

CHAPTER 11

Reporting and Analyzing Stockholders' Equity

ANSWERS TO QUESTIONS

1.
 - (a) Separate legal existence. A corporation is separate and distinct from its owners and it acts in its own name rather than in the name of its stockholders. In contrast to a partnership, the acts of the owners (stockholders) do not bind the corporation unless the owners are agents of the corporation.
 - (b) Limited liability of stockholders. Because of its separate legal existence, creditors of a corporation ordinarily have recourse only to corporate assets to satisfy their claims. Thus, the liability of stockholders is normally limited to their investment in the corporation.
 - (c) Transferable ownership rights. Ownership of a corporation is shown in shares of capital stock. The shares are transferable units. Stockholders may dispose of part or all of their interest by simply selling their stock. The transfer of ownership to another party is entirely at the discretion of the stockholder.
2.
 - (a) Corporate management is an advantage to a corporation because it can hire professional managers to run the company. Corporate management is a disadvantage to a corporation because it prevents owners from having an active role in directly managing the company.
 - (b) Two other disadvantages of a corporation are government regulations and additional taxes. A corporation is subject to numerous state and federal regulations. For example, state laws prescribe the requirements for issuing stock, and federal securities laws govern the sale of stock to the general public. Corporations must pay both federal and state income taxes. These taxes are substantial. In addition, stockholders must pay income taxes on cash dividends received.
3. Janie is incorrect. A corporation must be 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. A corporation may incorporate in a state in which it does not have a headquarters' office or major operating facilities.
4. In the absence of restrictive provisions, the basic ownership rights of common stockholders are the rights to:
 - (1) vote in the election of the board of directors and in corporate actions that require stockholders' approval.
 - (2) share in corporate earnings.
 - (3) maintain the same percentage ownership when additional shares of common stock are issued (the preemptive right).
 - (4) share in assets upon liquidation.
5. Legally, a corporation is an entity, separate and distinct from its owners. As a legal entity, a corporation possesses most of the privileges and is subject to the same duties and responsibilities as a natural person. The corporation acts under its own name rather than under the names of its

stockholders. A corporation may buy, own, and sell property, borrow money, enter into legally binding contracts, and sue or be sued.

6. The principal components of stockholders' equity for a corporation are paid-in capital and retained earnings.

Questions Chapter 11 (Continued)

7. The maximum number of shares that a corporation is legally allowed to issue is the number authorized. Gagne Corporation is authorized to sell 100,000 shares. Of these shares, 70,000 shares have been issued. Outstanding shares are those issued shares which have not been reacquired by the corporation; in other words, issued shares less treasury shares. Gagne has 66,000 shares outstanding (70,000 issued less 4,000 treasury).
8. The relative par values should have no effect on the investment decision. The par value of common stock has no effect on its market value. Par value used to be a legal amount per share which usually indicated the minimum amount at which a share of stock can be issued. Therefore, either stock mentioned in the question could be the better investment.
9. A corporation may acquire treasury stock (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, or (5) to avoid a takeover of the company by investors that are hostile to management.
10. When treasury stock is purchased, Treasury Stock is debited and Cash is credited at cost (\$11,000 in this example). Treasury stock is a contra stockholders' equity account and cash is an asset. Thus, this transaction has (a) no effect on net income, (b) decreases total assets, (c) has no effect on total paid-in capital, and (d) decreases total stockholders' equity.
11. (a) Common stock and preferred stock both represent ownership of the corporation. Common stock signifies the basic residual ownership; preferred stock is ownership with certain privileges or preferences. Preferred stockholders typically have a preference as to dividends and as to assets in the event of liquidation. However, preferred stockholders generally do not have voting rights.
- (b) Some preferred stocks possess the additional feature of being cumulative. Cumulative preferred stock means that preferred stockholders must be paid both current year dividends and unpaid prior year dividends before common stockholders receive any dividends.
- (c) Dividends in arrears are disclosed in the notes to the financial statements.
12. The debits and credits to retained earnings are:

Debits	Credits
1. Net loss	1. Net income
2. Cash and stock dividends	