

## Chapter 23: Corporate Stock and Earnings Issues

### Corporate Capital Structure

- A sole proprietorship has a single owner
- A partnership has only a few owners
  - In both types, each owner has a separate Owner's Capital account for reporting the owner's equity on the company's balance sheet.
  - The ending balance of each Owner's Capital account includes the investments by the owner plus the owner's share of the company's net income earned to date less the owner's withdrawals.
- State laws require special accounting procedures for the owner's equity of a corporation; these laws were established to protect the absentee owners of a corporation as well as its creditors.
- **Stockholders' equity** is the term used for the owners' equity of a corporation.
  - Includes at least two parts:
    - Contributed capital
    - Retained earnings
      - Each is governed by the laws of the state in which the company is incorporated
- Basic format of the stockholders' equity section of the corporation's balance sheet as follows:

#### *Stockholders' Equity*

##### Contributed capital

Capital stock, \$5 par, 20,000 shares authorized, 10,000 shares issued and outstanding.....	\$ 50,000
Additional paid-in capital.....	70,000
Total contributed capital.....	\$120,000

Retained earnings.....	90,000
Total Stockholders' Equity.....	<u>\$210,000</u>

- A corporation includes the total amount of investments made by its stockholders in **Contributed Capital**.
- A corporation reports the balance in its **Retained Earnings** account as the second part of its stockholders' equity. The amount the corporation reports in this account is the total lifetime corporate income that it has reinvested and that it has *not* distributed to stockholders as dividends.
- Capital Stock and Legal Capital
  - **Capital stock** is the ownership unit in a corporation.
  - **Stockholders** (or **shareholders**) are the owners of a corporation, and their evidence to corporate ownership is a stock certificate.
  - A **stock certificate** is a serially numbered legal document that indicates the number of shares of capital stock owned by a stockholder.
    - May also include information such as the legal capital and the method of transferring the capital stock to another owner.
- Stockholders' Rights
  - Shares of stock are transferrable between individuals.
  - Each stockholder has the following rights:
    - 1. The right to attend stockholders' meetings and to vote in setting and approving major policies and actions of the corporation. Included are policies and actions concerning such items as mergers with other companies, acquisitions of other companies, sales of major portions of the corporation, and the issuance of additional stock and bonds.
    - 2. The right to vote in the election of the board of directors. A **board of directors** is a group of individuals that has the responsibility and authority to supervise the corporation's ordinary business activities, make future plans, and take whatever action is

necessary in managing the corporation. Voting to elect the board of directors (and the *chair of the board*) also takes place at the stockholders' meetings.

- 3. The right to share in net income by receiving dividends from the corporation. The board of directors decides on the payment of dividends, however.
  - 4. The right to purchase additional capital stock if issued—a right known as the *preemptive right*. The **preemptive right** is the right to maintain a proportionate (pro rata) share of additional capital stock if it is issued. The right often is very significant for small, privately held corporations for which control is very important, but it less important for corporations with large numbers of shareholders who each own a relatively small number of shares. Stockholders may give up their preemptive right, for example, to allow the corporation to acquire another company by issuing a large number of additional shares of stock to obtain sufficient capital to do so.
  - 5. The right to share in the distribution of the assets of the corporation if it is liquidated (terminated). If a company is terminated, creditors have first priority in the collection of their claims; stockholders receive any remaining assets.
- Legal Capital
    - A company may issue capital stock in several ways:
      - Cash
      - Noncash exchanges
      - To employees through stock options
      - Other transactions
    - Because stockholders have a *limited liability* to protect creditors, state laws usually set a legal capital for all corporations.
    - **Legal capital** is the amount of stockholders' equity of a corporation that is cannot distribute to stockholders (unless the company is liquidated).
    - A corporation may not pay dividends or reacquire capital stock if these activities will reduce the legal capital.
  - Par Value Stock
    - A common way a corporation establishes its legal capital is by assigning a par value to each share of common stock.
    - The **par value** of capital stock is a monetary amount that the corporation designates as the legal capital per share in its articles of incorporation.
    - The par value is printed on each stock certificate.
    - The total legal capital of a corporation is determined by multiplying the par value per share by the number of shares issued.
    - For each issuance of capital stock, a corporation records the total dollar amount of the par value in a capital stock account.
    - Par value of a share of capital stock is usually very low.
    - Since a corporation usually issues capital stock at a price much higher than the par value, the legal capital is usually only a small part of the total amount received.
    - The total amount the corporation receives is the *market value*, the price at which the stock is issued.
    - The par value of capital stock has no direct relationship to its market value at any time.
  - No-Par Stock
    - **No-par capital stock** does not have a par value.
      - Some states require that the entire amount received by the corporation when it issues no-par stock be designated as legal capital, and the corporation records this amount in the capital stock account.
      - Many states, however, allow the corporation's board of directors to set a state value per share of no-par stock.

- The **stated value** of no-par stock is the legal capital per share of stock.
- The stated value per share, when multiplied by the number of shares issued, is the total amount of legal capital, and is the amount the corporation records in its capital stock account.
- **Additional Paid-In Capital**
  - A corporation records the excess value received from the issuance of stock, known as *additional paid-in capital*.
  - **Additional paid-in capital** is the difference between the market value (selling price) and the par (or stated) value in each stock transaction, and the corporation records it in its Additional Paid-In Capital account.
  - Additional paid-in capital sometimes arises from transactions not involving the original issuance of capital stock.
  - The concept of legal capital has a significant on corporate reporting, particularly as it applies to stockholders' equity.
  - A corporation uses a capital stock account to report its legal capital, and an additional paid in capital account to report the remainder of the total amount of capital contributed by stockholders.
  - Most external users are interested in the total contributed capital.
- **Classes of Capital Stock**
  - Two (or more) classes of capital stock
    - Common stock
    - Preferred stock
  - If a corporation issues only one class of capital stock, it is common stock.
  - **Common stock** is capital stock that shares in all the stockholders' rights.
    - Class A and Class B common stock
      - Usually one has much greater voting rights than the other in order to preserve control by the original shareholders.
  - A corporation may also issue **preferred stock**, which is capital stock for which stockholders receive certain additional rights in exchange for giving up some of the usual stockholders' rights.
    - Additional rights may involve the right to receive dividend before any dividend is paid to common stockholders, the right to convert the preferred stock to common stock at a later date.
    - Preferred stockholders may give up the right to vote in exchange for these rights.
    - May be callable or redeemable
    - Issues at par value often
  - When a company issues both common and preferred stock, it uses a Common Stock account and a Preferred Stock account to report the legal capital of each kind of stock.
  - Also uses an Additional Paid-In Capital on Common Stock account and an Additional Paid-In Capital on Preferred Stock account to report the differences between the market values (selling prices) it receives and the par (or stated) values of each kind of stock.
  - When a company issues both classes of stock, it expands the contributed capital component of its stockholders' equity to include the additional items (using assumed numbers of shares and dollar amounts) as follows:

*Stockholders' Equity*

Contributed capital

Preferred stock, \$100 par, 2,000 shares authorized, 600 shares issued and outstanding.....	\$60,000
Additional paid-in capital on preferred stock.....	72,000
Common stock, \$10 par, 30,000 authorized, 9,000 shares issued and outstanding.....	90,000
Additional paid-in capital on common stock.....	43,000
Total contributed capital.....	\$265,000