHOLDER'S EQUITY SECTION

Sale below cost:
- Same as above, but debit "Paid in Capital from Treasury Stock"
- If you deplete the entire amount of "Paid in Capital Treasury Stock", the excess is debited to retained earnings.
- Many states require restricting retained earnings preventing this to some extent.

Example: Sold 500 shares of its Treasury stock for $30 per share on June 1 --

Shares that it had acquired at $22 per share --
- Cash 15,000
- Treasury stock 11,000
- Paid in capital, treasury stock 4,000

Shares that it had acquired at $28 per share --
- Cash 15,000
- Treasury stock 14,000
- Paid in capital, treasury stock 1,000

Example: Sold 300 shares of its Treasury stock for $9 per share on Oct. 15 --

Shares that it had acquired at $22 per share --
- Cash 2,700
- Treasury stock 6,600
- Paid in capital, treasury stock 3,900

Shares that it had acquired at $28 per share --
- Cash 2,700
- Treasury stock 8,400
- Paid in capital, treasury stock 1,000
- Retained earnings 4,700

[We can only debit this for as much as is in the account. Per previous slide]

[We only have $1,000 to work with. The rest is Dr. to retained earnings]

Example: Sold 100 shares of its Treasury stock for $11 per share on Oct. 30 --

Shares that it had acquired at $22 per share --
- Cash 1,100
- Treasury stock 2,200
- Paid in capital, treasury stock 100
- Retained earnings 1,000

Shares that it had acquired at $28 per share --
- Cash 1,100
- Treasury stock 2,800
- Retained earnings 1,700
RETIREMENT - MECHANICS

1. Get rid of the common-stock and the related APIC
2. Get rid of the associate Treasury Stock and associated Paid in Capital from Treasury Stock
3. Depends on net leftover
   - Any credit remaining gets applied to new equity account: Paid in Capital - retirement
   - Any debit remaining gets applied to Retained Earnings

Example: Retired the remaining 100 shares of Treasury stock on Nov. 10 (initially sold for $25/ share) --

Shares that it had acquired at $22 per share --
- Common stock 1,000
- Additional paid in capital 1,500
- Treasury stock 2,200
- Paid in capital, retirement 300

Shares that it had acquired at $28 per share --
- Common stock 1,000
- Additional paid in capital 1,500
- Treasury stock 2,800
- Retained earnings 300

A Company authorized the sale of 1,000,000 shares of $1 par stock and sold all of them for $50/ share. To date they have had $750,000 of retained earnings:

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<td>Common stock, $1 par, 1,000,000 shares auth. issued and outstanding</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>APIC</td>
<td>$49,000,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>$750,000</td>
</tr>
<tr>
<td>Total Stockholders' equity</td>
<td>$50,750,000</td>
</tr>
</tbody>
</table>

THEN they reacquire 100,000 shares for $55/ share:
- Common stock $5,500,000
- Cash $5,500,000

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<tr>
<td>Common stock, $1 par, 1,000,000 shares authorized issued and 900,000 outstanding</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>APIC</td>
<td>$49,000,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>$750,000</td>
</tr>
<tr>
<td>Total paid in capital and retained earnings</td>
<td>$50,750,000</td>
</tr>
<tr>
<td>Less: Cost of Treasury Stock (100,000 shares)</td>
<td>$5,500,000</td>
</tr>
<tr>
<td>Total Stockholders' equity</td>
<td>$45,250,000</td>
</tr>
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PRESENTATION ON THE BALANCE SHEET

REMEMBER TO TRACK WHAT IS GOING ON WITH THE SHARES, AS WELL AS THE ACCOUNT BALANCES.
- When a Company issues stock, it remains “issued” until it is retired.
- So if a Company reacquires its stock, then there is a reduction to the number of shares "outstanding"- EXAMPLE on next slide
Real Quick - Par Value Method

Remember it is VERY uncommon, BUT it is very simple:
The cash received is debited and treasury stock is credited. All treasury stock is treated as a reduction to common stock and at par value.

Sales on a Subscription Basis

A partial payment is received originally and the stock is not issued until the full subscription price is received.
Common and Preferred Stock Subscribed is reported as an equity account below Common or Preferred Subscriptions Receivable -- is reported as a contra equity account.

Stock Issued in Non-Cash Transactions

If a Company exchanges stock for services or goods, the transaction is generally recorded at the fair value of the stock, or the service/goods, whichever is more readily determinable.

FOR EXAMPLE:
Public, Inc. purchases a truck by issuing 100 shares of its stock. The stock readily trades on the NYSE for $300/ share and has a $10 par value. The entry to record is:

| Equipment | $30,000 |
| Common Stock | $ 1,000 |
| APIC | $29,000 |

Cost of Issuing Stock

Costs for underwriting, legal, accounting, commissions, etc. are treated as a reduction to the amount received. Think about it, even if you got $1 million, but had to pay $100,000 to get it, then you really only received $900,000.

FOR EXAMPLE:
Go Public, Inc. made an initial public offering (IPO) of 1 million $1 par stock. The stock sold to the public for $100 per share and the Company spent $2,000,000 in fees to “go public”. The summarized entry would be:

| Cash | $100,000,000 |
| Common Stock | $ 1,000,000 |
| Cash (to go public) | $ 2,000,000 |
| APIC | $97,000,000 |
Not in THIS CHAPTER
Previous slide is accurate, but a big recent GAAP change is appropriate here: Costs of business combinations used to be capitalized but now are expensed as incurred...

- This could make public offerings more attractive than growth through acquisition.

DIVIDENDS
Dividends represent a Company distributing cash available to its owners.
- They are “Payable” when declared (authorized by BOD)
- They are a reduction to retained earnings (easy to remember- once “distributed” it is no longer “retained”)

Dividends
Few companies pay dividends in amounts equal to their legally available retained earnings. Why?
- Agreements with creditors
- State corporation laws
- To finance growth
- To provide for continuous dividends
- To build a cushion

Require information concerning three dates:
- a. Date of declaration
- b. Date of record
- c. Date of payment

Cash Dividends
What would be the journal entries made by a corporation that declared a $50,000 cash dividend on March 10, payable on April 6 to shareholders of record on March 5?

March 10 (Declaration Date) Debit Credit
Retained earnings 50,000
Dividends payable 50,000

March 5 (Date of Record)
No Entry

April 6 (Payment Date)
Dividends payable 50,000
Cash 50,000
Property Dividends- How They Work

Record at the FMV of the property granted, and record any gain or loss on the transaction- on the date of declaration. The rest is like other dividends.

Property Dividends Example

A dividend is declared Jan. 5th and paid Jan. 25th, in bonds held as an investment; the bonds have a book value of $100,000 and a fair market value of $135,000.

What is the journal entry on the date of declaration?

Investment (Bonds) 35,000
Gain on Investments 35,000
Retained earnings 135,000
Property dividend payable 135,000

What is the journal entry on the date of issuance?

Property dividend payable 135,000
Investment (Bonds) 135,000

Stock Dividend & Stock Split

Stock Dividend: Record at the fair value (as of the date of declaration) of the stock on the date of the transaction with credit to common stock at par and APIC for the value in excess of par.

Stock Split: No entry, but disclosure and adjustment to the number of shares outstanding and the par value per share.

Stock Dividend Example

Company has 1,000 shares of $1 par stock. On June 30, 2004, when the market value is $10/ share the BOD declares a 10% stock dividend to shareholders of record as of January 1, 2004 (fair value was $9/ share on that date). Paid October 1, 2004.

On Date of declaration (June 30, 2004) Entry:
Retained earnings (Stock div. Declared) 1,000
Common stock dividend distributable (EQUITY ACCT) 100
APIC 900

On Date of Payment (October 1, 2004) Entry:
Common stock dividend distributable (EQUITY ACCT) 100
Common Stock 100

(NOTE: It just flips from one equity account to the other)
Stock Split

Company has 1,000 shares of $1 par stock issued and outstanding, APIC of $10,000 and retained earnings of $500,000 on June 30, 2004 when the BOD declares a 2 for 1 stock-split.

What is the journal entry? NONE

BEFORE THE SPLIT:
- Common stock, $1 par, 1,000 shares: $1,000
- APIC: 10,000
- Retained Earnings: 500,000
- TOTAL STOCKHOLDERS’ EQUITY: $511,000

AFTER THE SPLIT:
- Common stock, $.50 par, 2,000 shares: $1,000
- APIC: 10,000
- Retained Earnings: 500,000
- TOTAL STOCKHOLDERS’ EQUITY: $511,000

FASB UPDATE

“Mezzanine financing”, which includes preferred stock which has debt-like features, is to be classified as debt.